Tax Notes

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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.

Back to Basics

***C.A.E. Inc. v. The Queen*, 2013 DTC 5084 (Federal Court of Appeal)**

The taxpayer in this case, C.A.E. Inc., is a leading manufacturer of civil aviation flight simulators. In addition to producing simulators for sale to customers, the taxpayer used its manufactured simulators to lease or provide flight training services to airlines. This case considers the income versus capital character of the taxpayer's profits on the sale of simulators to a financial services provider in the context of a sale-leaseback transaction where the subject simulators were leased back from the bank for use by the taxpayer in providing its flight training services. The case also addresses whether the taxpayer was entitled to claim capital cost allowance ("CCA") on simulators that were either (i) initially leased to customers or used in the taxpayer's flight services business but later sold to customers, or (ii) leased to customers who were given a purchase option.

The tax issues and contexts considered by the Federal Court of Appeal ("FCA") were as follows:

(1) The character of CAE's profits from the sale of a Canadair Regional Jet CL-65 simulator and an Airbus A330/A340 simulator to a bank under a sale-leaseback transaction where C.A.E. subsequently used the simulators to provide flight training services to Air Canada and whether C.A.E. was entitled to claim CCA in light of the fact that Air Canada held a purchase option in respect of the simulators.

(2) The character of C.A.E.'s profit from the sale of an Airbus A320 simulator and Airbus A330/A340 simulator to a bank leasing subsidiary under a sale-leaseback transaction where C.A.E. subsequently used the simulators to operate a flight training centre in Toronto.

(3) Whether C.A.E. was entitled to claim CCA on an Airbus A320 simulator that was leased to Airbus with a purchase option but was later sold to Khalifa Airways after having been unused for a period of time following the lapse of the Airbus lease.

(4) Whether C.A.E. was entitled to claim CCA on an Airbus A320 simulator where its construction was commenced on the basis of a sale contract with US Airways that was cancelled prior to delivery and, upon completion, was used by C.A.E. initially for use in its training premises in Montreal and then to lease to customers before eventually being sold.

(5) Whether C.A.E. was entitled to claim CCA on a used C.A.E.-built Boeing 747-400 simulator that C.A.E. reacquired, refurbished, and eventually leased to United with a purchase option and, following the termination of the lease, was used by the taxpayer at its Toronto training centre.

The Tax Court (*per* Jorré J) held that C.A.E.'s gains on the sales of the simulators in the circumstances described in paragraphs 1 and 2 represented income from the taxpayer's business of selling simulators and that the taxpayer was entitled to claim CCA on its cost of the simulators in the circumstances described in paragraphs 1, 3, 4, and 5.

On appeal to the FCA, C.A.E. appealed the Tax Court's conclusion that the gains from the sales of the simulators under the sale-leaseback transaction were on income account, and the Minister cross-appealed the Tax Court's findings with respect to C.A.E.'s entitlement to treat the simulators as depreciable property in the circumstances described in paragraphs 1, 3, 4, and 5 above.

The first issue that the FCA addressed was the question of whether C.A.E.'s gain on the sale of the simulator under the sale-leaseback was on income or capital account. Citing *Friesen* (95 DTC 5551), Noël JA held that the nature of property determines the resulting tax treatment. Therefore, if the property was held to be sold (i.e., as inventory) when the sale-leaseback took place, then any increase in value realized upon such disposition would be income regardless of the financing context.

The FCA found that there were three factors that were relevant in the present circumstances. First, the fact that C.A.E. continued to use the simulators to generate rental income before, during, and after their sale was useful in interpreting the nature of the properties. Second, the fact that, in the case of the sale-leasebacks, the sale transaction did not occur in the ordinary course of business was also relevant to understanding C.A.E.'s use of the property at that time. Third, it was appropriate to take into account the fact that the sale at the time of the sale-leaseback would not truly represent a commercial gain for C.A.E. when one took into account C.A.E.'s financial obligation to the transferee under the lease and that the transaction only made commercial sense if you took into account the revenues that C.A.E. expected to derive from providing flight training services to its customers using the simulators that were sold under the sale-leaseback. This was also consistent with the accounting treatment of the value realized from the sale, which was applied to reduce rental expense over the term of the contract.

