Tax Notes

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DEPARTMENT OF FINANCE INVITES COMMENTS ON PROPOSED TRUST MEASURES

On June 3, 2013, the Tax Legislation Division of the Department of Finance's Tax Policy Branch announced it was inviting comments regarding proposed income tax measures pertaining and relating to trusts. This solicitation of stakeholder input is pursuant to the government's announced intent in Budget 2013 to consult on possible trust-related tax measures, especially those pertaining to tax-planning opportunities associated with trust-level graduated taxation rates. Reproduced below are the Department of Finance's proposed measures:

GRADUATED RATES

The Government proposes measures to amend the income tax rules to apply flat top-rate taxation to grandfathered *inter vivos* trusts and trusts created by will. In addition, flat top-rate taxation is proposed to apply to estates ("flat top-rate estates") after a reasonable period of administration. Specifically, a deceased individual's estate would be considered a flat top-rate estate starting immediately after the 36-month period that follows the individual's death [upon expiry of that period, the estate would be subject to a deemed taxation year-end]. Estates of deceased individuals would therefore be eligible to retain, as testamentary trusts, access to graduated rates for up to the first 36 months of the estate's administration. These measures would apply to existing and new arrangements for the 2016 and later taxation years.

TRUSTS FOR THE DISABLED AND FOR MINOR CHILDREN

The income tax provisions contain special rules (i.e., the preferred beneficiary election rules and the rules for trusts for minor children) that suspend or lessen the effects of high flat-rate taxation on income accumulating in a trust for certain disabled persons or minor children. These special rules allow (subject to certain anti-avoidance rules) income to be recognized for tax purposes in the beneficiary's hands (i.e., taxed at the beneficiary's marginal rates) even though the income actually accumulates in the trust. The proposed measures on graduated rates would not change the preferred beneficiary election rules or the rules that apply to trusts for minor children.

SPOUSAL TRUSTS AND COMMON-LAW PARTNER TRUSTS

Upon the death of an individual, the individual's capital property is generally subject to a deemed disposition, with the result that accrued gains on capital property are recognized in computing the individual's income in their final tax return. Where the individual's property is on death transferred to the individual's spouse or common-law partner, the deemed disposition on death is suspended, and instead the property is transferred to the spouse or common-law partner on a tax-deferred (i.e., rollover) basis. The rollover is also available to eligible trusts, commonly referred to as spousal trusts and common-law partner trusts. The proposed measures on graduated rates would not change the rollover rules that apply on the death of a spouse or common-law partner.

RELATED INCOME TAX RULES

Consistent with the proposed measures for the elimination of graduated rates for trusts and flat top-rate estates, the Government is also consulting on possible measures to amend a number of related tax rules that are available to testamentary trusts and grandfathered *inter vivos* trusts. The proposed measures, described in greater detail below, would generally limit the application of the related rules to estates other than flat top-rate estates. Affected trusts and estates would, as a result, be subject to the same treatment as ordinary *inter vivos* trusts.

Income tax instalments — The income tax rules contain an instalment system that imposes a requirement on affected taxpayers to pay a portion of their estimated tax liability for a taxation year in instalments over the course of the year. The rules for individuals require, when they apply, that instalment payments be made on a quarterly basis. Testamentary trusts are exempt from the tax instalment rules and therefore are required to pay any tax owing only within 90 days after the end of the taxation year. The proposed measures would extend the instalment rules to trusts created by will and flat top-rate estates.

Alternative minimum tax — Individuals, including trusts, are subject to the alternative minimum tax ("AMT"). In computing AMT, a $40,000 basic exemption is available to testamentary trusts and grandfathered *inter vivos* trusts. The proposed measures would deny the basic exemption to grandfathered *inter vivos* trusts, trusts created by will, and flat top-rate estates.

Taxation year and fiscal period — The taxation year of a trust is generally the calendar year, and, similarly, any fiscal period of a trust is required to end in the calendar year in which it began. Testamentary trusts are exempt from these rules, being allowed off-calendar year taxation years and fiscal periods. The proposed measures would require trusts created by will and flat-top rate estates to use a calendar year taxation year and require that their fiscal periods end in the calendar year in which the periods began.

Part XII.2 tax — Part XII.2 of the Act imposes a trust-level distribution tax on trusts that make payable certain Canadian source income to non-residents and, in certain circumstances involving dealings in beneficial interests in the trust, to certain Canadian tax-exempts. These beneficiaries are referred to in Part XII.2 as "designated beneficiaries". Testamentary trusts are exempt from Part XII.2 and, in certain cases, from treatment as designated beneficiaries. The proposed measures would deny this preferential treatment under Part XII.2 to trusts created by will and flat top-rate estates.

Personal trust status — Personal trusts enjoy certain tax benefits, including the ability to distribute property to beneficiaries on a tax-deferred basis. A trust generally qualifies as a personal trust only if beneficial interests in the trust have not been acquired for consideration payable to the trust or to a contributor of property to the trust. Testamentary trusts automatically qualify as personal trusts, without regard to the circumstances in which beneficial interests in the trust are acquired. The proposed measures would subject trusts created by will and flat top-rate estates to the same conditions that apply to ordinary *inter vivos* trusts in determining eligibility as a personal trust.

Investment tax credits — Taxpayers, including trusts, are permitted to claim investment tax credits (ITCs) in respect of certain expenditures. *Inter vivos* trusts are generally required to recognize ITCs in the trust. Testamentary trusts, on the other hand, can make ITCs available to their beneficiaries for use by the beneficiaries in computing their own income tax liability. The proposed measures would require that the ITCs of trusts created by will and flat top-rate estates be recognized in the trust or estate.

