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2014 STEP CANADA ROUNDTABLE — PART I

— Stephanie Dewey, J.D., Analyst, Wolters Kluwer Limited

On June 17, 2014, the Canada Revenue Agency ("CRA") participated in the annual Roundtable session at the 16th National Conference of the Society of Trust and Estate Practitioners ("STEP") Canada held in Toronto, Ontario.

The CRA was represented by Phil Kohnen, Manager, Trusts Section, Income Tax Rulings Directorate, and Steve Fron, Manager, Trusts Section, Income Tax Rulings Directorate. Kim G.C. Moody of Moodys Gartner Tax Law LLP and Michael Cadesky of Cadesky and Associates LLP also sat on the panel. Paul LeBreux of Globacor Tax Advisors acted as moderator.

The Roundtable was presented in question and answer format. The summary below is based on notes taken by an attendee from Wolters Kluwer Limited during the session and a copy of the questions prepared by the panellists and released by STEP Canada. Written answers from the CRA will be published at a later date. All statutory references are references to the *Income Tax Act* (the "Act") unless otherwise noted.

Due to its length, this summary is divided into two parts. Part I includes summaries of answers to questions 1–8; Part II includes summaries of answers to questions 9–19. Part II will be published in a subsequent edition of *Tax Notes*.

Question 1: Transfer to Spouse and Common-Law Partner

Issue

The CRA was asked to comment on whether subsection 70(6) of the Act could be applied to both a transfer to a spouse and a transfer to a common-law partner. Subsection 70(6) provides a rollover for capital property transferred to a taxpayer's spouse or common-law partner who was resident in Canada immediately before the taxpayer's death as a consequence of the death.

Discussion

The CRA panellists confirmed that a taxpayer can have a spouse and a common-law partner at the same time for the purposes of the Act. In such a situation, subsection 70(6), which is applied on a property-by-property basis, could apply to both a property left to the spouse and a property left to the common-law partner.

Key References

- *Income Tax Act*, s. 70(6)
- CRA Document No. 2010-0373901I7, Bigamie fiscale — transfert de biens au décès, September 30, 2010

Question 2: Joint Spousal or Common-Law Partner Trust

Issue

The CRA was asked to comment on whether a trust with terms such that the settlor was entitled to receive all of the income of the trust during his or her lifetime, and the settlor's surviving spouse or common-law partner was entitled to receive income of the trust only after the settlor's death, could qualify as a joint spousal or common-law partner trust. A joint spousal or common-law partner trust, as defined in subparagraph 73(1.01)(*c*)(iii), requires that the individual or the individual's spouse or common-law partner is, "in combination with the other", entitled to receive all the income of the trust that arises before the later of the death of the individual and the death of the spouse or common-law partner.

Discussion

The CRA panellists confirmed that the terms in question would not prevent the trust from otherwise qualifying as a joint spousal or common-law partner trust, even though the spouse or common-law partner could die first and never receive any income of the trust.

Key References

- *Income Tax Act*, s. 73(1.01)(*c*)(iii), 104(4)(*a*), 248(1) "joint spousal or common-law partner trust"

Question 3: US Limited Liability Company/Share Capital

Issue

Proposed section 93.3 sets out rules for determining the share capital of a non-resident corporation without share capital (hereinafter referred to as the "non-resident corporation") for the purposes of the Act, including the foreign affiliate rules. In general terms, proposed section 93.3 requires the equity interests of the non-resident corporation to be classified as interests in shares. If passed, section 93.3 will generally be retroactive to taxation years ending after 1994.

Part One

The CRA was asked to comment on an example of a US limited liability company with equity interests determined by reference to a formula which provides for one party, a manager, to receive a 2% income allocation for management and an additional 20% profit share in certain circumstances. Residual profits are divided in accordance with a sharing ratio. The manager also has special voting rights.

Part Two

The CRA was presented with a second scenario wherein the allocation of income varies from year to year between two owners.

Discussion

The CRA panellists commented on the amendment generally with reference to the Department of Finance explanatory notes. To divide equity interests into deemed classes of shares, one must first determine the rights and obligations of all the equity interests in the non-resident corporation. This may require looking at the constituting documents of the non-resident corporation, the law under which the non-resident corporation was formed, and any agreements between holders of equity interests in the non-resident corporation. Equity interests with identical rights and obligations, except for proportionate differences (e.g., where differences in income entitlements are proportionate to differences in voting rights), will be deemed to be the same class of shares, while unique equity interests will be deemed to constitute a separate class of shares.