The FCA thus found that the sale-leaseback monetized the simulators to allow C.A.E. to carry on its business of providing simulator-related services and, therefore, the subject gains were on capital account.

Next, the FCA addressed the Crown's cross-appeal of the Tax Court's ruling that C.A.E. had a right to claim CCA. The FCA agreed with the Tax Court that the nature of property could change from year to year but disagreed with the approach that the Tax Court applied to reach that conclusion. In particular, the FCA disagreed with the Tax Court's view that the *Friesen* case is authority for the proposition that property that is inventory upon disposition cannot be treated differently in prior years. Further, the FCA expressed confusion as to why the Tax Court did not address the change-in-use rules in subsections 13(7) and 45(1).

The FCA found that the above flaws led the Tax Court to create a new category of property and to find that *Friesen* was no longer good law. The FCA held that these conclusions were not well-founded and were unnecessary.

Instead, the FCA stated that property cannot be depreciable property and inventory at the same time as *per* paragraph 1102(1)(*b*) of the *Income Tax Regulations*, and the Tax Court was incorrect in stating that depreciable property could give rise to a capital gain or income depending on the circumstances. As determined in *Friesen*, there are only two categories of property (i.e., capital property and inventory), and the disposition of capital property, whether or not depreciable, gives rise to capital gains rather than income gains.

The FCA explained that contrary to the Tax Court's justification, the structure of the definition of "capital property" in section 54 of the *Income Tax Act* (the "Act") is not explained by the fact that the disposition of depreciable property may not give rise to a capital gain. Rather, all capital property gives rise to capital gains upon disposition, but only depreciable property both results in a capital gain upon disposition and is subject to the CCA system. The distinction from other capital property is that no capital loss can be realized upon the disposition of depreciable property, given that such a loss is recognized through the CCA system.

The FCA addressed the statement in *Friesen* that property held in inventory when sold has the same character in preceding years. In *Friesen*, the taxpayer was claiming a loss resulting from an inventory write down under subsection 10(1). Therefore, the Crown in that case maintained that the taxpayer needed to show that the land was held as inventory, not only in the year of sale but in all preceding years. In *Friesen*, Major J rejected this argument, finding that inventory is property held for sale both in the year of sale and in prior years before it is sold. He also recognized the application of the change-in-use rules where the relevant conditions are met. While the FCA agreed with the Tax Court's desire to give effect to the change in use of the simulators, Noël JA found that it was unnecessary to create a new category of property or to reject *Friesen* to achieve this outcome.

The FCA then addressed the potential application of subsections 13(7) and 45(1) of the Act, which the Tax Court had failed to do.

In Interpretation Bulletin IT-218R, these subsections apply only when property is converted from an income producing

purpose to a non-income producing purpose. In the bulletin, the Canada Revenue Agency ("CRA") indicates that these subsections are not applicable where property is converted from inventory to capital property, since the property is used to gain or produce income in both instances. However, the FCA proposed a different way to read subsections 13(7) and 45(1), by considering that inventory does not generate income. This interpretation would allow subsections 13(7) and 45(1) to apply on a conversion of property from inventory to capital property and *vice versa*. The FCA found that this interpretation of subsection 45(1) was applied in *Roos* (94 DTC 1094 (TCC)) where Bowman CJ, as he was then, held that a piece of land held in inventory was subject to a deemed disposition when it was taken off the market and used to generate income. Noël JA stated that this may also have been what Major J had in mind in *Friesen* when he considered subsections 13(7) and 45(1). However, the FCA acknowledged that, if interpreted only this way, such an interpretation would preclude the application of subsections 13(7) and 45(1) when inventory is converted into personal-use property. Therefore, Noël JA proposed a reading of subsections 13(7) and 45(1) that reconciles both interpretations: where circumstances with a potential change in use include a personal-use property, the first question to ask is if the inventory is property that generates revenue. However, where there is a potential change in use that does not include personal-use property, then the first question to ask is if the inventory has an income producing function.

Noël JA cited sections of two CRA administrative positions that contemplate a notional disposition when property is converted from capital property to inventory. While acknowledging that these bulletins state that this policy is not rooted in subsections 13(7) and 45(1), the FCA found that a legislative basis for such a notional disposition would be required and that there is no other potential statutory authority. That said, Noël JA noted that if a result recognizing the change-in-use rules could not be achieved by applying subsections 13(7) and 45(1), he might have agreed with the Tax Court.