Tax administration rules — A number of tax administration rules apply only to ordinary individuals, and not to trusts. An exception is provided, however, for testamentary trusts, which have access to these special rules. These rules extend the period:

(i) during which the Canada Revenue Agency (CRA) may refund an overpayment of tax,

(ii) for objecting to a tax assessment,

(iii) for filing an agreement to transfer forgiven amounts under the debt forgiveness rules, and

(iv) during which, at the trust's request, the CRA may reassess or make determinations in respect of certain income tax liabilities.

The proposed measures would limit the category of trusts that would qualify for relief under the rules to testamentary trusts that are estates. Specifically, the rules would apply in respect of taxation years for which an estate that is a testamentary trust is not a flat top-rate estate.

The Department of Finance's consultation is open to anyone, and the closing date for submissions is December 2, 2013. Input can be emailed to trusts-fiducies@fin.gc.ca, faxed to (613) 992-2136, or submitted in writing when marked and

addressed to: Trust Graduated Rates, Tax Legislation Division, Tax Policy Branch, Department of Finance, L'Esplanade Laurier, 17th Floor, East Tower, 140 O'Connor Street, Ottawa, Canada, K1A 0G5.

JUST AS INTENDED: *1392644 ONTARIO INC. ET AL. V. THE QUEEN*

— *Timothy Fitzsimmons, Partner with the Toronto office of Dentons Canada LLP*

The role of intent in the determination of whether a worker is an employee or independent contractor has taken on greater significance in the last decade or so. However, despite a series of decisions on the issue from the Tax Court and the Federal Court of Appeal, there appeared to be some inconsistency in how and when intent was to be considered when applying the "four-in-one" test from *Wiebe Door Services Ltd. v. The Queen*[1] and *1671122 Ontario Ltd. v. Sagaz Industries Canada Inc.*[2]

Some court decisions had placed significant emphasis on the parties' intent, whereas other decisions relegated intent to a secondary or tie-breaker role. Obviously, this has led to some confusion as to the contours of the correct analysis regarding the classification of a worker. However, the Federal Court of Appeal's decision in *1392644 Ontario Inc. et al. v. The Queen*[3] has provided some clarity on the role of intent and the manner in which the classification analysis should be undertaken.

In *1392644 Ontario Inc. et al.*, two taxpayers ("Connor Homes" and "Connor Group Homes") were licensed in Ontario to operate a foster home system and a number of group homes. Connor Homes and Connor Group Homes provided care for children who have serious behavioural and developmental disorders. Connor Homes and Connor Group Homes employed or retained numerous individuals to provide such care, including child and youth workers, social workers, certified therapists, and psychologists.

For certain periods in 2008 to 2010, the Minister of National Revenue (the "Minister") assessed two workers as employees of Connor Homes and a third worker as an employee of both Connor Homes and Connor Group Homes. The taxpayers appealed to the Tax Court.

In its decision, the Tax Court referred to the test from *Wiebe Door* and *Sagaz*, namely that, when classifying a worker, the central question is whether the worker is performing services as a person in business on his or her own account. This determination is made with reference to several factors, including control, ownership of tools, whether the worker hires his or her own helpers, the degree of financial risk taken by the worker, the degree of responsibility for investment and management held by the worker, and the worker's opportunity for profit in the performance of his or her tasks.[4]

The Court noted that the current appeal was the fourth time that Connor Homes had appealed a decision of the Minister under the *Canada Pension Plan*[5] and the *Employment Insurance Act*[6] that certain of its workers were employees.[7] In the three previous cases, the Tax Court judges had concluded that the workers were employees of Connor Homes and not independent contractors. The Tax Court made the following statements regarding the findings of fact in the previous cases and the evidence presented in the current appeal:

> [42] There was no evidence before me that the facts with respect to the operation of Connor Homes has changed since the previous decisions of the Court or that Connor Group Homes was operated in a different manner. In fact, it is clear from the evidence before me that Connor Homes continued to exercise significant control over the workers and that Connor Group Homes exercised similar control.
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> [43] This control existed for both child and youth workers and for the area supervisors. In particular, both groups of workers were expected to follow the lengthy and detailed procedural manual, attend the mandatory monthly staff meetings, and continuously fill out forms relating to the performance of their duties. Both groups of workers were supervised by Connor Homes or Connor Group Homes employees and it was important for both that childcare workers and area supervisors respect the chain of command. Approval was required before the workers could change shifts and, similar to previous appeals, the wages of the workers was set by Connor Homes and Connor Group Homes.
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> [44] The only manner in which the child and youth workers and the area supervisors could increase their pay was to work more hours. There was no chance for the worker to increase her return by reducing expenses or by producing more work. It is clear from the evidence before me that only a few tools were required by the worker: a cell phone and access to a computer.

With respect to the parties' intentions, the Court noted that the written contracts stated that the workers were providing their services as independent contractors.[8] The Court cited the holding of the Federal Court of Appeal in *TBT Personnel Services Inc. v. M.N.R.*[9] that intention clauses are relevant but not conclusive, and that the *Wiebe Door* factors must also be considered to determine whether the contractual intention was consistent with the remaining contractual terms and the manner in which the relationship operated in fact. The Court stated that, in the current appeal, any contractual intention (i.e., that the workers were independent contractors) was not consistent with the

manner in which the relationship operated in fact. Rather, the relationship operated in a manner consistent with an employee-employer relationship.

The Tax Court dismissed the appeals, holding that two workers were employees of Connor Homes and the third worker was an employee of both Connor Homes and Connor Group Homes.

The taxpayer appealed to the Federal Court of Appeal and argued that the Tax Court judge had erred by (i) placing weight on the findings of fact made in the other three previous judgments of the Tax Court, and (ii) not considering and misapplying the test for determining whether a worker is an employee or an independent contractor, particularly by not giving proper weight to the intention of the parties as expressed in their contracts.