Part One

With respect to the first example, assuming that each member has a single equity interest (as determined in accordance with the non-resident corporation's constituting documents, the law under which it was formed, and any agreements between the holders), the CRA panellists commented that there would be two classes of shares and all of the manager's income rights plus his or her special voting rights would be attached to one such class. If the manager had two equity interests, there could still be two classes of shares; the manager would own a proportion of one class and all of the second class, to which the manager's additional income rights and special voting rights would be attached. If the manager's equity interests were divided into more than two distinct units, such as where he or she could transfer some rights separately from the others, there could be more than two deemed classes.

Part Two

The CRA panellists commented that the application of proposed section 93.3 to the second scenario would depend on the relevant facts, including the non-resident corporation's constituting documents, the law under which it was formed, and any agreements between the holders.

Key References

- CCH Special Report No. 072H, *Draft Legislation: Technical Amendments Relating to Income Tax, Excise Duties and Sales Tax*, July 12, 2013

Question 4: US Limited Liability Limited Partnerships

Issue

The CRA was asked how it viewed limited liability limited partnerships ("LLLPs"). Certain US states permit LLLPs, which do not require a general partner who is liable for the partnership debts (but note that limited partners may still be liable for debts if they participate in the business of the partnership).

Discussion

With respect to whether an LLLP constitutes a partnership under Canadian law, the CRA panellists referred to the Supreme Court of Canada decision in *Backman v. The Queen*, 2001 DTC 5149. At paragraph 26 of that decision, the Court held that a determination of whether a partnership exists in a particular case will depend on "an analysis and weighing of the relevant factors in the context of all the surrounding circumstances".

The CRA takes a two-step approach to the classification of foreign entities whereby first, the characteristics of the entity under foreign law and relevant documents including the partnership agreement are considered, and second, these characteristics are compared to established categories of entities under Canadian law in order to classify the foreign entity into one of these categories.

The panellists noted that the classification of an LLLP may be considered in an advance income tax ruling. A request for an advance ruling should include a description of the characteristics of the foreign entity and an analysis of its proper classification, as well as all relevant documents including a copy of the foreign law under which the entity was created.

Key References

- *Backman v. The Queen*, 2001 DTC 5149 (SCC)

Question 5: "Evil Trusts"

Issue

The CRA was asked to comment on the application of the attribution rules in subsection 75(2) to arrangements whereby a trust is structured to intentionally cause subsection 75(2) to apply. In the example considered by the panel, corporation A owns 100% of the voting shares of corporation B, such that they are connected corporations. Corporation

A settles a trust, of which it acts as the trustee, with common shares of corporation B, triggering the application of subsection 75(2). As a result, when corporation B pays a dividend to the trust, the dividend is attributed back to corporation A and treated as a non-taxable intercorporate dividend, while the cash is distributed to the beneficiary.

The application of subsection 75(2) was considered recently in *The Queen v. Sommerer*, 2012 DTC 5126 ("*Sommerer*"), where the Federal Court of Appeal ("FCA") held that subsection 75(2) did not apply where property was sold to a trust by a beneficiary of the trust for fair market value ("FMV"). It was also considered in *The Brent Kern Family Trust v. The Queen*, 2013 DTC 1249 ("*Brent Trust*"), where the Tax Court of Canada applied the principle in *Sommerer* and found that subsection 75(2) did not apply to a trust that was structured to cause its application because the subject property was purchased for valuable consideration.

Discussion

The CRA panellists declined to comment on *Brent Trust*, as it is currently under appeal. The panellists commented that the CRA agrees with the general proposition in *Sommerer* that subsection 75(2) does not apply where there is FMV consideration for property transferred to a trust; however, the CRA will continue to challenge where there is no FMV consideration. In a scenario such as that described in the example above, the CRA may assess the trust or the beneficiary to include the dividend income under paragraph 12(1)(*j*) or subsection 104(13), depending on the facts. In addition, the general anti-avoidance rule may be applicable.

Key References

- *Income Tax Act*, s. 12(1)(*j*), 75(2), 104(13)
- *The Queen v. Sommerer*, 2012 DTC 5126 (FCA)
- *The Brent Kern Family Trust v. The Queen*, 2013 DTC 1249 (TCC); under appeal to the FCA, Docket No. A-375-13
- *Re Pallen Trust*, 2014 DTC 5039 (BCSC), wherein a trust's application for an order rescinding dividends after the Minister determined that subsection 75(2) did not apply was granted

Question 6: Trust Audit Issues

Issue

The CRA was asked to provide an update on the most common audit issues regarding trusts.