In determining whether C.A.E. was entitled to CCA, the Tax Court found that the probability that certain options to purchase would be exercised was a relevant consideration in determining whether or not property was held as inventory. Noël JA for the FCA held that property that is held for sale is not "less" for sale because a sale is unlikely. The FCA stated that the key question was whether or not C.A.E. was bound to sell if a buyer exercised its purchase option or whether the purchase option was merely an invitation to negotiate. In the present case, the FCA noted that the options that had been provided to United and Airbus were firm. Therefore, in respect of such options, the simulators were being held for sale. The fact that the simulators were used to produce income in the meantime did not change that result; the legislator had provided that inventory — and property held in inventory — cannot be depreciable property, even if it is used to produce income. The FCA concluded that C.A.E. was precluded from claiming CCA only in those two scenarios where the purchase options could not be considered "real options", but was allowed to claim it in the other two scenarios where the purchase options were found to be firm.

— *Lindsay Hollinger*

Magnitude of Unreported Income Insufficient on Own To Support Gross Negligence Penalties

***Murugesu et al. v. The Queen*, 2013 DTC 1046 (Tax Court of Canada)**

In this case, the taxpayers, a corporation (the "Corporation") and its sole shareholder (the "Shareholder"), filed separate appeals. The Shareholder appealed personal assessments and gross negligence penalties for 2000, 2001, and 2002. The Corporation appealed corporate assessments and gross negligence penalties for 2002. The two appeals were heard together on common evidence by the Tax Court of Canada.

The Shareholder had immigrated to Canada in 1990. He had little education. Initially, he had worked in Canada as a farm worker for Sargent Farms. In 1997, he started a business of providing farm workers to Sargent Farms. The Shareholder incorporated this business in 2001. Due to his limited knowledge of English, the Shareholder relied on his accountant to prepare tax returns for both himself and the Corporation.

The Tax Court of Canada (*per* D'Arcy J) first addressed the Corporation's appeal with respect to its 2002 taxation year in respect of $171,142 in income said by the Minister to be unreported. Apart from penalties, the sole issue was whether the Corporation incurred an expense for wages in excess of what was reported on its 2002 income tax return, as this expense would reduce the amount of additional income.

In this regard, the Corporation accepted that it had understated its gross revenue by $171,142. However, the Corporation maintained that its accountant had also substantially understated the Corporation's wage expense. The Court accepted the Corporation's position on this point, concluding that the Corporation understated its 2002 income by $82,286, which was the difference between its unreported gross revenue of $171,142 and an $88,856 understatement of the wages that it had paid in cash.

The Court subsequently reviewed the Shareholder's 2002 taxation year. In assessing, the Minister had assumed that the Shareholder appropriated all of the $171,142 of alleged unreported income of the Corporation and, therefore, included that amount in the Shareholder's income under subsection 15(1).

The Shareholder testified that he had not appropriated any funds from the Corporation. While he acknowledged that the Corporation had paid amounts to him, he claimed that he had informed his accountant of all cash withdrawals. Moreover, the Shareholder argued, in any event, that he should not be subject to gross negligence penalties.

After emphasizing in his reasons that he found the Shareholder to be a credible witness, Mr. Justice D'Arcy noted that a significant portion of the cash paid out by the Corporation had been reported as employment income by the Shareholder. The Shareholder also testified that the Corporation had paid monies to the Shareholder's spouse since she provided services to the Corporation. Although the amount of the spouse's income was not provided to the Court, D'Arcy J assumed that the additional cash paid out by the Corporation was used in payment of the spouse as well as in payment of the employees.

In respect of the evidence provided by the Canada Revenue Agency ("CRA"), the Court noted that an investigations officer for the CRA testified that she had not even spoken to the Shareholder prior to issuing the assessments. She also testified that she had not performed an analysis of the Corporation's cash withdrawals and that she was not aware that the Corporation paid some of its employees in cash. Further, a schedule prepared by the Minister included approximately $59,000 of withdrawals that the Corporation made after its 2002 year end.

Therefore, the Court concluded that the objective evidence supported the Shareholder's testimony that he had not appropriated any amounts from the Corporation.

