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CAN TRANSFER PRICING RULES BE APPLIED TO AN ARM'S LENGTH SALE?

— Irina Oks and Travis Chalmers,[1] Richter LLP (Montreal)

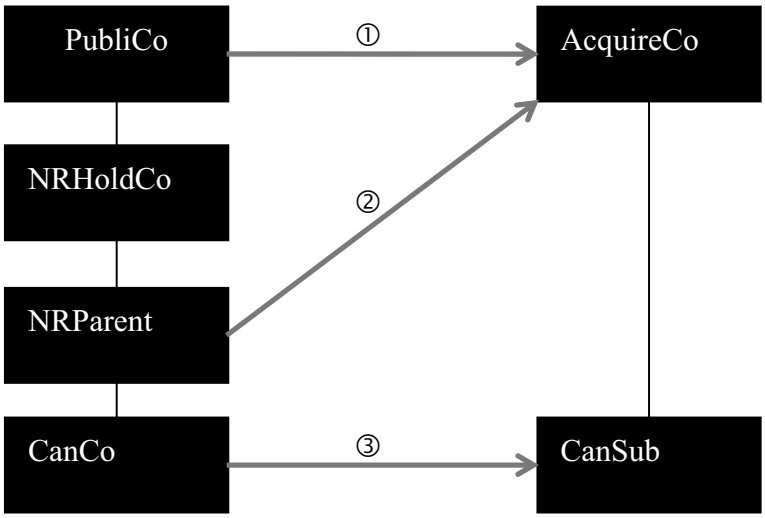
On November 15, 2013, the Canada Revenue Agency ("CRA") released Technical Interpretation No. 2013-0478621I7, "Transfer of intangibles — Transfer pricing adjustments" ("TI"), in response to a question relating to a sale of a multinational group's business division[2] to an arm's length multinational purchaser. The CRA concluded that transfer pricing rules can apply to an arm's length sale of a business in such a situation.

Facts

A US-based public company ("PubliCo") and its subsidiaries, including an indirect Canadian subsidiary ("CanCo"), sold a business division to an arm's length multinational whose parent company, AcquireCo, was a non-resident of Canada.

As part of the arrangement, CanCo transferred the division's assets to a Canadian subsidiary of AcquireCo ("CanSub") at book value (transaction (3)). PubliCo received from AcquireCo all amounts that exceeded the portions of the consolidated sale price paid to Publico's subsidiaries (transactions (1) and (2)).[3]

The figure below depicts the transactions that occurred.



PubliCo subsequently considered that an insufficient portion of the purchase price was allocated to CanCo's intangibles, and therefore wished to make a retroactive adjustment to reflect the increased value of the Canadian division upon its sale. The group's representative therefore asked the CRA what the effects of a failure to allocate would be if the initial allocation (based on book value going to CanCo) had been incorrect, and under what tax rules the CRA would make an adjustment.[4]

The CRA considered several provisions of Canada's *Income Tax Act* (the "ITA") that may be applicable in this situation. First, the CRA considered the applicability of subsection 69(4) of the ITA, which deals with shareholder appropriations. The application of subsection 69(4) requires that property of a corporation be appropriated to a shareholder or for its benefit. Since PubliCo is not a direct shareholder of CanCo, subsection 69(4) is not applicable.[5]

After considering several other provisions of the ITA, the CRA concluded that the adjustment would be made pursuant to Canada's transfer pricing rules, which were best suited to the situation at hand. However, the CRA did not elaborate on the mechanics of the adjustment (i.e., which transaction would be adjusted). This conclusion raises a number of issues which should be on the radar of any multinational group which has as members Canadian entities. After a brief review of the legal principles applicable to these facts, we address some of these issues.

Overview of the Law

Section 247 of the ITA provides the transfer pricing rules for transactions between a taxpayer and a non-resident person with whom the taxpayer does not deal at arm's length. In particular, paragraphs 247(2)(*a*) and (*c*) require the CRA to adjust the transfer price between a taxpayer and a non-resident person with whom the taxpayer does not deal at arm's length if certain conditions are met:

> 247(2) Where a taxpayer [. . .] and a non-resident person with whom the taxpayer [. . .] does not deal at arm's length [. . .] are <u>participants in a transaction or series of transactions</u> and
>
> (*a*) the terms or conditions made or imposed, in respect of the transaction or series, between <u>any of the participants</u> in the transaction or series differ from those that would have been made between persons dealing at arm's length [. . .],
>
> any amounts that [. . .] would be determined for the purposes of this Act in respect of the taxpayer [. . .] for a taxation year or fiscal period shall be adjusted [. . .] to the quantum or nature of the amounts that would have been determined if,
>
> (*c*) where only paragraph (a) applies, the terms and conditions made or imposed, in respect of the transaction or series, <u>between the participants in the transaction or series</u> had been those that would have been made <u>between persons dealing at arm's length</u> [. . .].