Discussion

The CRA panellists reviewed trust compliance issues that the income tax rulings directorate has considered recently. The panellists commented that the range of issues covered was quite broad, but noted that the following issues have been considered recently: attribution under subsection 75(2); section 105 benefits; gifts by will; the subsection 112(3.2) stop-loss rule; whether late or amended designations, such as under subsection 104(21), can be filed; carrying charges; and the deductibility of lawyer and accounting fees.

Key References

- *Income Tax Act*, s. 75(2), 104(21), 105, 112(3.2)
- CRA Document No. 2010-0366301I7, Attribution of Trust Income and Gain, November 2, 2010
- CRA Document No. 2012-0472161I7, Gifts by Will, January 27, 2014

Question 7: Safe Income

Issue

Pursuant to subsection 55(2), an intercorporate dividend may be recharacterized as a capital gain or proceeds of disposition of shares if the dividend was received as part of a transaction or event, or series of transactions or events,

one of the purposes of which (or in the case of a deemed dividend under subsection 84(3), one of the results of which) was to significantly reduce the capital gain that would have been realized on a disposition of any shares at FMV immediately before the dividend. Any portion of the gain that is attributable to safe income (generally, the after-tax retained earnings of the corporation) is deducted from the calculation of this hypothetical gain, such that subsection 55(2) will not apply if the dividend does not exceed safe income on hand. Where subsection 55(2) applies, it applies to the entire dividend (less any amount subject to Part IV tax), unless a designation is made under paragraph 55(5)(*f*) for a portion of the dividend to be treated as a separate taxable dividend. Where a paragraph 55(5)(*f*) designation is made, the dividend is treated as two dividends, one of which would be subject to subsection 55(2), and the other of which might not be, if the corporation has sufficient safe income on hand. The CRA was asked to comment on circumstances where a paragraph 55(5)(*f*) designation is not made, and a capital gain is self-assessed, for tax-planning reasons.

Discussion

In its response, the CRA panellists referred to *The Queen v. Nassau Walnut Investments Inc.*, 97 DTC 5051 ("*Nassau*"). In *Nassau*, the FCA found that the designation under paragraph 55(5)(*f*) was not a genuine election. The Court further noted that the purpose of paragraph 55(5)(*f*) is to prevent the conversion of an entire dividend into a taxable capital gain under subsection 55(2), where a portion of the dividend is attributable to safe income. The panellists further referred to the FCA decisions in *The Queen v. Brelco Drilling Ltd.*, 99 DTC 5253; *Lamont Management Limited v. The Queen*, 2000 DTC 6256; and *The Queen v. Kruco Inc.*, 2003 DTC 5506, wherein the Court set out the general principle that safe income should not be subject to double taxation when distributed to another corporation.

The panellists commented that the CRA's practice is to apply subsection 55(2) to the excess of a dividend over safe income only. Where a recipient corporation does not make a designation under paragraph 55(5)(*f*), but instead self-assesses a capital gain, the CRA could reassess to reduce the amount of the gain by applying the purpose test under subsection 55(2), or, where a surplus stripping scheme is involved, the CRA may apply the general anti-avoidance rule.

Key References

- *Income Tax Act*, s. 55(2) and (5)(*f*)
- *The Queen v. Nassau Walnut Investments Inc.*, 97 DTC 5051 (FCA)
- *The Queen v. Brelco Drilling Ltd.*, 99 DTC 5253 (FCA)
- *Lamont Management Limited v. The Queen*, 2000 DTC 6256 (FCA)
- *The Queen v. Kruco Inc.*, 2003 DTC 5506 (FCA)

Question 8: Transfer of Property by a Personal Trust to a Beneficiary

Issue

The CRA was asked to comment on an example where a Canadian-resident "personal trust" (as defined in subsection 248(1)) holds property that has appreciated in value since acquisition. The trust owes an amount to a capital beneficiary in respect of a loan. The trust is to be wound up and the trustee wishes to transfer the property to the capital beneficiary in settlement of the debt on a rollover basis under subsection 107(2).