The Court went on to consider whether the Minister properly levied gross negligence penalties in respect of the Shareholder's 2000, 2001, and 2002 taxation years and in respect of the Corporation's 2002 taxation year.

Given that D'Arcy J had concluded that the Shareholder did not receive a shareholder benefit in 2002, the penalty in respect of his 2002 year was therefore negated by the Court.

As to the standard applicable in respect of the penalties in issue, the Court referred to *Venne* (84 DTC 6247 (FC)), noting that the concept of "gross negligence" implies a high degree of negligence tantamount to intentional acting, i.e., an indifference as to whether the law is complied with or not.

The Court noted that the investigations officer for the CRA acknowledged that she had based her decision to levy gross negligence penalties on the magnitude of the unreported amounts, the fact that the Shareholder and the Corporation made cash withdrawals, and the fact that the Shareholder used some of the cash withdrawals to purchase a new condominium.

D'Arcy J concluded that the Shareholder was not a sophisticated business person and, given his limited knowledge of English and of the Canadian taxation system, had no choice but to rely on an accountant. In light of the evidence presented, it appeared that the accountant had been negligent in preparing the tax returns in issue. However, the Court found that neither the Shareholder nor the Corporation had been grossly negligent. The Court consequently vacated all subsection 163(2) penalties.

The *Murugesu* case emphasizes that a decision to levy gross negligence penalties cannot be justified simply by the magnitude of unreported income or by cash withdrawals. Such grounds are in and of themselves inadequate justification for imposing gross negligence penalties.

— *David Roulx*

Tax Court Vacates Assessment of Survivor under Deceased's RRSP

***Kiperchuk v. The Queen*, 2013 DTC 1088 (Tax Court of Canada)**

In *Kiperchuk*, the Tax Court vacated the Minister's assessment of the taxpayer, the spouse of a deceased delinquent taxpayer, for a portion of the deceased's unpaid tax equal to an amount she received for no consideration as the beneficiary under the deceased's RRSP.

The taxpayer and her husband, David, separated in 1996. The taxpayer petitioned for divorce. In 1997, the (then) Ontario Court ordered David to irrevocably designate the taxpayer as the beneficiary under certain of his benefits arrangements, including his RRSP, and not to deplete their assets. This order was continued in January 1998 and again in June 1998. Although the June 1998 court order reserved to David the right to petition the Court to vacate the non-depletion order for, among other things, unpaid income tax and goods and services tax, it appears that David never petitioned the Court to do so.

The taxpayer remained separated from David until David's death in 2002. The divorce was never finalized.

David was liable under the *Income Tax Act* (the "Act") for unpaid tax of approximately $438,000 for the tax years of 1994 through 2001 inclusive. As of his death, approximately $75,000 was available for distribution from his RRSP, to which the taxpayer was entitled by virtue of her status as David's designated beneficiary. The taxpayer withdrew these funds in January 2004. The taxpayer paid no consideration for the amounts withdrawn.

The Minister assessed the taxpayer on the basis that David had transferred property (the balance of the RRSP) to her on his death for no consideration at a time when he was liable for unpaid tax under the Act, and, consequently, the taxpayer incurred a joint liability for that unpaid tax under subsection 160(1) of the Act to the extent of the value of the property transferred ($75,000).

The taxpayer appealed to the Tax Court. She argued that, because she was David's designated beneficiary under the RRSP, the funds held in the RRSP never formed part of his estate available for the satisfaction of creditors. In this regard, she argued that the proceeds of RRSPs vest in the designated beneficiary by virtue of section 53 of Ontario's *Succession Law Reform Act*, and therefore there is no "transfer" of property within the meaning of subsection 160(1).

The Tax Court (*per* Lamarre J) found in favour of the taxpayer, for slightly different reasons, and vacated the Minister's assessment.

Lamarre J relied on the Federal Court of Appeal's decision in *Livingston* (2008 DTC 6233) for the test in order for subsection 160(1) to apply:

(1) The transferor (in this case, David) must be liable for tax under the Act.

(2) There must be a direct or indirect transfer of property (here, the balance of the RRSP).

(3) The transferee must be the transferor's spouse or common-law partner (or a person who has since become the transferor's spouse or common-law partner), a person under the age of 18, or any other person with whom the transferor was not dealing at arm's length.

