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SUPREME COURT OF CANADA: "TRUE INTENTION" OF PARTIES APPLIED TO RECTIFY WRITTEN AGREEMENTS

— Joseph Frankovic, Toronto

In the recent cases of *Services Environnementaux AES Inc. and Centre Technologique AES Inc.* and *Riopel et al.* (2013 DTC 5174), the Supreme Court of Canada ("SCC") considered the issue of whether the true and common intention of parties could form a legal contract and rectify the parties' written documents where they do not properly reflect this intention. The SCC held in favour of the taxpayers and found in the affirmative.

The *AES* case involved a share-for-share exchange that was intended to take place on a tax-deferred basis. Among other things, in order to achieve the tax deferral (a section 86 rollover under the federal *Income Tax Act*), the non-share consideration received on the transfer could not exceed the adjusted cost base ("ACB") of the transferred shares. Unfortunately, in this case, the ACB of the transferred shares was erroneously valued in the relevant documents as significantly higher than the actual ACB, such that the non-share consideration received on the transfer was higher than the actual ACB. As a result, Revenu Québec and the Canada Revenue Agency ("CRA") assessed the taxpayer in respect of the taxable capital gain arising from the transfer of the shares.

The *Riopel* case similarly involved a series of transactions that was meant to take place on a tax-deferred basis. In order to achieve the deferral, a sale of shares was meant to take place before an amalgamation of two corporations. However, owing to an error made by the taxpayers' tax advisers, the amalgamation took place before the sale of shares as set out in the relevant documents. Revenu Québec and the CRA subsequently assessed and added a taxable dividend to the income of one of the taxpayers (apparently, the dividend would have been a tax-free capital dividend, had the order of transactions been carried out as planned).

In both cases, the Quebec Court of Appeal held in favour of the taxpayers. The Quebec Court held that the true common intention of the parties was to carry out the transactions on a tax-deferred basis. The true intention was not properly recorded in the relevant documents, and under the civil laws of Quebec, it was open to the Court to correct the errors in the documents and give legal effect to the parties' true intention.

The Agence du Revenu du Québec appealed the decisions. The SCC dismissed the appeals and upheld the Quebec Court of Appeal judgments.

The SCC held that the contract between the parties in each case involved their true intention or "agreement of wills" that the transactions be carried out on a tax-deferred basis. This intention was not properly implemented and therefore was not consistent with the "declared will" of the parties in the relevant written documents. Since that intention

was not properly reflected in the written documents, it was open to the Quebec Court to remedy the errors of the documents and ascertain the intention of, and the actual contract between, the parties.

In terms of the level of specificity required in the intention of the parties, the SCC found that the parties intended to carry out the transactions "in such a way as to defer the tax liability associated with those transactions by following procedures provided for in tax legislation" (paragraph 36). The Court went on to comment that a taxpayer's intention to reduce tax in a transaction would not in itself form the basis of court intervention, at least under the civil laws of Quebec. That intention had to be accompanied by "a more precise and more clearly defined object". In the cases at hand, the Court found that the agreements between the parties "provided for obligations whose objects were sufficiently determinable". The agreements provided for "the establishment of determinate structures . . . that would, had they been drawn up properly, have made it possible to meet the objectives being pursued by the parties". Thus, according to the Court, the parties' intention in each case "had been clearly defined and related to obligations whose objects were determinate or determinable" (paragraph 54).

In this regard, in the previous *Juliar* decision dealing with the common law remedy of rectification (2000 DTC 6589), the Ontario Court of Appeal seemed to frame the intention requirement in more general terms. The Ontario Court allowed the rectification of a transaction by finding, among other things, that the taxpayers intended the transaction to occur "on a basis which would not attract immediate liability for income tax" (paragraph 19 of that decision). There was no discussion of further particulars, such as the intention to establish determinate structures.

The ratio of the SCC decisions does not apply directly to the common law remedy of rectification in income tax matters, simply because the decisions dealt with Quebec civil law regarding contracts rather than the common law of contracts (even though the law of contracts is substantially similar under both regimes). Still, the effect and result of the decisions mirrored that which could be provided under common law rectification. The SCC refused to consider the request of the Attorney General of Canada to rule on the "broadened" application of rectification under the common law that has developed since the Ontario Court of Appeal decision in the *Juliar* case. Arguably, then, *Juliar* remains the leading judicial authority on the common law remedy of rectification as it applies to income tax matters.