Note that reference is made in subsection 247(2) to the concept of a "series of transactions". The rules would adjust a transaction where the non-arm's length parties are "participants" in the series. That is, if some participants are arm's length and some are not, the transfer pricing legislation might apply. The term "series of transactions" is defined as being "deemed to include any related transactions or events completed in contemplation of the series"; the case law surrounding the term results in it being applied in an expansive manner that can include future and past transactions.[6] The inclusion of the "series of transactions" concept in the legislation, combined with the wording of the remainder of the provision, introduces ambiguity that requires multinationals entering into group-wide transactions to tread carefully. Theoretically, where the majority of participants in a series of transactions deal at arm's length but only two do not, the series could be caught by section 247 and any transaction in the series could be adjusted by the CRA. Therefore, even though CanCo and CanSub deal at arm's length, CanCo, CanSub, and Publico may be viewed as participants in a series of transactions and therefore be subject to section 247. This will be discussed in further detail below.

Moreover, Information Circular 87-2R[7] ("IC") provides the CRA's interpretation of the Canadian transfer pricing rules. For example, paragraph 13 of the IC notes that "[w]here the terms or conditions of controlled transactions differ from those that would have been made between persons dealing at arm's length, [subsection 247(2) applies]". In this context, the IC defines "controlled transactions" as "transactions between parties not dealing at arm's length". If the CRA were to apply this interpretation as though it were law, then transaction (3) would not be considered a "controlled transaction"— it would be one entered into between parties dealing at arm's length.

Analysis

As described above, the CRA may adjust a transaction or series where it considers that the terms and conditions "made or imposed" would not have been entered into between parties dealing at arm's length.

Based on the facts described in the TI, every transaction in the series has been entered into between parties dealing at arm's length. Any non-arm's length parties involved are "participants" in a series of transactions, with no actual transactions between them. That is, there are three separate transactions described, each between one entity in the PubliCo group and one entity in the AcquireCo group, being transactions (1), (2), and (3).

The most obvious transaction out of the three to be adjusted on these facts is the one between CanCo and CanSub. This assumes that the language of subsection 247(2) can be applicable to an arm's length sale between two Canadian corporations who deal at arm's length. Presumably, the CRA would adjust transaction (3) to increase the purchase price of CanCo's assets. This would be on the basis that the two groups' parents "imposed" non-arm's length terms and conditions, in the context of a "series of transactions" in which some of the "participants" in the series (e.g., the respective members of each group) did not deal at arm's length.

There are a few issues with such a potential adjustment. First, the arm's length purchaser might not, in all cases, be interested in paying a higher price for those assets. A request by CanCo to adjust the purchase price subsequent to a transfer pricing adjustment could fall on deaf ears. Unless the CRA assesses both Canadian taxpayers for the transfer pricing adjustment (one to each of CanCo and CanSub), double taxation could eventually arise. For example, where the CRA adjusts CanCo's proceeds of disposition but not the purchase price of CanSub, CanSub's cost basis in the purchased assets would be lower; this could give rise to double taxation on disposition by CanSub of the purchased assets.

Second, such a transfer pricing adjustment would be made between two Canadian taxpayers, instead of the typical adjustment between one Canadian taxpayer and one non-resident. It is perhaps counterintuitive that a transfer pricing adjustment would be made between two Canadian taxpayers dealing at arm's length, pursuant to a rule aimed at preventing non-arm's length terms and conditions in cross-border transactions. The CRA could potentially assume that the Canadian companies are acting with one mind or colluding on the transaction price via the "participants in a series of transactions" concept included in the legislation. Under Canadian law, CanCo would have the burden of disproving that assumption.

Another potential adjustment, arguably more in line with usual transfer pricing policy, would be for the CRA to impute the existence of a transaction between the related parties CanCo and PubliCo, wherein the additional remuneration to which CanCo is entitled would be received from Publico. This option, however, is challenging for the CRA to pursue since it requires that the CRA "recharacterize" a transaction into existence pursuant to paragraphs 247(2)(*b*) and (*d*). The law requires that the series of transactions being recharacterized "would not have [been] entered into" between parties dealing at arm's length. For obvious reasons, this would be difficult to demonstrate on the facts described in the TI: the two groups are, in fact, dealing at arm's length and have entered into the transactions in question.