The Federal Court of Appeal dismissed the appeals.[10]

On the first issue, the Federal Court of Appeal held that the lower court had noted that the facts in the present appeal were essentially the same as those considered in the three previous appeals before three other judges of the Tax Court. In this case, however, the lower court judge had reviewed the parties' evidence, weighed it, and reached his own conclusions. Thus, there was no error committed by the lower court judge.

On the second issue — the role of intent — the Federal Court of Appeal noted the jurisprudential trend towards considering — and giving weight to — the stated intention of the parties.

For example, in *Wolf v. The Queen*,[11] the Federal Court of Appeal held that a mechanical engineer was an independent contractor. In his concurring judgment, Justice Décary stated that the parties' intent was the "essence of the contractual relationship" and "When a contract is genuinely entered into as a contract for services and is performed as such, the common intention of the parties is clear and that should be the end of the search."[12] In a second concurring judgment, Justice Noël stated that ". . . in a close case such as the present one, where the relevant factors point in both directions with equal force, the parties' contractual intent, and in particular their mutual understanding of the relationship cannot be disregarded."[13]

In *Royal Winnipeg Ballet v. The Queen*,[14] the Tax Court found that a group of dancers were employees of a ballet company, and the Court stated that intent served as a tie-breaker where the *Wiebe Door* test yields no definitive result. The Federal Court of Appeal overturned the lower court decision and held that the dancers were independent contractors. The Court of Appeal stated the following:

> [64] In these circumstances, it seems to me wrong in principle to set aside, as worthy of no weight, the uncontradicted evidence of the parties as to their common understanding of their legal relationship, even if that evidence cannot be conclusive. The judge should have considered the *Wiebe Door* factors in the light of this uncontradicted evidence and asked himself whether, on balance, the facts were consistent with the conclusion that the dancers were self-employed, as the parties understood to be the case, or were more consistent with the conclusion that the dancers were employees. Failing to take that approach led the judge to an incorrect conclusion.

In *City Water International Inc. v. M.N.R.*,[15] the Tax Court concluded that certain service workers were employees of the taxpayer. The Federal Court of Appeal overturned the lower court, finding that the workers were independent contractors. On the issue of intent, the Court of Appeal stated the following:

> [27] In balancing the above factors, the result of the inquiry is not obvious. Therefore, it is necessary to determine what weight should be given to the intention of City Water and the Service Workers at the time of their initial engagement. . . .
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> [31] In my analysis, since the relevant factors yield no clear result, greater emphasis should have been placed on the parties' intention by the Judge in this case.

In *Combined Insurance Co. of America v. M.N.R.*,[16] the Tax Court concluded that an insurance salesperson was an employee of the taxpayer. In its reasons, the Tax Court did not refer to the parties' intent. The Federal Court of Appeal overturned the lower court decision on the basis that the judge had failed to consider certain evidence and had failed to apply the correct legal test. The Court of Appeal surveyed the jurisprudence on the four-in-one test and the role of the parties' intent and stated,

> [35] In my view, the following principles emerge from these decisions:
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> 1. The relevant facts, including the parties' intent regarding the nature of their contractual relationship, must be looked at in the light of the factors in *Wiebe Door*, *supra*, and in the light of any factor which may prove to be relevant in the particular circumstances of the case;
> 2. There is no predetermined way of applying the relevant factors and their importance will depend on the circumstances and the particular facts of the case.
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> Although as a general rule the control test is of special importance, the tests developed in *Wiebe Door* and *Sagaz*, *supra*, will nevertheless be useful in determining the real nature of the contract.

In *National Capital Outaouais Ski Team v. M.N.R.*,[17] the Tax Court found that a downhill skiing instructor was an employee of the taxpayer. In this case, the worker and the taxpayer disagreed as to the character of their relationship (i.e., although the written agreement stated that the worker was an independent contractor, the worker testified at the hearing that he had "applied for employment" with the taxpayer). The Tax Court stated that in every case one "must return to the basic principles" elucidated in *Sagaz*, and that "courts must evaluate all of the relevant facts and circumstances to determine if these reflect the intention that the parties originally stated". The Federal Court of Appeal held that the lower court had not erred in placing little or no weight on the parties' stated intentions, as there was no presumption in respect of the parties' characterization of the relationship.

In *Kilbride v. The Queen*,[18] the Tax Court determined that a management consultant was an employee of a company rather than an independent contractor. The Federal Court of Appeal upheld the lower court decision and stated,

> [11] This is not a close case where the *Wiebe Door* test is inconclusive, requiring the court to give greater weight to the intention of the parties. Although the trial judge found that the parties may have intended the appellant to be an independent contractor, she concluded that the actual relationship did not reflect that understanding and their subjective intention must be disregarded (see *Royal Winnipeg Ballet v. Minister of National Revenue*, 2006 DTC 6323 at para. 61 (F.C.A.)).

In *TBT Personnel Services Inc. v. M.N.R.*,[19] the Tax Court determined that certain truck drivers were employees of the taxpayer (and that certain other truck drivers were independent contractors). The Federal Court of Appeal overturned part of the lower court's decision, concluding that all but four of the truck drivers were employees. On the issue of intent, the Court of Appeal stated,

> [35] Such intention clauses are relevant but not conclusive. The *Wiebe Door* factors must also be considered to determine whether the contractual intention suggested by the intention clauses is consistent with the remaining contractual terms and the manner in which the contractual relationship operated in fact.

In *Lang and Lang v. M.N.R.*,[20] the Tax Court determined that certain furnace and duct-cleaning workers were independent contractors. In his reasons, former Chief Justice Donald Bowman surveyed the case law up to that point and stated the following:

> [34] Where does this series of cases leave us? A few general conclusions can be drawn:
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> . . .
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> (d) Intent is a test that cannot be ignored but its weight is as yet undetermined. It varies from case to case from being predominant to being a tie-breaker. It has not been considered by the Supreme Court of Canada. If it is considered by the Supreme Court of Canada the dissenting judgment of Evans J.A. in *Royal Winnipeg Ballet* will have to be taken into account.
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> (e) Trial judges who ignore intent stand a very good chance of being overruled in the Federal Court of Appeal. (But see *Gagnon* [2007 FCA 33] where intent was not considered at trial but was ascertained by the Federal Court of Appeal by reference to the *Wiebe Door* tests that were applied by the trial judge. Compare this to *Royal Winnipeg Ballet*, *City Water* and *Wolf*.)