(4) The fair market value of the property transferred (here, approximately $75,000) must exceed the fair market value of the consideration that the transferee gives for it (here, nil).

There was no dispute that the Minister satisfied prong Nos. 1 and 4 of the test.

The Court disagreed with the taxpayer and found that the Minister also satisfied prong No. 2. As noted, the taxpayer argued that no transfer had taken place. The Court discussed in some detail the scope of the word "transfer" for the purposes of subsection 160(1). Lamarre J relied on the Exchequer Court's decision in *Fasken Estate* (49 DTC 491) and the Tax Court's decision in *Montreuil* (95 DTC 138) for the proposition that the word "transfer" in this context has a very broad meaning, under which "all that is required is that the husband should so deal with the property as to divest himself of it and vest it in his wife . . ." (*Fasken Estate*) and that, as of the moment of death, there is a transfer to a spouse of a right to claim the legacy amount provided in the deceased's will (*Montreuil*). Applying these cases to the taxpayer's facts, the Court agreed with the Minister that there was indeed a transfer of the property held in the RRSP at the time of David's death.

However, after finding that there had been a transfer, the next question that arose for the Court was the identity of the "transferor". If the transferor was David's estate, the Court suggested that the transfer would not have occurred at arm's length by virtue of paragraph 251(1)(*b*), which would deem the taxpayer and the estate not to deal at arm's length (thus satisfying prong No. 3). The Court relied on the Tax Court's decision in *Homer* (2009 DTC 1175) for the proposition that the proceeds of a deceased's RRSP devolve directly to the beneficiary and do not form part of his or her estate. Accordingly, in this case, the transferor for purposes of subsection 160(1) could not have been David's estate. The Court relied on *Homer* for the further proposition that, in these circumstances, the transferor is arguably (though not definitively) the testator.

The Court then concluded that the Minister could not satisfy prong No. 3, because the Minister could not show a spousal or otherwise non-arm's length relationship between the transferor and the transferee. The Court found that the operative time for determining whether a spousal or non-arm's length relationship existed was the time of the transfer. In this case, the taxpayer did not become entitled to a transfer of funds under the RRSP until David was deceased. She was no longer therefore a "spouse". In this regard, Lamarre J relied on the Ontario Supreme Court's 1982 decision in *Re Kindl Estate* for the proposition that marriage ends on death. She further concluded that there was no evidence to find that the taxpayer was otherwise *de facto* not at arm's length under paragraph 251(1)(*c*).

The decision may hamper the Minister's efforts to collect unpaid taxes from the spouses of delinquent taxpayers who receive certain amounts outside of the estate on the taxpayers' deaths. It is not difficult to envision circumstances similar to the taxpayer's that may prevent the Minister from relying on subsection 160(1) to collect amounts in the

future. The decision also raises a secondary question as to who the transferor of the property under an RRSP would be in these situations. While the Court concluded that it could not be the deceased's estate and further that it was arguably the testator, it did not decide this question definitively.

— *Mark Firman*

Burden of Proof for Deducting Legal Fees

***Dr. Mike Orth Inc. v. The Queen*, 2013 DTC 1110 (Tax Court of Canada); *371501 B.C. Ltd. v. The Queen*, 2013 DTC 1108 (Tax Court of Canada)**

In these companion cases, the Tax Court of Canada considered the burden on a taxpayer to prove that legal fees are deductible in computing income. Notwithstanding a taxpayer's right to assert solicitor-client privilege, a taxpayer has the burden of proof to make out a *prima facie* case that legal fees that were deducted in computing income were incurred for the purpose of earning income from a business. Accordingly, a taxpayer may need to present evidence that would otherwise be protected by solicitor-client privilege and allow the Minister fair cross-examination on that evidence in order to demonstrate the deductibility of legal fees.

The taxpayers, Dr. Mike Orth Inc. and 371501 B.C. Ltd., and a third corporation, 440214 B.C. Ltd., were related corporations. 371501 B.C. Ltd.'s appeals were heard immediately after those of Dr. Mike Orth Inc., and the parties agreed that 440214 B.C. Ltd.'s appeals would be settled on the basis of the reasons in 371501 B.C. Ltd.'s appeals.