Conclusion

One potential implication of this TI is that the CRA may begin challenging purchase price allocations in the context of business arrangements between multinational groups dealing with one another at arm's length. Therefore, as a part of their transfer pricing compliance activities, multinational groups doing business in Canada should consider a careful review of the valuation assumptions they make for purchase price allocations, even when the arrangement is between two arm's length groups. This review should be done before the agreements are concluded, so as to avoid having to adjust the purchase price allocation after the fact and risk double taxation on income earned in Canada.

Notes:

[1] Irina Oks holds a Master's degree in economics and has practised in transfer pricing in Israel and Canada. Travis Chalmers is an Ontario lawyer, advising clients from a variety of industries on Canadian domestic and international tax.

[2] The TI refers to a sale of two business divisions under nearly identical circumstances. For the purposes of this article, the authors treat these as a single division.

[3] There is no information on Transaction (2), which is not relevant for this analysis.

[4] Depending on the situation of CanSub, it could also be in its interest to have a higher cost basis in the transferred assets, to allow increased depreciation expenses.

[5] If the fact pattern were different, and Publico was a direct shareholder of CanCo, a potential adjustment could have been made under subsection 69(4) to increase the value attributable to CanCo's assets.

[6] For a detailed discussion of the meaning of the term "series of transactions" in Canada, see the following cases: *OSFC Holdings Ltd. v. R.*, 2001 FCA 260; and *Copthorne Holdings Ltd. v. R.*, 2012 DTC 5007 (SCC).

[7] IC 87-2R, International transfer pricing, issued September 27, 1999.

CORPORATION CONTROLLED BY MAJORITY-INTEREST PARTNER OF PARTNERSHIP

The Canada Revenue Agency ("CRA") was asked if a corporation and a partnership would be considered affiliated with each other within the meaning of paragraph 251.1(1)(*d*) of the *Income Tax Act* (the "Act") if the corporation was controlled by a single person who was the "majority-interest partner" (as defined in subsection 248(1) of the Act) of the partnership. The taxpayer considered that they were not affiliated because the corporation was controlled by only one person instead of a group of persons. The CRA agreed with the taxpayer's conclusion, noting that this was supported by the current case law in the *Southside Car Market Ltd. v. The Queen* (82 DTC 6179) and *Leslie Emory v. The Queen* (2010 DTC 1074) decisions. However, the corporation and the partnership could still be considered "affiliated persons" under paragraph 251.1(1)(*e*) or subparagraph 251.1(1)(*b*)(i) of the Act. In the first instance, this affiliation could be based on the definition of "majority-interest partner" in subsection 248(1) of the Act, which could be broadened by using the concept of "affiliated persons". Since the corporation would be clearly affiliated under subparagraph 251.1(1)(*b*)(i) of the Act to the shareholder controlling it and this shareholder would also hold a majority interest in the partnership, the corporation would be considered a partner holding a majority interest in the partnership. The corporation and the partnership would therefore be considered to be affiliated to each other under paragraph 251.1(1)(*e*) of the Act. Note that the notion of control referred to in subsection 251.1(1) of the Act covers not only the *de jure* but also the *de facto* control (see subsections 251.1(3) and 256(5.1)). Therefore, if it was proven that the partnership had a *de facto* control over the corporation, they could also be considered affiliated under subparagraph 251.1(1)(*b*)(i) of the Act.

— *External Technical Interpretation, Reorganizations Division, January 15, 2014, Document No. 2013-0515651E5*

SMALL BUSINESS CORPORATION — FUTURE INCOME TAX ASSETS

The Canada Revenue Agency ("CRA") was asked if a future income tax asset ("FITA"), as the expression is defined in Chapter 3465 of the CICA Manual, was considered an asset used principally in an active business carried on in Canada for the purpose of defining "qualified small business corporation share" ("QSBCS") in subsection 110.6(1) and "small business corporation" ("SBC") in subsection 248(1) of the *Income Tax Act*.

The CRA confirmed that a FITA was not an asset considered for those definitions which reversed a previous position of the CRA (i.e., answer to Question 29 of the Federal Taxation Roundtable at the 2008 APFF Annual Conference). A FITA must therefore be ignored to determine if a share is a QSBCS or if a corporation is an SBC. If a FITA becomes an income tax receivable ("ITR"), the ITR will be considered to determine if a share is a QSBCS or if a corporation is an SBC. This will be the case if the ITR is derived from the operation of an active business.