Discussion

The CRA panellists noted that "capital interest" is defined in subsection 108(1) to mean "all rights of the taxpayer as a beneficiary under the trust", and includes a right "to enforce payment of an amount by the trust that arises as a consequence of any such right". The panellists further referred to the Tax Court of Canada case *Chan v. The Queen*, 99 DTC 1215 ("*Chan*"), wherein the Court considered what constitutes a "distribution" under subsection 107(2). At paragraph 13 of the decision, the Court describes a distribution under subsection 107(2) as an allotment of trust property to a beneficiary in accordance with the beneficiary's proportionate share. The distribution must be made by the trustee in accordance with the trustee's fiduciary duty, and not for consideration (unless the trust deed provides

otherwise). The panellists commented that in the example, the repayment of the loan would not be a distribution, but rather a settlement of a debt, and would be received by the beneficiary not in accordance with his or her rights as a capital beneficiary, but by virtue of his or her rights as a creditor. A transfer that settles a debt cannot also be a subsection 107(2) distribution.

Key References

- *Income Tax Act*, s. 107(2), 108(1) "capital interest"
- *Chan v. The Queen*, 99 DTC 1215 (TCC); appeal dismissed 2001 DTC 5570 (FCA)
- CRA Document No. 2013-0503481E5, Distribution of Property by a Trust, December 19, 2013

CONNECTING LEGAL FEES TO BUSINESS INCOME — CHANGE OR *STATUS QUO* FOR DEDUCTIONS?

—Carman R. McNary, Q.C., Tax Partner with the Edmonton office of Dentons Canada LLP

It is perhaps not surprising that we are still dealing with cases on the boundary between deductible and non-deductible expenses, particularly when we are dealing with something like legal fees being sought as deductions against income. After all, it can be an important characterization to make when the deduction has the essential effect of shifting at least some of the burden of legal expenses from the litigant to the rest of us as taxpayers. But what is a bit surprising is how the courts have found ways to define the boundary. Two recent decisions of the Tax Court of Canada provide consistent and relatively clear guidance on the issue.

Both *Ironside v. Canada*, [2013] T.C.J. No. 298, 2014 DTC 1002 (TCC), and *Gouveia v. Canada*, [2013] T.C.J. No. 353, 2014 DTC 1035 (TCC), involve taxpayers who faced securities-related prosecutions arising from positions as directors and officers of companies. Both had left their respective employments and were, in the years in which deductions of legal fees were claimed, engaged in "new" businesses — Ironside as a chartered accountant and Gouveia as a consultant. Both argued that the expenses they incurred to defend themselves from the charges against them were necessary business expenses because they were incurred to protect against the risk that the business would be shut down (in Ironside's case, if he lost his designation as a chartered accountant) or at least that revenue would be lost through damage to reputation if convicted (in both cases).

The basic test for deduction of legal fees, at least in the general cases not relying on one of the *Income Tax Act*'s (the "Act") several provisions for specific deduction, is that the legal fees incurred in respect of a particular business or property must fit within the general rules that follow from subsection 9(1) of the Act and be part of the determination of "profit from that business or property for the year". Further, consistent with all other such business expenses, legal fees are subject to the restrictions of subsection 18(1) of the Act, and must have been incurred for the purpose of gaining or producing income from that business or property and not be on account of capital. Those tests, as the Supreme Court noted in *Symes v. The Queen*, [1993] S.C.J. No. 131, 94 DTC 6001 ("*Symes*"), have really not been improved upon or added to by decades of judicial interpretation. On that basis, one might have thought the results in the two recent cases would be quite simple to predict — simply answer the question "Were the legal expenses by Ironside/Gouveia incurred for the purpose of earning income from a business or property?"

That would be premature, however, because the Supreme Court in *Symes* went on to describe several distinct factors to be considered by the Court to assist in applying the general principle to what would undoubtedly be a broad spectrum of facts.

First, would similar businesses "normally" incur a similar expense? This implies, if not explicitly requires, an "objective" analysis of all of the circumstances, rather than accepting the evidence of the taxpayer as to the purpose that was intended. But despite apparent simplicity, this factor raises other questions, such as "Who or what is 'similar'?" and "What is 'normal'?" In any event, the result based on this case might be expected to go in favour of the taxpayers, since one would expect that other accountants, in the case of *Ironside*, would normally be willing to pay legal fees to defend against an action that had every likelihood of costing them their designation and therefore their livelihood. That would also be premature.