In the recent Tax Court jurisprudence, some decisions consider the parties' intent to be of "particular importance" or a "significant and material guideline or criteria to be considered along with all the other considerations",[21] whereas other decisions seem to have marginalized the role of intent in the characterization analysis.[22]

In *1392644 Ontario Inc. et al.*, the Court of Appeal noted the difficulty that had developed in the application of the approach described in *Wolf* and *Royal Winnipeg Ballet*. The Court of Appeal emphasized that the parties may describe their relationship as they see fit, but the legal effect that results from the relationship is not to be determined at the sole subjective discretion of the parties. The Federal Court of Appeal stated:

> [38] Consequently, *Wolf* and *Royal Winnipeg Ballet* set out a two-step process of inquiry that is used to assist in addressing the central question, as established in *Sagaz* and *Wiebe Door*, which is to determine whether the individual is performing or not the services as his own business on his own account.
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> [39] Under the first step, the subjective intent of each party to the relationship must be ascertained. This can be determined either by the written contractual relationship the parties have entered into or by the actual behavior of each party, such as invoices for services rendered, registration for GST purposes and income tax filings as an independent contractor.
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> [40] The second step is to ascertain whether an objective reality sustains the subjective intent of the parties. . . . [T]he subjective intent of the parties cannot trump the reality of the relationship as ascertained through objective facts. In this second step, the parties' intent as well as the terms of the contract may also be taken into account since they colors [*sic*] the relationship. . . . [T]he relevant factors must be considered "in the light of" the parties' intent. However, that being stated, the second step is an analysis of the pertinent facts for the purposes of determining whether the test set out in *Wiebe Door* and *Sagaz* has been in fact met,

i.e., whether the legal effect of the relationship the parties have established is one of independent contractor or of employer-employee.

The Court of Appeal noted that, in this case, the lower court judge had proceeded in an inverse order (i.e., dealing with the parties' intent in the second stage of his analysis). The Court of Appeal stated that the first step of the analysis should always be to determine the intent of the parties. However, despite the lower court's inverse analysis, the judge had reached the correct conclusion regarding the status of the workers.

This is helpful guidance from the Federal Court of Appeal on the manner and stage at which intent should be considered when determining whether a worker is an employee or independent contractor.[23]

While there seemed to be a general consensus in the case law that intent was a factor to be considered (with the exception of those cases in which the court either failed to consider intent or considered it merely a tie-breaker), the courts have appeared to continue to wrestle with the manner in which the analysis should proceed. This was not helped, obviously, by the seemingly contradictory decisions from both the Tax Court and Federal Court of Appeal.

However, the analytical "road map" described in *1392644 Ontario Inc. et al.* should remove any doubt about the first two steps of the characterization analysis. This is helpful, in that at least counsel and the courts will not be sidetracked by disagreements on how the analysis should proceed. Now that the framework of the legal test has been clarified, counsel and the courts can focus on the much more challenging aspect of the characterization — the consideration of the *Wiebe Door* and Sagaz factors, the weight that should be given to any factor in a particular case, and the evidence adduced at the hearing regarding the reality of the parties' working relationship.

Notes:

[1] [1986] 3 F.C. 553 (FCA).

[2] 2001 SCC 59.

[3] Unreported; see Court File Nos. 2010-948(CPP)I, 2010-949(CPP)I, 2010-950(EI)I, 2010-951(EI)I, 2011-237(EI)I, 2011-239(CPP)I, 2011-241(EI)I, and 2011-242(CPP)I.

[4] *Ibid.*, at paragraph 28.

[5] R.S.C. 1985, c. C-8.

[6] S.C. 1996, c. 23.

[7] See *1392644 Ontario Inc. (o/a Connor Homes) v. The Queen* (2003 TCC 816), *1392644 Ontario Inc. (c.o.b. Windswept on the Trent) v. The Queen* (2004 DTC 2853 (TCC)), and *1392644 Ontario Inc. (o/a Connor Homes) v. The Queen* (2006 TCC 521).

[8] *1392644 Ontario Inc.*, *supra*, at paragraph 45.

[9] 2011 FCA 256, at paragraphs 34-35.

[10] 2013 FCA 85.

[11] 2002 FCA 96, reversing [2000] T.C.J. No. 696.

[12] *Wolf*, *supra*, at paragraphs 117–121.

[13] *Wolf*, *supra*, at paragraphs 122–124.

[14] 2006 FCA 87, reversing 2004 TCC 390.

[15] 2006 FCA 350.

[16] 2007 FCA 60, reversing 2005 TCC 478.

[17] 2008 FCA 132, affirming 2007 TCC 123.

[18] 2009 DTC 5002 (FCA), affirming 2007 DTC 1718 (TCC).

[19] 2011 FCA 256, reversing 2010 TCC 360.

[20] 2007 DTC 1754 (TCC).

[21] See, for example, *Wellbuilt General Contracting Ltd. v. M.N.R.* (2010 TCC 541) and *Malleau v. M.N.R.* (2013 TCC 47).

[22] See, for example, *Integrated Automotive Group v. The Queen* (2011 TCC 468), *North Delta Real Hot Yoga Ltd. v. The Queen* (2012 TCC 369), and *Dean v. M.N.R.* (2012 TCC 370).