The issue in each of the appeals was whether legal fees were incurred by the taxpayer for the purpose of earning income from its business. The taxpayers had provided to the Canada Revenue Agency copies of the invoices for the legal fees, as well as a general description of the nature of the legal services. The taxpayers took the position that detailed descriptions of the legal services and specific legal advice provided were subject to solicitor-client privilege. The Minister accepted that the information sought was subject to privilege, but took the position that the information that was provided was insufficient to determine whether the legal fees were deductible in computing income. In particular, the Minister was concerned that some of the legal work was done for the shareholders of Dr. Mike Orth Inc. and 371501 B.C. Ltd., not the corporations themselves, and that some of the work related to capital transactions.

The Court, *per* Rip CJ, began its analysis by considering how general tax litigation principles apply where the taxpayer claims solicitor-client privilege over relevant information or documents. In the Canadian tax system, the Minister makes an assessment on the basis of particular assumptions of fact. The taxpayer bears an initial burden of demolishing the Minister's assumptions and does so by presenting evidence that raises such a degree of probability in its favour that it must be accepted if the Court believes it. This is called a "*prima facie* case". In response, the Minister can present its own evidence or raise doubts about the taxpayer's evidence. The Minister's counsel is entitled to challenge vigorously the taxpayer's evidence by cross-examination.

Given that the taxpayer bears the initial burden, it is no answer for the taxpayer to say "that information is privileged". Even if the taxpayer, when presenting its evidence, discloses some privileged information, the taxpayer must allow a fair and open cross-examination of that evidence. Where, during the cross-examination, the taxpayer claims privilege on matters that he or she led in examination-in-chief, a possible consequence is that the taxpayer will not establish a *prima facie* case.

In his reasons, Rip CJ endorsed another Tax Court decision, *Richard A. Kanan Corporation* (2011 DTC 1168), which also considered the deductibility of legal fees. In that case, Campbell J noted that adequate proof of the deductibility of legal fees will depend on the facts of each case, and that, in general, the taxpayer must present descriptions of the tasks undertaken by the lawyers and the fees for those tasks. Campbell J also concluded that disclosure of some privileged information to support the deductibility of legal fees does not mean that the taxpayer waives privilege over the entirety of the lawyer's file.

The sole witness for Dr. Mike Orth Inc. and 371501 B.C. Ltd. was Thomas Howard Olson, a lawyer in the law firm whose fees were in issue. He explained that, at the beginning of the taxpayers' fiscal years, the firm would determine anticipated services for the upcoming year and fix a fee. The firm did not have a precise method of allocating fees as to hours or percentage of work, but applied a "ballpark" method to allocate fees between work done for related entities such as the taxpayers and their shareholders. For Dr. Mike Orth Inc.'s 2003 year, for example, the firm was engaged to work on 16 different projects, and Mr. Olson suggested that 13 of the 16 should be billed to Dr. Mike Orth Inc. and the remaining three to its shareholders.

In examination-in-chief, Mr. Olson mentioned that the firm worked on projects relating to, among other things, corporate distributions and shareholder conflicts for Dr. Mike Orth Inc. However, Mr. Olson refused to answer questions on cross-examination about these projects on the basis that the information was privileged. Rip CJ noted other

problems with the evidence presented by Dr. Mike Orth Inc.: it did not present relevant documents such as financial statements, tax returns, and the minute book and there were mistakes in several invoices. For example, three invoices originally charged to Dr. Mike Orth Inc. were subsequently charged to its shareholders. Overall, Rip CJ found that Mr. Olson's evidence was not convincing (even though credibility was not in issue). Mr. Olson had not made inquiries of other lawyers at the firm to prepare for trial and could not recall a number of relevant facts. As a result, the Court concluded that Dr. Mike Orth Inc. had not made out a *prima facie* case for the majority of the legal fees claimed. The Court did allow Dr. Mike Orth Inc.'s appeal in part, permitting the deduction of fees that the Court concluded, on a balance of probabilities, related to tax advice, tax return preparation, and distributions to shareholders.