The second factor also likely supports the taxpayers in these two cases — whether the deduction is ordinarily allowed as a business expense by accountants. That is a fascinating nod to the accounting profession's collective wisdom in these matters, but more importantly, it seems somewhat circular since presumably accountants would ordinarily allow expenses that were incurred for the qualifying purpose. But regardless, applied to *Ironside* and *Gouveia*, one might have thought that the expenses were incurred to protect the current income stream, and hence, would be allowed as business expenses. Again, that would be premature.

The final factor the Supreme Court included was whether an expense would have been incurred even if the person was not carrying on the business against which it was deducted, or in other words "Would the need exist apart from the business?", a so-called "but for" test. That is much more difficult to apply where, as in these cases, there is clearly more than one reason for the expense; there are personal considerations, wealth preservation considerations, and yes, income considerations. No doubt all three came into play for both Ironside and Gouveia. The question, one supposes, is whether or not having more than one purpose takes one outside of "incurred for the purpose of gaining or producing income from a business or property".

To answer that question, the Tax Court has refined the discussion somewhat, and identifies and discusses a "connectivity" test — is the expense actually (and sufficiently) "connected" to the income it is supposedly intended to earn? And this is the relatively new and nuanced approach that is important; the Court went on essentially to hold that where the expense arose from conduct that was not itself related to the business from which the income was to be earned, the required connection did not exist. Because Ironside had to pay lawyers to defend him in respect of conduct in his former corporate life and not his accounting practice, he could not deduct those legal expenses against his current accounting income.

There is a certain harsh logic to this approach, but in the case of legal fees in particular, one might ask whether this is unduly restrictive. More to the point, one might ask from what part of either determining business income for purposes of subsection 9(1) or the restriction in paragraph 18(1)(*a*) that expenses be "incurred for the purpose of gaining or producing income from a business or property" the restriction or requirement for connectivity arises? Regardless of such musings (and subject to the decision of the Federal Court of Appeal in *Gouveia*, appeal filed on January 13, 2014), as a result of these two decisions, the test has become somewhat more precise, and we have a better understanding of where the line may be drawn.

Finally, it seems difficult to envision planning around this requirement, as legal fees are typically incurred in "real time" and, for the most part, one can expect the sorts of defence costs raised by Ironside or Gouveia to be incurred sometime after the situation that gave rise to the need to incur them has passed. In advising clients with respect to deductibility, care should be taken in light of these cases.

A number of tax lawyers from Dentons Canada LLP write commentary for Wolters Kluwer's Canadian Tax Reporter *and sit on its Editorial Board as well as on the Editorial Board for Wolters Kluwer's* Canadian Income Tax Act with Regulations, Annotated. *Dentons Canada lawyers also write the commentary for Wolters Kluwer's* Federal Tax Practice *reporter and the summaries for Wolters Kluwer's* Window on Canadian Tax. *Dentons Canada lawyers wrote the commentary for* Canada–U.S. Tax Treaty: A Practical Interpretation *and have authored other books published by Wolters Kluwer:* Canadian Transfer Pricing *(2nd Edition, 2011);* Federal Tax Practice; Charities, Non-Profits, and Philanthropy Under the Income Tax Act; *and* Corporation Capital Tax in Canada. *Tony Schweitzer, a Tax Partner with the Toronto office of Denton's Canada LLP and a member of the Editorial Board of Wolters Kluwer's* Canadian Tax Reporter*, is the editor of the firm's regular monthly feature articles appearing in* Tax Topics.

STANDING COMMITTEE ON FINANCE ANNOUNCES PRE-BUDGET CONSULTATION PROCESS

On June 6, 2014, the House of Commons Standing Committee on Finance (the "Committee") invited Canadians to participate in its pre-budget consultation process, and requested that stakeholders share their priorities for the upcoming 2015 federal Budget. The closing date for written submissions, which are not to exceed 2,000 words in length (including an executive summary), is August 6, 2014. Input and requests to appear before the Committee can be submitted via email to finapbc-cpb@parl.gc.ca.

BILL C-31 RECEIVES ROYAL ASSENT

Bill C-31, *Economic Action Plan 2014 Act, No. 1*, received Royal Assent on June 19, 2014, becoming S.C. 2014, c. 20. The amendments from former Bill C-31, which implements certain provisions of the 2014 federal Budget and other previously announced measures, will be added to Wolters Kluwer's *Income Tax Act* online and on DVD as soon as possible and will be included in the 98th edition of Wolters Kluwer's *Canadian Income Tax Act with Regulations, Annotated*, which will be published this summer. Commentary in the *Canada Income Tax Guide* will be revised as soon as possible for the amendments.