[23] For those certain cases in which there is contradictory or no evidence adduced in respect of the parties' intent, the courts will likely look only to the Wiebe Door and Sagaz factors. See, for example, *687352 BC Ltd. v. M.N.R.* (2012 TCC 127) or *M.A.P. (Mentorship, Aftercare, Presence) v. M.N.R.* (2012 DTC 1112 (TCC)).

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.

De Facto Director Found Liable for Failure of Corporations To Remit Payroll Source Deductions and GST Amounts

***Chell v. The Queen*, 2013 DTC 1055 (Tax Court of Canada)**

In *Chell*, the appellant, Allan A. Chell, was unsuccessful in appealing three director's liability assessments issued against him in respect of corporations that he had resigned from more than two years prior to the issuance of the assessments. The decision, written by Justice Hogan, provides useful guidance on what it means to be a *de facto*, as opposed to *de jure*, director of a corporation for purposes of determining whether an individual, notwithstanding the

fact that he or she has formally resigned from the office of director, may continue to be held liable under the director's liability provisions of the *Income Tax Act* ("ITA") and the *Excise Tax Act* ("ETA").

The assessments issued against Mr. Chell were dated May 5, 2008 and pertained to (i) the failure of cDemo Inc. ("cDemo") to remit payroll source deductions; (ii) the failure of cDemo to remit goods and services tax ("GST") amounts; and (iii) the failure of Global Autolink Corp. ("Global") to remit payroll source deductions. In aggregate, the assessments totalled approximately $300,000. The two payroll source deduction assessments were made pursuant to subsection 227.1(1) of the ITA and the GST remittance assessment was made pursuant to subsection 323(1) of the ETA. The subsections are worded very similarly:

> ITA 227.1(1): Where a corporation has failed to deduct or withhold an amount as required by subsection 135(3) or 135.1(7) or section 153 or 215, has failed to remit such an amount or has failed to pay an amount of tax for a taxation year as required under Part VII or VIII, the directors of the corporation at the time the corporation was required to deduct, withhold, remit or pay the amount are jointly and severally, or solidarily, liable, together with the corporation, to pay that amount and any interest or penalties relating to it.
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> ETA 323(1): If a corporation fails to remit an amount of net tax as required under subsection 228(2) or (2.3) or to pay an amount as required under section 230.1 that was paid to, or was applied to the liability of, the corporation as a net tax refund, the directors of the corporation at the time the corporation was required to remit or pay, as the case may be, the amount are jointly and severally, or solidarily, liable, together with the corporation, to pay the amount and any interest on, or penalties relating to, the amount. [emphasis added]

However, under both director's liability regimes, there is a limitation period that applies such that an assessment cannot be issued against a director more than two years after the director last ceased to be a director of the corporation in question (see subsection 227.1(4) of the ITA and subsection 323(5) of the ETA).

In respect of Mr. Chell's circumstances, he was a consultant in the automobile industry. In 2001, he helped found and became a director of cDemo, which was established to develop smart phone applications to facilitate automobile inspections. In 2000, he helped found and became a director of Global, which was initially in the automobile resale industry, but in 2003 shifted into the business of providing technological solutions to assist its clients in selling automobiles online. Unfortunately, both corporations became insolvent in the mid-2000s and were behind in making remittances to the Canada Revenue Agency (the "CRA") on account of payroll source deductions and, in the case of cDemo, GST remittances. All of the other directors of each corporation resigned, leaving Mr. Chell as the sole director of each.

In January 2006, Mr. Chell took steps to resign as a director of each of cDemo and Global by posting a resignation letter at the offices of the corporations. Four to six weeks later, he delivered a copy to the lawyer for the two corporations, who took no action given that both cDemo and Global had unpaid legal bills at the time. Nothing was filed with the corporate registry to reflect that Mr. Chell had resigned. After posting his resignation, Mr. Chell continued to be involved with cDemo and Global, including in the following manner:

- He continued to meet with the CRA every few weeks throughout 2006 and into 2007 to discuss cDemo's and Global's outstanding liabilities for source deductions and GST.
- He signed a bill of sale on behalf of cDemo pursuant to which certain assets were sold to a former employee of cDemo, and he subsequently sent the proceeds of the sale to the CRA.
- Over the course of a few months in early 2007, he engaged in discussions with a group of investors regarding a potential sale of other assets of cDemo, which did not ultimately materialize.
- After a request from a former director of cDemo, in June 2006, he signed and filed a statutory declaration with the corporate registry to remove the former director from the list of directors maintained by the registry.
- He continued to pursue business development activities in the United States for Global. He was in regular contact with a particular US client to negotiate a potential agreement that, as he indicated to the CRA in July 2006, would provide sufficient revenue to clear Global's outstanding remittances. In this regard, he provided a document to the CRA in September 2006 outlining the potential revenue and identifying himself as the president and CEO of Global. An agreement with the US client was ultimately not reached.

Mr. Chell did not indicate to the CRA that he was no longer a director of either corporation, though he claimed that the CRA did not ask and he was under no obligation to so advise the CRA.

The issues that Hogan J addressed in the decision were twofold. First, he considered whether Mr. Chell was either a *de jure* or *de facto* director of cDemo and/or Global within the two years preceding the assessments (which, as noted above, were dated May 5, 2008). Second, he considered whether Mr. Chell could rely on the due diligence defence in subsection 227.1(3) of the ITA and subsection 323(3) of the ETA.

Mr. Chell's position was that he ceased to be director of cDemo and Global on January 11, 2006, which is the date on

which he posted his letter of resignation at the offices of the corporations. He argued that any activities performed by him after that date were in his capacity as creditor and shareholder, not director. In the alternative, Mr. Chell argued that he exercised due diligence to prevent cDemo and Global from failing to remit the source deductions and GST.

The Minister's position was that Mr. Chell did not cease to be a director of cDemo or Global more than two years prior to the date of the assessments and that he did not exercise due diligence, such that he became liable to pay the unremitted source deductions and GST.