CAE INC. — A REVISIT OF THE CHANGE-IN-USE RULES

— Harriet Man, KPMG LLP

In *CAE Inc. v. Canada* (2013 DTC 5084), the Federal Court of Appeal ("FCA") ruled that the change-in-use rules under subsections 45(1) and 13(7) of the *Income Tax Act* (the "Act") apply when a capital property is converted into inventory, and *vice versa*. The decision, which goes against the decisions in older jurisprudence and the Canada Revenue Agency's ("CRA's") long-standing position, creates uncertainties for taxpayers. If the CRA were to strictly follow the decision, it could mean that taxpayers would have an income recognition event with resulting taxes payable when a property is converted from one income-earning purpose to another. This situation could cause undue hardship to taxpayers and in particular to real estate developers, because it normally takes several years to redevelop properties for sale.

The CRA's comments on the FCA decision at the 2013 Canadian Tax Foundation ("CTF") Conference Roundtable in November 2013 certainly give taxpayers some comfort on the CRA's assessing position on this matter. The CRA stated that, while it needs to take the Court's decision into account, it believes that the comments were *obiter dicta*, and thus the CRA will not change its administrative position. The CRA believes the FCA's decision to be inconsistent with the context and purpose of the rules. The CRA also believes that the decision would result in difficult compliance and administrative issues for taxpayers and the CRA. The CRA expects to have something to report on this matter in a few months. For now, its position remains as stated in IT-102R2 and it advises taxpayers not to "read too much into the case".

We can find indications of the underlying tax policy in several places. First, the 1994 and the 2001 Finance Technical Notes state that subsection 45(1) provides for a deemed disposition and reacquisition of property where its use is altered, wholly or in part, from a personal use to an income-earning or income-producing use, or *vice versa*. Although the Technical Notes do not have the force of law, they do offer valuable insights to the intention and operation of this legislation.

By way of history, section 45 was introduced by the 1971 Canadian tax reform when the capital gain and loss legislation first came into effect on January 1, 1972. It could be inferred from the commentaries published then that section 45 was intended to apply when principal residences are converted to commercial property, and *vice versa*. On page 31 of the "Summary of 1971 Tax Reform Legislation", Honourable E.J. Benson stated, "As a general rule, when a personal asset is converted to a business use, it would be treated as having been sold at its fair market value". Paragraph 279 of "Explanation of Canadian Tax Reform," published by CCH Canadian Limited in January 1972, provides similar commentary on how section 45 would apply when a personal residence was converted to a commercial use.

Second, section 45 is contained in subdivision c of the Act, which governs the calculation of taxable capital gains and allowable capital losses. If one were to accept that section 45 applies to a conversion of property from one income-earning use to another, a conversion and deemed disposition of inventory into income-producing capital property under subparagraph 45(1)(*a*)(i) would give rise to a taxable capital gain or an allowable capital loss (where the stop-loss rules would likely apply) and not regular income or loss, under subdivision c. In tax policy terms, this result does not seem to be logical.

Third, a subsection 45(2) election could be made to defer gain recognition if the property was acquired initially for some other purpose but is subsequently converted into income-producing capital property (subparagraph 45(1)(*a*)(i)). If "some other purpose" in this context includes holding inventory, only allowing a tax-deferred election under subsection 45(2) for a conversion from inventory to capital property and not from a capital property to inventory does not appear to be a logical result from a tax policy perspective. A logical explanation might be that the election is intended to grant relief from immediate taxation to taxpayers who have converted their personal-use properties (and not inventory) to commercial use. For an example of this interpretation of tax policy, see CCH Canadian Limited's "Explanation of Canadian Tax Reform" (1972).

Lastly, it should be noted that the operation of the change-in-use rules in sections 45 and 13 is slightly different. While section 45 mandates a deemed disposition and reacquisition when properties are converted from some other use to an income-producing use and *vice versa*, a deemed disposition only occurs when a depreciable property is converted from an income-producing use to some other use pursuant to paragraph 13(7)(*a*). When the depreciable property is converted from some other use to an income-producing use, paragraph 13(7)(*b*) only establishes the deemed acquisition cost of the converted depreciable property; the Act does not provide a deemed disposition on this type of conversion.