PRESCRIBED INTEREST RATES — THIRD QUARTER OF 2014

The prescribed interest rates for the third quarter of 2014 were released by the Canada Revenue Agency on June 12, 2014. Except for corporate taxpayers' rates for interest on pertinent loans and indebtedness (which will be 4.93%), the rates have not changed from the second quarter of 2014 and are noted below.

- 1% to calculate a deemed interest taxable benefit on subsidized employee and shareholder loans;
- 1% on refunds of income tax overpayments paid to corporate taxpayers;
- 3% on refunds of income tax overpayments paid to non-corporate taxpayers; and
- 5% on payments of overdue income taxes, insufficient income tax instalments, unremitted employee source deductions, CPP contributions or EI premiums, and unpaid penalties.

These rates will be in effect from July 1, 2014 to September 30, 2014.

A listing of the prescribed interest rates for each quarter, dating back to 2000, is reproduced under "Quick Links" in the *Canada Income Tax Guide* on DVD and online.

USE OF FUTURE INCOME TAX ASSET IN SMALL BUSINESS CORPORATION

The Canada Revenue Agency ("CRA") was asked if a future income tax asset could be considered to be used principally in an active business carried on in Canada for the purpose of the following expressions:

- "qualified small business corporation share" ("QSBCS") defined in subsection 110.6(1) of the *Income Tax Act* (the "Act"); and
- "small business corporation" ("SBC") defined in subsection 248(1) of the Act.

The CRA confirmed that a future income tax asset was not considered an asset for the purpose of determining if a share was a QSBCS or if a corporation was an SBC. However, when the asset becomes an income tax receivable, it must be considered for that determination. In other words, contrary to a future income tax asset, an income tax receivable will be treated as an asset used in an active business for the purpose of the above definitions. The CRA also noted that its Technical Interpretation Nos. 2000-001582, issued on October 2, 2000, and 2008-0285301C6, issued on October 10, 2008 at the Federal Taxation Roundtable of the APFF Annual Conference, were no longer valid. Those two interpretations indicated at the time that a future income tax asset shown on a corporation's balance sheet was an asset for the purpose of defining a QSBCS or an SBC. To reach its decision, the CRA relied on the definition of "future income tax asset" in Chapter 3465 of the CICA Manual and the definition of "deferred income tax asset" in IAS 12 "Income Taxes".

— Association de planification fiscale et financière (APFF), 2013 Conference, Federal Taxation Roundtable — Question 25, October 11, 2013, Document No. 2013-0499671C6

QUEBEC BUDGET

On June 4, 2014, the Government of Quebec tabled its post-election 2014 Budget. While the Budget contained no changes to personal tax rates, it did propose several new measures, including an amendment such that retirement income splitting for the 2014 taxation year would only be allowed between spouses where the person whose retirement income was being split was 65 or older before the end of the taxation year. In addition to proposing a loan program to help assist seniors with the payment of property taxes, the Budget also proposed the following changes to personal tax credits and subsidies:

- seniors over the age of 70 with annual incomes of $40,000 or less will be eligible for a new refundable tax credit of up to $40 for amounts paid after June 4, 2014 for programs to enhance their well-being;
- the tax credit for experienced workers will apply to the first $4,000 (previously $3,000) of income over $5,000 for the 2015 taxation year; and
- the $7/day rate of daycare subsidization is to be indexed starting with an increase to $7.30/day per child on October 1, 2014.

The Budget proposes reducing the small business tax rate for small companies that engage more than 25% of their activity toward manufacturing and processing and have paid-up capital of $10 million or less; the reductions would be up to 2% and up to 4% for income earned after June 4, 2014 and April 1, 2015, respectively (the rate currently stands at 8% on the first $500,000 of income). Depending on size, location, income, and level of manufacturing, an additional deduction of up to 6% of gross income was proposed for remote manufacturing small and medium-sized enterprises ("SMEs") with paid-up capital less than $15 million. As well, a temporary reduction to the health services fund was proposed for natural and applied science sector SMEs with payrolls between $1 million and $5 million. In addition to proposing a 20% decrease to several refundable corporate tax credits for qualifying expenditures incurred after June 4, 2014 or for contracts made after June 3, 2014, the Budget also proposed the elimination, delayed implementation, or scaling back of several other tax credits (including certain SR&ED and manufacturing and processing credits).