Hogan J observed that the ITA and ETA do not define the time at which an individual ceases to be a director of a corporation for purposes of the director's liability provisions. Hogan J indicated that the relevant corporate law is determinative on the issue. Citing *Mosier* (2002 GTC 28 (TCC)), Hogan J stated:

> [22] [. . .] A *de jure* director is an individual who has been appointed as such pursuant to the corporate law of the jurisdiction in which the corporation was created or continued, as the case may be. A *de facto* director can exist in two forms. As Bowman A.C.J., as he then was, observed in *Mosier* [. . .] "*de facto* directors can be those who are ostensibly duly elected but who may lack some qualification under the relevant company law, and those who simply assume the role of director without any pretence of legal qualification". Either *de jure* or *de facto* directorship can give rise to director's liability.

Hogan J found that Mr. Chell had properly resigned, for corporate law purposes, as a director of both cDemo and Global by posting his letter of resignation at the corporations' offices on January 11, 2006 and therefore ceased to be a *de jure* director of each corporation on that date.

On the question of *de facto* directorship, in the case of cDemo, Hogan J was swayed by the fact that (i) Mr. Chell had signed a bill of sale to sell assets of cDemo on May 16, 2007, which the Court concluded could only have been authorized by a director; and (ii) in June 2006, Mr. Chell signed a statutory declaration to remove a former director from the corporate registry, which the Court found was effective only if signed by a director. On the latter point, the Court was not dissuaded from a finding of *de facto* directorship based on Mr. Chell's claim that he was unaware that he was signing in the capacity of director.

In the case of Global, Hogan J was swayed by the fact that (i) Mr. Chell's ongoing negotiations with the prospective US client were not "consistent with the role of creditor and shareholder" but rather "would suggest to a third party that the appellant was still a director of Global"; and (ii) "[b]ecause [Mr. Chell's] behaviour remained the same following his legal resignation, a third party would not suspect that his status had changed" and in continuing to act on behalf of Global, he "created the impression that he was still a director of the corporation".

The Court also considered Mr. Chell's interactions with the CRA to reinforce a finding that he continued to act as a *de facto* director following his legal resignations. This was because Mr. Chell's interactions with the CRA began prior to his legal resignation and continued thereafter without any change in behaviour or notification to the CRA that he was no longer a director of the corporations. In Hogan J's view:

> [33] [. . .] The Appellant resigned occultly, yet he continued to cooperate with the CRA as if his status had not changed. In my view, the appellant's actions created the impression that he was still an active director of both corporations.

Therefore, the Court held that Mr. Chell was a *de facto* director of cDemo until at least June 2006 and a *de facto* director of Global until at least October 2006, being the time at which he ceased attempting to conclude a contact with the US client. He was therefore a director for purposes of the director's liability provisions of the ITA and ETA within the two years preceding the three assessments under appeal.

Regarding the due diligence defence, the Court found that "subsections 227.1(3) of the ITA and 323(3) of the ETA entail a modified objective analysis which involves considering what a reasonable person would have done in the circumstances of the individual under assessment". Furthermore, the Court found that in order to establish the defence, the director "must show that he or she took positive actions to prevent the corporation's failure to remit the amounts in question". In the case of Mr. Chell, the facts showed that he was an "insider director" with a high degree of familiarity with the businesses of cDemo and Global. The Court held that a director with such a level of familiarity would have been aware of the financial difficulties the corporations were facing. However, Mr. Chell did not take any positive steps to ensure that the corporations continued to meet their remittance obligations. Furthermore, the source deductions and GST amounts were apparently diverted to fund the corporations' failing enterprises. Accordingly, the Court concluded as follows:

> [39] [. . .] According to the appellant, he never reviewed the books of cDemo or Global, and was unaware of the remittance patterns of the companies. The appellant asserted that he had delegated cDemo's and Global's tax function to key employees who were responsible for managing the remittance obligations of the two

> corporations. The appellant cannot discharge his statutory obligation by delegating the remittance function to an employee without any oversight on his part.
>
> [40] The evidence shows that the appellant did not exercise "the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances". A reasonable person in the appellant's circumstances would have anticipated that the corporations' financial difficulties could affect the remittance obligations of the two corporations and would have taken steps to prevent failures to remit. The appellant's lack of oversight and his inaction cannot serve as the foundation of a due diligence defence. [emphasis added]

Each of the three appeals was therefore dismissed, with one set of costs to the Minister.

In *Netupsky* (2003 GTC 591 (TCC)), a similar GST case that was not cited in *Chell*, the sole director of a company resigned for corporate law purposes more than two years before a director's liability assessment but continued to deal with the CRA auditor and other creditors of the corporation as though he were still a director. Submissions made on the individual's behalf argued that to the extent he performed any functions after his formal resignation, he did so in his capacity as shareholder. The Court accepted this and concluded that he was not a *de facto* director of the company and was therefore not liable. Mr. Chell performed similar functions for cDemo and Global after his formal resignation, but was ultimately found liable. It is not clear from the judgment in *Chell* precisely why the things that Mr. Chell did were necessarily things done in his capacity as director. This is particularly true in the case of Global, where Mr. Chell merely attempted (and failed) to procure a contract with a client; with respect, it is not self-evident why such activities would necessarily be conducted *qua* director and not *qua* shareholder.

— *Brian O'Neill*

Informer Privilege Trumps the Crown's Obligation To Disclose Anonymous Tips

***R. v. McLellan*, 2013 DTC 5047 (Supreme Court of British Columbia)**

The British Columbia Supreme Court recently affirmed that informer privilege remains hallowed and cannot be undermined by ordering disclosure of information contained in confidential tips unless the Court can be certain the disclosure will not pose any risk that the informer might be identified. The issue presents some difficulty in cases in which the Canada Revenue Agency (the "CRA") "crosses the Rubicon" from undertaking an audit to investigating possible criminal charges. The ruling in *McLellan* has particular significance in light of the recent federal Budget proposals "to combat international tax evasion and to address international aggressive tax avoidance", in part, by expanding the CRA's powers of investigation.