Since the CRA considers that there is no real difference between a FITA under Chapter 3465 of the CICA Manual and a deferred income tax asset ("DITA") under the IAS 12, the above position is also valid for a DITA. A DITA is also therefore ignored to determine if a share is a QSBCS or if a corporation is an SBC.

— *External Technical Interpretation, Business and Employment Income Division, July 17, 2013, Document No. 2012-0473261E5*

FEDERAL GOVERNMENT INTRODUCES BUDGET BILL C-31

On March 28, 2014, the federal government introduced Bill C-31, *Economic Action Plan 2014 Act, No. 1*. In addition to income tax measures contained in the March 24, 2014 Notice of Ways and Means Motion ("NWMM"), Bill C-31 also contains amendments regarding the Canada-US Enhanced Tax Information Exchange Agreement (February 5, 2014 proposals), electronic funds transfers (January 9, 2014 proposals), the CRA's offshore tax informant program and communication of taxpayer information (July 12, 2013 proposals), and labour-sponsored venture capital corporations (November 27, 2013 proposals). Some of the measures from the tabled NWMM include:

- increasing the maximum amount for the adoption tax credit (NWMM clause 6, Budget 2014 Resolution 1);
- expanding the expenses eligible for the medical expense tax credit (NWMM clause 10, Budget 2014 Resolution 2);
- introducing the search and rescue volunteers tax credit (NWMM clauses 7 and 8, Budget 2014 Resolutions 3–6);
- extending the mineral exploration tax credit for flow-through shares (NWMM clause 18, Budget 2014 Resolution 7);

- doubling the carryforward period for donations of ecological land to conservation charities (NWMM clause 5, Budget 2014 Resolutions 30 and 31);
- reducing the maximum number of required source-deduction payments for certain employers (NWMM clause 33);
- modifying pension transfer limits pertaining to underfunded pension plans (NWMM clause 36);
- deeming certified cultural property acquired under a tax shelter to be gifted at the lower of fair market value and acquired cost base (NWMM clause 30, Budget 2014 Resolution 33); and
- requiring the Minister of Finance to table annually a list of outstanding tax measures (NWMM clause 31).

A copy of CCH *Special Report* No. 079H, which contains the Notice of Ways and Means Motion and Explanatory Notes, may be ordered by calling (416) 224-2248 (toll-free 1-800-268-4522), by faxing (416) 224-2243 (toll-free 1-800-461-4131), or by emailing cservice@cch.ca.

DEPARTMENT OF FINANCE RELEASES DRAFT LEGISLATION

On April 8, 2014, the Department of Finance released draft legislative proposals and explanatory notes relating to the Canadian film and television production tax credit. This draft legislation reintroduces proposed amendments from former Bill C-10 from 2007, with minor revisions. Other proposals include technical amendments to GST/HST legislation. The closing date for comment on the draft legislation is May 8, 2014, and input can be submitted via email to ConsultationTA2014-MT@fin.gc.ca, or in writing to Tax Policy Branch, Department of Finance, 140 O'Connor Street, Ottawa, Ontario, K1A 0G5.

A copy of CCH *Special Report* No. 080H, which contains the Draft Legislation and Explanatory Notes, may be ordered by calling (416) 224-2248 (toll-free 1-800-268-4522), by faxing (416) 224-2243 (toll-free 1-800-461-4131), or by emailing cservice@cch.ca.

YUKON BUDGET

The 2014 Yukon Budget was tabled on March 25, 2014. The Budget contained one tax change, reducing the small business tax rate from 4% to 3%. The Budget documents are posted on the provincial News Tracker on CCH Online and are also available in the Budgets category under the provincial tax reporters online and on DVD. The CCH commentary on the Budget is available in the *Alberta and Territories Tax Reporter* online and on DVD, under the heading Budgets.

NEWFOUNDLAND AND LABRADOR BUDGET

The 2014 Newfoundland and Labrador Budget was tabled on March 27, 2014. The Budget contained several tax-related measures, including:

- reducing the small business corporate income tax rate from 4% to 3%, effective July 1, 2014;
- decreasing the provincial dividend tax credit rate for non-eligible dividends from 5% to 4.1%, and for eligible dividends from 11% to 5.4%, also effective July 1, 2014;
- increasing income thresholds for the low-income tax reduction, such that in 2014 provincial income tax will be eliminated for individuals with net income up to $18,547 and for families with net income up to $31,362; and
- increasing the annually paid Newfoundland and Labrador seniors' benefit to a maximum of $1,036.