371501 B.C. Ltd. presented some additional evidence, including its income tax returns and financial statements, and Rip CJ found these materials helpful. For example, Mr. Olson stated that one invoice, claimed by 371501 B.C. Ltd. in its 2003 year, related one-third each to a share subscription, compensation, and dividends. Rip CJ was unable to find any evidence of a share subscription, but did find that compensation and dividends were paid. Accordingly, he allowed two-thirds of the deduction claimed. Mr. Olson acknowledged that some other invoices related to the sale of capital assets and, thus, should have been deducted from proceeds of disposition instead of being claimed on current account. In conclusion, the Court allowed 371501 B.C. Ltd.'s appeal in part, permitting the deduction of legal fees relating to compensation, dividends, and tax return analysis.

The taxpayers have appealed these decisions to the Federal Court of Appeal.

— *Jeffrey Love*

DRAFT LEGISLATIVE PROPOSALS RELEASED FOR PUBLIC COMMENT

On July 12, 2013, the Department of Finance released a package of draft legislative proposals to the *Income Tax Act* and the *Income Tax Regulations*, as well as to the *Excise Act Tax*; references to the "Announcement Date" in the explanatory notes and draft legislation refer to the date of July 12, 2013. The proposed technical changes relate to:

- the taxation of Canadian corporations with foreign affiliates (including changes to ensure that various rules apply appropriately to structures that include partnerships, changes to certain of the base-erosion rules, and new rules to ensure an appropriate income inclusion for "stub-year foreign accrual property income" on dispositions of foreign affiliate shares);
- the application of the "exempt surplus" rules to certain trusts resident in Australia in which a controlled foreign affiliate of a Canadian corporation has a beneficial interest;
- the circumstances under which government officials can confidentially alert law enforcement organizations to evidence of the commission of a serious crime based on taxpayer information (such as money laundering or terrorism financing); and
- the rules for determining the residence of international shipping corporations.

Interested parties are invited to provide comments by Friday, September 13, 2013 to:

Tax Policy Branch

Department of Finance

140 O'Connor Street

Ottawa, Ontario

K1A 0G5

Alternatively, comments may be submitted via email to: consultationTA2013-MT@fin.gc.ca.

SUPREME COURT OF CANADA — APPLICATIONS FOR LEAVE TO APPEAL DISMISSED

On July 11, 2013, the Supreme Court of Canada dismissed the application for leave to appeal in the case of *Ronald Ereiser v. Her Majesty the Queen*, 2013 DTC 5036 (FCA). The case concerned a taxpayer's appeal to vacate tax reassessments partly on the grounds that conduct of Canada Revenue Agency ("CRA") investigators had amounted to misfeasance of public office; the taxpayer alleged that investigators had used the threat of increased assessments to attempt to coerce him to plead guilty to criminal charges. The Tax Court of Canada held that it hadn't jurisdiction to

deal with misfeasance in public office leading up to an assessment, and accepted the Minister's position that a grossly inflated reassessment to coerce a guilty plea to a criminal charge was not a basis upon which the Tax Court of Canada could vacate an assessment. The Federal Court of Appeal affirmed the lower court's decision, found the Tax Court had made no error warranting intervention when the taxpayer's ground of appeal was so struck, and dismissed the taxpayer's appeal and the Crown's cross-appeal.

On July 11, 2013, the Supreme Court of Canada also dismissed the application for leave to appeal in the case of *Robert Ivan Tennant v. Her Majesty the Queen*, 2013 DTC 5054 (ABCA). The case concerned a taxpayer who had initially appealed several notices of assessment issued in July 1991, later abandoned these appeals, and ultimately filed a statement of claim against the Minister of National Revenue on section 15 Charter grounds of discrimination, i.e., that the CRA had assessed the tax liability of the taxpayer's business partner differently than the taxpayer's own tax liability. While a Master of the Alberta courts had denied the Minister's attempts to strike down the taxpayer's statement of claim, and while the Alberta Court of Queen's Bench ("ACQB") found it had inherent jurisdiction to hear the taxpayer's request for Charter relief, the ACQB ultimately struck down the claim as it found the taxpayer was not "able to provide the immutable personal characteristics that he possesses that are the basis for the differential treatment he claims". The Alberta Court of Appeal confirmed the ACQB's decision and additionally found the taxpayer's suit to be a collateral attack upon an administrative order — i.e., the assessments on which appeals had earlier been abandoned — and dismissed the taxpayer's appeal.

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