Before the FCA's decision in *CAE*, the tax community seems to have accepted that there is no provision in the Act that renders the conversion of income-producing capital property to inventory a taxable event. For example, the Wolters Kluwer CCH *Real Estate Income Tax Guide* states, "The jurisprudence is clear that when there is a conversion of income-producing capital property to inventory, the fair market value of the property at the time of the conversion becomes the cost of the inventory for the purposes of computing a trading profit on the subsequent disposition." (See ¶20-725, which cites, for example, *Pinehill Investments Limited v. M.N.R.*, 67 DTC 204 (TAB); *J. Bert Macdonald and Sons Limited v. M.N.R.*, 70 DTC 6032 (Ex. Ct.); *Highland-Young Associates Limited v. M.N.R.*, 81 DTC 531 (TRB); *Moluch v. M.N.R.*, 66 DTC 5463 (Ex. Ct.); *Roos et al. v. The Queen*, 94 DTC 1094 (TCC), and *Dawd v. M.N.R.*, 81 DTC 888 (TRB).)

It follows that on a subsequent disposition of the property, part of the gain will be on income account and the remainder on capital account, which is consistent with the CRA's position in IT-218R and IT-102R2.

Despite the CRA's statement at the CTF Conference that it will not change its administrative position, uncertainty remains because the FCA's interpretation of the legislation in *CAE* seems to produce a different result than the CRA's and the tax community's understanding of the underlying tax policy. As such, if another case went to court in the future, the results could be different from the CRA's administrative policy. It remains to be seen whether the Department of Finance will consider changes to the Act to provide more clarity on this matter for taxpayers.

DEPARTMENT OF FINANCE RELEASES DRAFT TECHNICAL LEGISLATIVE PROPOSALS

On January 9, 2014, the Department of Finance's Tax Policy Branch announced it was inviting comments on draft legislative proposals to require certain financial intermediaries to report to the CRA international electronic funds transfers of $10,000 or more. The reporting requirements, to be required beginning in 2015, are designed to combat international tax evasion and to address international aggressive tax avoidance. The request for comment is in conjunction with Finance Canada's release of its document "Explanatory Notes — Reporting of International Electronic Funds Transfers". The closing date for comment on the draft legislation is February 10, 2014, and input can be submitted via email to IEFT-TI@fin.gc.ca; or in writing to: Tax Policy Branch, Department of Finance, 140 O'Connor Street, Ottawa, Ontario, K1A 0G5.

CONSULTATION PAPER: PROPOSED REGISTRATION OF TAX PREPARERS PROGRAM

On January 17, 2014, the Minister of National Revenue invited comments on its proposed Registration of Tax Preparers Program, introduced as part of a new three-point plan to improve compliance and provide support to the small and medium-sized business community. The process consultation is open to everyone. The closing date for submissions is May 31, 2014 and comments can be submitted online at http://cra-arc.sondages-surveys.ca/s/RTPP-PIPDR/?l=en or in writing to: Registration of Tax Preparers Program Consultations, Canada Revenue Agency, Place de Ville, 806-8th Floor, Tower B, 112 Kent Street, Ottawa, Ontario, K1A 0L5.

INCOME TAX FOLIO S4-F3-C1, PRICE ADJUSTMENT CLAUSES

Effective January 14, 2014, the Canada Revenue Agency announced an update to Income Tax Folio S4-F3-C1, Price Adjustment Clauses. The update to the Folio — which replaces and cancels Interpretation Bulletin IT-169, Price Adjustment Clauses — addresses issues including use of a price adjustment clause, requirements governing the recognition of a price adjustment clause, and consequences arising from a price adjustment clause's application. Special applications of price adjustment clauses are also addressed, including interactions with share redemptions, estate freezes, butterfly reorganizations, and sales of accounts receivable.

2014 CORPORATE AND PERSONAL TAX RATE CHARTS

Charts have been added to the product for 2014 federal and provincial corporate income and capital tax rates, personal income tax rates, payroll taxes, and health premiums. These charts can be accessed from the "Quick Links" feature in the *Canada Income Tax Guide* table of contents on CCH Online and will be added to the DVD and to Volume 1 in print in a future update.