The Budget documents are posted on the provincial News Tracker on CCH Online and are also available in the Budgets category under the provincial tax reporters online and on DVD. The CCH commentary on the Budget is available in the *Atlantic Tax Reporter* online and on DVD, under the heading Budgets.

NOVA SCOTIA BUDGET

The 2014 Nova Scotia Budget was tabled on April 3, 2014. The Budget contained one main tax change, the elimination of the post-secondary graduate retention rebate for the 2014 and subsequent years. While the Budget also indicated an intention to expand the provincial child tax benefit, few details about this were provided. The Budget documents are posted on the provincial News Tracker on CCH Online and are also available in the Budgets category under the provincial tax reporters online and on DVD. The CCH commentary on the Budget is available in the *Atlantic Tax Reporter* online and on DVD, under the heading Budgets.

PRINCE EDWARD ISLAND BUDGET

The 2014 Prince Edward Island Budget was tabled on April 8, 2014; it contained no new tax increases or other tax measures. The Budget documents are posted on the provincial News Tracker on CCH Online and are also available in the Budgets category under the provincial tax reporters online and on DVD. The CCH commentary on the Budget is available in the *Atlantic Tax Reporter* online and on DVD, under the heading Budgets.

CRA PUBLICATIONS REVISED

- On April 8, 2014, the Canada Revenue Agency ("CRA") released IC 00-1R4, Voluntary Disclosures Program. The information circular cancels and replaces the previous IC 00-1R3.
- Effective April 9, 2014, the CRA released updates to Income Tax Folio S1-F3-C2, Principal Residence. The updates to the Folio include general revisions to enhance readability and are detailed in the Folio's "Chapter History".
- Information Circular IC 89-2R3, Directors' liability, dated April 10, 2014, has been updated. This circular outlines the liability of corporate directors where a corporation fails to deduct, withhold, remit, or pay tax.
- Information Circular IC 97-2R14, Customized forms, dated March 3, 2014, has been revised for a correction. This circular sets out guidelines for approval and filing of customized returns and forms.

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.

Federal Court of Appeal Upholds Tax Court's Decision To Deny Capital Dividends

***Groupe Honco Inc. v. The Queen*, 2014 DTC 5006 (Federal Court of Appeal)**

In this case, the Federal Court of Appeal ("FCA") upheld a decision of Justice Boyle of the Tax Court affirming assessments for the 2004 taxation year in which the Minister applied the anti-avoidance rule in subsection 83(2.1) of the *Income Tax Act* (the "Act") to treat certain capital dividends as taxable dividends in respect of three related companies, Groupe Honco Inc. ("Groupe Honco"), 9069-4654 Quebec Inc. ("New Supervac"), and Gastion Paul Lacasse Inc. ("Gastion").

Pursuant to subsection 83(2) of the Act, where a dividend becomes payable by a private corporation to its shareholders and the corporation makes the prescribed election, the dividend is deemed to be a capital dividend to the extent of the corporation's capital dividend account. Such dividend will be not be included in the recipient shareholder's income. When, however, the dividend was received by a shareholder in a transaction or as part of a series of transactions where "one of the main purposes" was to receive the capital dividend, subsection 83(2.1) of the Act operates to deem the dividend to be a taxable dividend.

In 1997, Groupe Honco, a Quebec construction company, began construction on a $600,000 building for 9075-7207 Quebec Inc. ("Old Supervac"), a manufacturer of high-pressure vacuum trucks. Before construction was completed, Old

Supervac experienced significant financial difficulties. When it became clear that Old Supervac did not have the financial means to complete the transaction as originally contemplated, Mr. Lacasse, the principal of the Groupe Honco companies, and Mr. Bédard, the principal of Old Supervac, agreed that Groupe Honco would lease the building to Old Supervac. During this time, Mr. Bédard was diagnosed with terminal cancer and had to withdraw from the daily management of his business.