Robert McLellan was charged in June 2011 with three offences under section 239 of the *Income Tax Act* (the "Act"), relating to (i) making false statements in his returns by failing to report $778,603 of income; (ii) wilfully evading payment of taxes in the amount of $151,405; and (iii) causing Corrine McLellan to claim various child benefits in the amount of $20,398, to which she was not entitled, by making false statements as to his income in his returns thereby causing family income to be understated.

The CRA received an anonymous tip, began an audit, and eventually laid criminal charges. The case was first heard in Provincial Court, and the trial judge held an *in camera* session to review the informant evidence. The trial judge made an order for limited disclosure and an order that a *voir dire* hearing should take place to challenge the evidence in order to determine its admissibility at trial. A caveat to the *voir dire* order was that, since the disclosure was limited, any questions on cross-examination would not be permitted if the answer could disclose information that would identify the informant or reveal the contents of the tip other than allegations of criminal conduct.

After reviewing the informant evidence, the trial judge ruled that the Crown had to disclose parts of the tips it had received from an informant "which could be construed as constituting accusations of criminal violations of the *Income Tax Act*". The Crown sought a judicial stay of the proceedings against Mr. McLellan in order to be able to appeal the disclosure order to the British Columbia Supreme Court.

The appeal decision focused on (i) the *Canadian Charter of Rights and Freedoms* (the "Charter") challenge mounted by the defence as to the admissibility of information received by the CRA pursuant to an audit leading it to undertake a criminal investigation; and (ii) whether the trial judge had erred in making the disclosure order and concluding defence counsel could question witnesses about the tip on a *voir dire*.

In his reasons dealing with the underlying Charter issues, Willcock J referred to the principles set out in the Supreme Court of Canada's decision in *Jarvis* (2002 DTC 7547) in concluding that the CRA "cannot use its extensive audit

powers to conduct criminal investigations". In *Jarvis*, a taxpayer was similarly charged with evasion under section 239 of the Act after an audit had begun following a tip received by the CRA that the taxpayer had not reported the sales of his late wife's artwork. Through the course of the audit investigation the taxpayer had complied by answering questions but, in the view of the Supreme Court of Canada, was not properly cautioned and informed of his rights when the investigation turned into one for criminal misconduct. The Supreme Court held:

> [W]here the predominant purpose of a particular inquiry is the determination of penal liability, CCRA officials must relinquish the authority to use the inspection and requirement powers under s. 231.1(1) and 231.2(1). In essence, officials "cross the Rubicon" when the inquiry in question engages the adversarial relationship between the taxpayer and the state. There is no clear formula that can answer whether or not this is the case. Rather, to determine whether the predominant purpose of the inquiry in question is the determination of penal liability, one must look to all factors that bear upon the nature of that inquiry.

The basis of the defence in the criminal proceedings in *McLellan* was that the CRA had improperly used information and had improperly "crossed the Rubicon". No ruling had yet been made on the substance of the *Jarvis* application by the trial judge, nor had the *voir dire* been conducted. While it was accepted in the decision that the Crown had not used any information obtained from the tip in launching the criminal investigation, the information from the CRA that the Crown was relying on was not explicitly set out. Willcock J simply concluded that some words of the tip may be relevant to the Charter challenge.

McLellan confirms that informer privilege remains hallowed and ought to only be breached in the narrowest circumstances, primarily where the accused's innocence is at stake. The test to meet in order to raise the "innocence at stake" exception is to demonstrate a basis on the evidence for concluding that disclosure of the informer's identity is necessary to prove the innocence of the accused. In *McLellan*, the parties agreed that the "innocence at stake" exception did not apply. Accordingly, the only consideration was the extent to which the trial judge was permitted to allow any of the information provided in the tip to be disclosed.

Willcock J set out the guiding principles that must be considered in cases of informer privilege and confirmed that it is of an "absolute nature". He cited Binnie J in the recent Supreme Court of Canada decision in *Barros* ([2011] 3 SCR 368), holding that:

> The jurisprudence establishes that the identity of police informers is protected by a near-absolute privilege that overrides the Crown's general duty of disclosure to the defence. This privilege is subject neither to judicial discretion nor any balancing of competing interests (although qualified by an "innocence at stake" exception).

The test guiding the courts in determining what information from a tip may be disclosed is whether there is any risk at all that disclosure could lead to the identification of the informer. As courts are generally not privy to the seemingly minute or unimportant details that could enable such identification, judges must err on the side of extreme caution. Willcock J held that it is only open to a trial judge to edit and order disclosure of such tips where it is certain the identity will not be revealed:

> Because it is "virtually impossible" to know what details of a tip might tend to identify an anonymous informant, it will rarely be possible to have the requisite certainty in cases where the informant is anonymous.

Willcock J found that the trial judge was not sufficiently certain to have made any such determination, and further, that it was wholly improper to have left any discretion to the Crown as to what ought to be disclosed pursuant to the order.

In reviewing the contents of the anonymous tip, Willcock J concluded that it was indeed impossible to have the requisite certainty that any disclosure would not tend to identify the informant. Willcock J found he was unable to redact the information and held that all the material provided by the CRA was protected by informer privilege and could not be disclosed, on a *voir dire* or otherwise.

McLellan illustrates that in most instances it will be virtually impossible to redact an anonymous tip sufficiently for it to be disclosed. While not discussed in *McLellan*, this may in a sense permit the CRA to use such tips with impunity. Given the almost absolute nature of informer privilege, the potential for the CRA to "cross the Rubicon" inappropriately may continue to be a live issue. Given the 2013 federal Budget proposals regarding tipping in respect of international tax non-compliance, including proposals to compensate for tips in some circumstances, the issue of informer privilege is likely to become more contentious if the CRA indeed pursues more, and broader, criminal investigations.