2014 AUTOMOBILE RATES AND LIMITS

On December 30, 2013, the Department of Finance released the automobile rates and limits for 2014, which remain unchanged from 2013. For vehicles acquired after 2013, the limit on the capital cost of passenger vehicles for purposes of capital cost allowance remains at $30,000, plus applicable federal and provincial sales taxes (Regulation 7307(1)); the limit on deductible leasing costs beneath the capital cost ceiling remains at $800 per month, plus applicable federal and provincial sales taxes (Regulation 7307(3)); and the maximum interest deduction for amounts borrowed to purchase an automobile remains at $300 per month (Regulation 7307(2)).

For 2014, the limit on tax-exempt allowances paid to employees for business use of the employee's vehicle that are deductible by employers will remain at 54 cents per kilometre for the first 5,000 kilometres and 48 cents for additional kilometres (Regulation 7306). For Yukon, Northwest Territories, and Nunavut, these figures will also remain at 58 cents and 52 cents, respectively. The rate for determining the operating expense taxable benefit for the personal portion of automobile expenses paid for by an employer will remain at 27 cents per kilometre (Regulation 7305.1). The rate for taxpayers employed principally in selling or leasing automobiles will also remain at 24 cents per kilometre.

CRA'S 2013 MEAL AND VEHICLE RATES

The Canada Revenue Agency has released the 2013 meal and vehicle rates that can be used by individuals to calculate meal and travel expenses for purposes of the northern residents' deduction, moving expenses, and transportation to obtain medical services. The flat rate meal amount remains at $17 per meal to a maximum of $51 per day. For the simplified method of calculating vehicle expenses, the 2013 per kilometre rates are shown in the chart below.

Province/Territory	*Kilometre*
Alberta	51.5
British Columbia	51.0
Manitoba	47.5
New Brunswick	49.5
Newfoundland and Labrador	53.0
Northwest Territories	58.5
Nova Scotia	51.0
Nunavut	58.5
Ontario	55.0
Prince Edward Island	50.5
Quebec	57.0
Saskatchewan	45.5
Yukon	63.5

FOCUS ON CURRENT CASES

This is a regular 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.

Disallowed Business Losses from a Partnership Formed Strictly for Personal Reasons

***Bouchard v. The Queen*, 2013 DTC 1203 (Tax Court of Canada)**

In this case, the taxpayer was the father of a tremendously gifted 19-year-old athlete. Indeed, the taxpayer's daughter was an extraordinary talented tennis player enjoying a very promising career.

At the time his daughter was nine years old, the taxpayer conceived a business venture through which he raised funds and attempted to defray costs related to the development of his daughter's tennis talent. The taxpayer formed a limited partnership whereby he would be able to attract investors with the promise of sharing his daughter's income stream once she became a professional player. It was proposed that investors would receive a portion of the taxpayer's daughter's future tennis earnings after she became professional.

Even though the stated purpose of the partnership was to promote junior tennis and financially assist promising young players, the taxpayer admitted that the partnership's mission was to finance one athlete in particular, his daughter.

The contributions to the partnership and the equity in the partnership varied from year to year depending on the total funds individual partners had contributed. The taxpayer then funnelled the expenses incurred for his daughter through the partnership and claimed a deduction in his income tax returns.

The Minister disallowed the taxpayer's deduction of his losses from the partnership under reassessments for his 2005 to 2007 taxation years.

The Minister claimed that the expenses of the partnership were completely personal in nature since the taxpayer's daughter was the sole beneficiary of the enterprise. Moreover, it was also argued that the expenses were not deductible because the partnership did not have a source of income against which expenses could be deducted pursuant to the *Income Tax Act*. The Minister additionally submitted that the taxpayer did not demonstrate a pursuit of profit or a reasonable expectation of profit by the partnership in relation to the enterprise. Finally, the Minister advanced that the relationship between the partnership and the taxpayer's daughter was more in the nature of a loan than it was in the nature of a business venture.

The Tax Court (per Masse J) first pointed out the well-known principle that a taxpayer can arrange his or her affairs in such a way as to minimize the payment of taxes. Even though a taxpayer enters an arrangement with the principal object of creating tax deductions, this does not mean that the arrangement was not for the purposes of earning revenue. Therefore, the Court stressed that a taxpayer can enter a partnership with the primary motivation of securing a tax loss but there must at least be an ancillary intention to carry on business in common with the view of profit.