After Mr. Bédard's death in May 1999, Old Supervac received proceeds as a beneficiary of a life insurance policy taken on Mr. Bédard's life, which proceeds gave rise to an addition to the company's capital dividend account. Some of the proceeds were paid by Old Supervac as capital dividends to Mr. Bédard's widow in October and November 1999. Over the same months, New Supervac, a wholly owned subsidiary of Groupe Honco, acquired the business and assets of Old Supervac. It also acquired an option to purchase the issued and outstanding shares of Old Supervac. In November 1999, New Supervac exercised its option and purchased the outstanding shares of Old Supervac. The two companies were amalgamated in 2001 to allow New Supervac to deduct Old Supervac's tax losses. In 2004, New Supervac declared a capital dividend to Groupe Honco, which in turn declared a capital dividend to its sole shareholder, Gastion. Gastion then declared a capital dividend to Mr. Lacasse.

At trial, the Tax Court found that one of the main purposes of New Supervac's purchase of the outstanding shares of Old Supervac was to use the company's capital dividend account. On this basis and pursuant to subsection 83(2.1), Boyle J held that the dividends at issue were to be treated as taxable dividends and not capital dividends.

At the FCA, the appellants advanced several arguments. First, the appellants relied on *Copthorne Holdings Ltd.* (2012 DTC 5007 (SCC)) to argue that too much time had passed between the various transactions for them to be considered a series. In the alternative, the appellants contended that the Tax Court should have considered as part of this series of transactions the initial negotiations of the construction of the building for Old Supervac in 1997 and, as a result, placed too much emphasis on New Supervac's purchase of Old Supervac's shares. Finally, the appellants claimed that the Tax Court judge erred by requiring an inordinately high evidentiary threshold to refute the Minister's assumptions of fact. As such, the appellants contended that the Tax Court should not have concluded that New Supervac acquired the Old Supervac shares for the purpose of benefiting from the company's capital dividend account. In particular, the appellants took issue with the trial judge's view that contemporaneous corroborative evidence from written documents or from third parties was important in proving a lack of intention to purchase the Old Supervac shares for the purpose of accessing the capital dividend account.

The FCA dismissed the appellants' arguments. The Court was of the view that the appellants' reliance on *Copthorne* was misplaced. Not only did *Copthorne* deal with a different provision in the Act, namely, the general anti-avoidance rule in section 245, the Supreme Court of Canada in that case stated that the length of time between transactions "may" be relevant in determining whether a particular transaction was part of the same series of transactions; however, the length of time between transactions is not definitive in such a determination. Accordingly, the FCA saw no reason to overturn the trial judge's finding of fact that the purchase of Old Supervac shares by New Supervac formed part of the series of transactions that included the payment of the capital dividend in 2004.

It was acknowledged by both the Tax Court and the FCA that Groupe Honco had several "main purposes" in acquiring the Old Supervac shares. The purposes accepted by the Courts were as follows: (1) to permit Groupe Honco to recover the costs of the building; (2) to permit the vacuum business to be carried on by New Supervac without a need for new third-party certification; and (3) to permit the use of Old Supervac's tax losses.

The FCA remarked that the "[t]he phrase 'one of the main purposes' is unambiguous and implies that a taxpayer may have more than one main motive in acquiring the shares". In this case, the Tax Court found that the appellants did not discharge their burden of demonstrating that the acquisition of the capital dividend account and the receipt of tax-free dividends was not one of the main purposes of the purchase of the Old Supervac shares. The taxpayer had the initial onus of "demolishing" the assumptions of the Minister. If this condition had been met, the onus would have shifted to the Minister, who would then have had to rebut the taxpayer's evidence and prove, on a balance of probabilities, the validity of her assumptions.

The FCA found "baseless" the appellants' criticism of the trial judge's requirement for third-party or written corroborative evidence to prove a lack of intention to purchase the Old Supervac shares in order to use the company's capital dividend account. The FCA reiterated that "where purpose or intention is to be ascertained, it must not be supposed that courts will be satisfied with only the taxpayer's statements, *ex post facto* or otherwise, as to the

subjective purpose of a particular transaction". The trial judge noted that Groupe Honco's lawyer involved in structuring the share purchase did not testify at trial. The absence of key testimony and written documentation, such as Old Supervac's financial statements, which would have shed light on the appellants' intentions, left it open to the trial judge to draw an adverse inference against the appellants. As a result, the trial judge was not satisfied that the capital dividend account did not have a role in New Supervac's acquisition of Old Supervac. The FCA found there was no error in the trial judge's reasons to justify allowing the appeal.

This case illustrates the potentially broad scope of subsection 83(2.1). Despite the fact that there were several main purposes for the transactions at issue that were unrelated to the capital dividends, which in this case, included the recovery of Groupe Honco's costs of the building and the maintenance of a critical third-party certification, subsection 83(2.1) still applied to treat the capital dividends as taxable dividends.