— *Stephanie Sugar, Articled Student*

Federal Court Orders Imprisonment for Director of Taxpayer if Failure To Comply with Order To Disclose Records Continues

***Minister of National Revenue v. The Money Stop Ltd.*, 2013 DTC 5043 (Federal Court of Canada)**

In *The Money Stop*, the Federal Court ordered the taxpayer and its director (together, the respondents) to pay fines and the Minister's legal costs (on a solicitor-client basis) as well as to provide certain financial records to the Minister, failing which the director would be imprisoned for up to three years.

The taxpayer was a "payday lender" (as characterized by the Federal Court). Its director was Tel Sutherland. In July and August 2011, the Minister requested certain financial records of the taxpayer by October 2011 in order to conduct an audit. The taxpayer failed to comply with the request.

The Minister applied to the Federal Court for an order of compliance pursuant to section 231.7 of the *Income Tax Act* (the "Act"). Justice Harrington granted the order in February 2012, which compelled both the taxpayer and Mr. Sutherland to provide the requested records. The respondents failed to comply with the order.

Consequently, the Minister initiated contempt proceedings against the respondents. At the contempt hearing held in July 2012, the respondents admitted that they had not complied with Harrington J's order. Based on the admission, Justice Zinn found the respondents guilty of contempt. Nevertheless, Zinn J granted the respondents a further 30 days in which to provide to the Minister six enumerated items of financial information, including a username and password to the taxpayer's QuickBooks records, the taxpayer's Corporate Minute Book, a completed Form RC59 (Business Consent Form) to allow the Canada Revenue Agency to deal with the individual that had prepared the taxpayer's corporate tax returns, and certain bank statements and cheque records. Failing production within 30 days, Zinn J's order provided that the respondents could be sentenced for their contempt.

The respondents produced five boxes of documents. These contained some, but not all, of the records subject to Zinn J's order. The documents disclosed did not contain the username and password to the taxpayer's QuickBooks records, the Corporate Minute Book, the completed Form RC59, and a number of the bank and cheque records. The Minister requested that the Court sentence the respondents for their contempt.

No one appeared for the respondents at the sentencing hearing held in January 2013. Zinn J found that the respondents had ample notice of the hearing, based in large part on the fact that Mr. Sutherland had been in contact with the Court registry about the hearing before it took place. He appears to have decided not to attend without any further explanation. The Minister's evidence was therefore uncontested.

In determining the appropriate sentence, the Court relied on Rule 472 of the *Federal Courts Rules* and the prevailing case law. Rule 472 empowers the Court to, among other things, order a person in contempt to a term of imprisonment of less than five years or until the person complies with the order; to pay a fine; to pay the opposing party's costs; to do or refrain from doing anything; or any combination of these.

The Court also relied on the Federal Court's decision in *Minister of National Revenue v. Marshall* (2006 DTC 6182), in which the Court considered the following factors relevant in determining a sentence for contempt of an order to disclose information pursuant to section 231.7 of the Act:

(1) the need to ensure compliance with orders of the Court and continued confidence in the administration of justice;

(2) proportionality;

(3) aggravating factors, including the gravity of the conduct and whether the offence is a subsequent offence; and

(4) mitigating factors, such as the offender's good faith or apology, or whether the offence is the first offence.

The Court recognized that ensuring compliance with orders made under the Act was critical to Canada's self-reporting tax compliance regime. Zinn J characterized the failure to follow a court order made under the Act as a threat to Canada's social and other programs, and indeed to the government as a whole, which depend on tax revenue for survival. Moreover, he found that the respondents' breach of the order in this case was intentional. While the respondents did provide some of the documents that the Minister had requested, the Court was particularly disturbed by the respondents' continued failure to provide the username and password to the taxpayer's QuickBooks records. The decision indicates that the parties discussed this piece of information at length in the previous hearing, and it seemed to the Court not especially difficult to provide.

The Minister conceded that Mr. Sutherland's appearance at each previous hearing was a mitigating factor in sentencing. The Court, however, accorded it little weight given that neither he nor any agent appeared at the sentencing hearing.

Having considered all of the factors, Zinn J relied on the penalty ordered in *Marshall* in ordering the respondents:

(1) To pay a fine of $5,000 and the Minister's legal costs (on a solicitor-client basis) of $19,905.74, within 30 days, failing which Mr. Sutherland would be imprisoned for 30 days.

(2) To provide the remaining records listed in the initial order within 30 days, failing which Mr. Sutherland would be imprisoned for three years (concurrently with any other term of imprisonment under the order) or, if earlier, until the remaining records are provided to the Minister.

The order contained a mitigating provision whereby Mr. Sutherland could defer or avoid imprisonment if, within 30 days, the respondents arranged an oral examination under oath in which they could produce sufficient evidence to convince the Court that the respondents were unable to pay the fine and costs and/or unable to produce some or all of the remaining records listed in the order.

The previous orders in this case (which were summarized in the decision) confirm that a court may attempt to accommodate and grant concessions to taxpayers when they initially delay providing records to the Minister in order to conduct an audit. In the end, however, the decision also confirms that the Court will resort to ordering imprisonment, fines, and enhanced costs as a response to contempt, should its orders and previous concessions be ignored, flaunted, and abused. Importantly, this case, which culminated in a potential three-year prison term for the taxpayer's director, arose from the Minister's procedural request for records in advance of an audit. The Minister had yet to make any finding that the taxpayer had failed to comply with the substantive provisions of the Act. The decision therefore confirms that the judiciary will take the procedural requirements of the Act just as seriously as the taxing provisions.

— *Mark Firman*

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