The Court then determined that the key issue to be determined in this appeal was whether the partnership was carrying on business with a view to profit. Relying on the Supreme Court's decision in *Stewart v. Canada*, 2002 DTC 6969, Mr. Justice Masse concluded that the taxpayer had to establish that his predominant intention was to make a profit from the partnership and that the partnership was carried out in accordance with objective standards of businesslike behaviour.

The Court found that the taxpayer was not looking at the partnership as a source of profit, but was instead looking for a means to finance his daughter's development as a tennis player based on the following factors:

(1) The objects of the partnership did not speak of profits;

(2) The business losses claimed by the taxpayer were completely, in the Court's view, personal in nature and as such were not deductible pursuant to paragraph 18(1)(*h*);

(3) The manner in which the partnership was operated was not for the purpose of earning income from a business activity and it was only operated in such a way as to create tax deductions;

(4) The partnership's purported source of income was totally dependent on the taxpayer's daughter's goodwill and willingness to voluntarily share her future income once she turned professional. There was no way to oblige the taxpayer's daughter to repay the partnership for the moneys that were expended on her behalf;

(5) The partnership had no source of revenue since any future potential revenues would not be earned by the partnership but would be earned by the taxpayer's daughter;

(6) Any equipment, financial support, or winnings received by the taxpayer's daughter during the taxation years were not reported as revenue by the partnership;

(7) There was no effort made to sign up any other athletes to share their future income stream. There was no search for other talent, even though the purpose of the partnership was the promotion of junior tennis; and

(8) The partnership had no operating costs other than banking expenses.

Having found that the predominant purpose and intention was personal in nature, the Court dismissed the taxpayer's appeal.

This case offers an interesting application of the Supreme Court's teachings in *Stewart* and reaffirms that in its expanded form, the test as set out by the Supreme Court implies that a taxpayer must not only demonstrate that he or she intended to carry on an activity for profit but also that his or her predominant intention was to make a profit from an activity being carried out in accordance with objective standards of businesslike behaviour.

— *David Roulx*

RECENT CASES

Reversionary trust rules did not apply; dividend paid to family trust not a non-taxable intercorporate dividend to beneficiaries

The taxpayer was a family trust ("Brent Trust") established for the benefit of K, his family, and an operating company ("OPCO"). Brent Trust held common shares in a separate, related holding company ("Holdco"), and K held the preferred shares of Holdco. OPCO declared a dividend in the amount of $245,000, payable to a second family trust ("Kern Trust"), of which Holdco was a beneficiary. Kern Trust allocated the dividend to Holdco. Holdco declared a dividend in the same amount to Brent Trust as the common shareholder of Holdco. The taxpayer reported no income from the dividend declaration on the basis that OPCO, a beneficiary of Brent Trust, was the transferor of the dividend and an enduring beneficiary triggering subsection 75(2) attribution rules. As the dividend was an intercorporate dividend under section 112, it was treated as a tax-free receipt. K was then paid the dividend from his preferred shares in OPCO and subsequently lent the money back to OPCO. Similar transactions took place in 2006 in the amount of $155,000. The Minister disallowed the taxpayer's claim because subsection 75(2) did not apply, and also because of the general anti-avoidance rule ("GAAR") and the alleged abuse of the relevant subsection.

The taxpayer's appeal was dismissed. Subsection 75(2) did not apply, because the taxpayer purchased the subject shares for valuable consideration from OPCO. Accordingly, the dividend was not attributable to OPCO but instead remained to the benefit and for the account of the taxpayer. The GAAR issue was moot as subsection 75(2) did not apply.

Brent Kern Family Trust, 2013 DTC 1249

Relocating expenses not eligible as taxpayer still worked for same employer at same location

The taxpayer claimed moving expenses of $8,502 in 2010 under subsection 62(1) of the *Income Tax Act*. She sold her home and moved 70 kilometres to Edmonton to keep her job with her employer and continue to earn employment income. The Minister disallowed the claim because the taxpayer did not move to earn income from employment at a new work location.

The taxpayer's appeal was dismissed. There was no evidence that the taxpayer's physical work location had changed or that there was an "eligible relocation" because she performed new duties with the same employer at the same business location.

Langelier, 2013 DTC 1256

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