— *Jeremy Ho*

Consequences of Failing To Provide Information and Documents, and of Ignoring a Compliance Order of the Federal Court

***MNR v. Vallelonga*, 2014 DTC 5011 (Federal Court)**

Upon the failure of a taxpayer to provide information and documents relating to an audit, the Minister sought and, in the reasons in this matter, obtained an Order of contempt from the Federal Court requiring that the taxpayer, within 60 days of the Order: (1) pay a fine and costs; and (2) provide the demanded information and documents. Under the Order, the taxpayer stood to be imprisoned if he did not both: (1) provide the information and documents; and (2) pay the fine and costs.

The facts leading to this Order of contempt are summarized in the paragraphs that follow.

In November 2011, the Minister issued a lengthy requirement for information and documents relating to an audit of the taxpayer for possible unreported income. The requirement was ignored. Several months later, in May 2012, the Minister obtained from the Federal Court a compliance order demanding the requested information and documents. The compliance order was also ignored.

In February 2013, the Minister sought an order of contempt of Court against the taxpayer for ignoring the compliance order. Under Rule 468 of the Federal Court Rules, before a person can be found guilty of contempt there must be a hearing during which the contempt must be proved beyond a reasonable doubt and at which the person may present any defences that he or she may have.

In November 2013, at the hearing which led to the Order of contempt being issued, the Minister established that the taxpayer had not provided the information and documents, had ignored many requests for the information and documents, and had full knowledge of the compliance order. The taxpayer acknowledged his failure to provide the information and documents, and undertook to provide them within 60 days of the Court's order. The Court determined that the taxpayer was fully aware of his obligations under the compliance order. The Court found that the taxpayer's failure to comply was sufficient to establish beyond a reasonable doubt that the taxpayer was guilty of contempt of court.

The question then turned to the appropriate penalty for the taxpayer's contempt. Under Rule 472, the Court has the power to order the payment of a fine and/or costs, in addition to ordering imprisonment of up to but less than five years. The Crown sought an order for $17,732 in fines and solicitor-client costs. In addition, the Crown sought imprisonment of the taxpayer for up to three years if, within 60 days, the taxpayer failed to pay the fine and costs or to provide the information and documents.

In considering the appropriate penalty, the Court considered the taxpayer's undertaking to provide the information and documents within 60 days to be a mitigating factor suggesting a reduced punishment. However, the Court found that the taxpayer's continuous failure to provide the information and documents despite being aware of his legal obligation to do so was an aggravating factor. Ultimately, the Court concluded that the Crown's requested order, as varied very slightly by the Court, was reasonable and proportionate to achieve the goal of ensuring compliance with the Order of the Court.

This case is a good reminder of the Minister's powers when seeking information and documents and of the serious consequences to taxpayers who choose to ignore the Minister's requests and a court's orders.

— *Brandon Siegal*

RECENT CASES

ABIL denied — no proof debt became bad or was incurred to earn income

The taxpayer was appealing the denial of an allowable business investment loss ("ABIL") for a $100,000 investment in Seahorse International Ventures made in February 2008. D was the sole shareholder of the taxpayer and managed the business of installing and maintaining signs. He testified that his son, A, approached him about making an investment in Seahorse and he relied on his son in so doing. A was introduced to B, who was the promoter on behalf of R, the sole shareholder of Seahorse. R was later convicted of securities violations with respect to investments in another corporation. The taxpayer's investment was to be returned within four months at a 25% interest rate, but no money was ever recovered.

The appeal was dismissed. To claim an ABIL, the investment must have been made in a Canadian-controlled private corporation ("CCPC") (which Seahorse was) that was carrying on an active business. The investment must have been made for the purpose of earning income and must have become a bad debt. The burden of proof on the issue of whether Seahorse was carrying on an active business was on the respondent, who did not introduce sufficient evidence to show that Seahorse was not carrying on an active business. The fact that Seahorse did not file tax returns was a reflection of R's disregard for legal obligations, not proof that there was no business activity. The taxpayer did not provide credible evidence that the debt was incurred to earn income or that it became a bad debt. The only evidence provided was given by D and A, and was self-serving and implausible. Given the size of the investment, it was difficult to believe D's testimony that he had little knowledge of the investment. No unrelated witnesses were called and there was no documentation produced supporting the terms of the indebtedness or that Seahorse could not repay the debt. The taxpayer was able to get a letter from R confirming that Seahorse was a CCPC, but seemingly made no efforts to recover the debt. While it was possible the taxpayer was a victim of a fraud, it was also possible that it participated in a scheme to claim a deduction. The taxpayer failed to establish a *prima facie* case that would entitle it to claim an ABIL.

Affordable Sign Service Ltd., 2014 DTC 1053

Minister justified in reassessing taxpayer's estate beyond normal reassessment period

The deceased taxpayer's daughter D was the executor of his estate (the "Estate"). The law firm acting for the Estate asked D to collect her father's tax information and have a professional prepare the date of death return for the Estate. The firm D hired failed to include in that return the fair market value of her father's RRIF, which amounted to $228,164, and D signed the return, later not recalling whether or not she had read it. The Minister reassessed the Estate beyond the normal reassessment period to include the $228,164 in the date of death return. On the Estate's appeal to the Tax Court of Canada, it argued, in part, that, even if the Estate made a misrepresentation in failing to report the $228,164 in the return, the Minister was not entitled to rely on subsection 152(9) of the *Income Tax Act* to justify the argument that the misrepresentation resulted from carelessness or neglect, particularly since the reply contained no specific reference to that subsection in the list of statutory provisions being relied upon.

The Estate's appeal was dismissed. Subparagraph 152(4)(*a*)(i) stipulates that if the Minister wishes to reassess beyond the normal reassessment period, he must prove that a taxpayer has made a misrepresentation attributable to neglect, carelessness, or wilful default. Subsection 152(9) permits the Minister to raise alternative arguments in support of an assessment beyond the normal reassessment period under certain conditions. The Estate argued that subsection 152(9) only permits the Minister to raise a new argument in support of an assessment but not as a new basis for that assessment. This argument was untenable since any alleged distinction between a new argument and a new basis is purely semantics. It was not necessary to determine whether the Minister presented a new argument in support of his

reassessment by alleging that the misrepresentation was attributable to neglect. Even if this were a new argument, the Minister had clearly met the conditions set out in *Walsh v. The Queen* (2007 DTC 5441) for subsection 152(9) to apply in any event, and the Estate was not prejudiced by the omission of a specific reference to subsection 152(9) in the reply. The parties agreed that to prove neglect, the Minister had to prove that the Estate failed to exercise reasonable care. The applicable standard is that of a wise and prudent person. The Estate's failure to include the $288,164 in its date of death return was a misrepresentation. Had D exercised reasonable care, she would have reviewed the deceased taxpayer's T4RIF, seen the $228,164 on that form, and looked for that amount in the date of death return prior to signing it. Therefore, D (and through her, the Estate) made a misrepresentation that was attributable to neglect, and D's conduct evidenced an overall desire to put as little effort as possible into the preparation of the Estate's date of death return. The Minister's reassessment beyond the normal reassessment period was, therefore, justified.

Krenbrink, 2014 DTC 1065

But for existence of corporation, incorporated employee would be considered employee, not independent contractor

Muirhead Holdings ("MH") was reassessed on the basis that it was carrying on a personal services business ("PSB") and, as such, was only entitled to limited deductions for its incorporated employee, G. G and his wife owned MH, which was under contract to Harvest Operations Corp. ("Harvest") to provide oil well site and facilities services. The services were provided solely by G, the only employee of MH, although Harvest had employees doing similar work. MH would be a PSB if G's activities would reasonably be considered to be those of an employee of Harvest were it not for the existence of MH. G argued that the intention of the parties should be considered.

The appeal was dismissed. G's argument to consider the intention of the parties was not helpful as case law has held that contracts involving third parties purchasing services from corporations owned by an incorporated employee are always contracts for services, as corporations cannot be employees under a contract of service. The PSB provisions would be meaningless if the intention of the parties were to be taken into account as that contract can only be a contract for services. To determine G's status, the factors of control, tools, chance of profit, and risk of loss were relevant — that is, whether G was an employee or independent contractor. Harvest dictated the terms and conditions of G's contract; G had to abide by Harvest's rules and was subject to evaluation and supervision. There were no distinctions suggested between G and Harvest's other employees. Although G provided his own truck and light tools, that was a neutral factor. G had no opportunity to increase his revenues nor was he at risk of loss. All of G's working hours were spent on activities controlled by Harvest. Given all the factors, if one ignored MH and G were to work directly for Harvest, he would be considered an employee and not as someone in business on his own account.

G & J Muirhead Holdings, 2014 DTC 1067

TAX NOTES

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