While the Budget proposed harmonization with many of the 2014 federal Budget proposals, certain items (including the increase in the maximum amount of expenditures eligible for the adoption expense tax credit, the extension of the mineral exploration tax credit, and certain consequential amendments arising from the elimination of graduated rate taxation for certain trusts and estates) were not among the measures proposed for harmonization. Budget documents, along with Wolters Kluwer commentary, are posted on the provincial News Tracker on CCH Online and are also available in the *Quebec Tax Reporter* online and on DVD.

NUNAVUT BUDGET

The 2014 Nunavut Budget was tabled on May 26, 2014 and contained no new tax measures. Budget documents, along with Wolters Kluwer commentary, are posted on the provincial News Tracker on CCH Online and are also available in the *Alberta and Territories Tax Reporter* online and on DVD.

SUPREME COURT OF CANADA — APPLICATIONS FOR LEAVE TO APPEAL DISMISSED

On May 29, 2014, the Supreme Court of Canada ("SCC") dismissed with costs the application for leave to appeal in the case of *Transalta Corporation v. The Queen*, 2014 DTC 5018 (FCA). The case concerned a corporate taxpayer who, having made a settlement offer that was rejected by the Minister of National Revenue (the "Minister"), was eventually successful before the Tax Court of Canada ("TCC") (in *Transalta Corporation v. The Queen*, 2012 DTC 1106). Arguing that after the pre-decision settlement offer the Minister had not attempted to negotiate or provide a counter-offer, the taxpayer subsequently brought a motion requesting an order for costs beyond the normal tariff amounts, substantial indemnity costs, and additional cost amounts. The TCC refused the motion, agreeing with the Minister's position that it had been precluded from accepting the taxpayer's offer due to the "legal disability" concept (i.e., that there was no legal or factual scenario in which the Minister could have accepted the taxpayer-offered settlement). In affirming the TCC's decision, the Federal Court of Appeal stated it was not persuaded the TCC had erred in law regarding the

legal disability concept from *CIBC World Markets Inc. v. Canada*, 2012 GTC 1011, and that the TCC had not considered irrelevant factors or reached an unreasonable conclusion in refusing the taxpayer's motion.

On May 29, 2014, the SCC also dismissed with costs the application for leave to appeal in the case of *Neville v. National Foundation for Christian Leadership*, 2014 BCCA 38. The case concerned taxpayers who, having been denied a tax deduction pursuant to "a failed tax scheme" (see *Ballard v. The Queen*, 2011 DTC 5040), brought a claim against the registered charitable organization to whom the underlying donations were made. In affirming the Supreme Court of British Columbia's dismissal of the taxpayers' application, the British Columbia Court of Appeal agreed that "there was no claim in trust or otherwise" between the taxpayer and the organization because the transaction had been a gift, and alternatively because no unjust enrichment had occurred as the taxpayers had received from the organization both a bursary and a "risky tax receipt" in exchange for their donations.

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.

Standard of Proof Required on *Ex Parte* Application for Jeopardy Orders

***Tassone v. MNR*, 2014 DTC 5009 (Federal Court)**

The *Tassone* decision provides guidance on two issues: (1) the standard of disclosure required from the Minister in making an *ex parte* application for a jeopardy order; and (2) the test for when a jeopardy order can be set aside, or more specifically, what constitutes reasonable grounds to doubt the Minister's assertion that collection would be jeopardized by delay.

The taxpayers, a married couple, were Canadian residents who had not filed tax returns for the taxation years 2004 to 2011. The Minister conducted an audit and discovered that the taxpayers had declared significant income from family-owned companies when making applications for loans and other bank financing. The Minister also found that significant sums had been deposited in the taxpayers' Canadian bank accounts throughout the period, without explanation about the source of those funds.

The Minister issued preliminary Notices of Assessment to the taxpayers for the 2004 to 2011 taxation years for a total of approximately $5.6 million in undeclared revenue and assessed each taxpayer as owing approximately $3.6 million (i.e., the total owing since the Minister was unable to determine which taxpayer should be assessed for what amount). The taxpayers filed Notices of Objection, but neither of them filed affidavits on the application to set aside the jeopardy order and therefore avoided cross-examination by the Minister.

The audit also revealed that the taxpayers controlled a company incorporated in Panama, Balboa Internacional Associada S.A. Balboa had significant assets that the Minister was not able to trace fully. Further, in 2007 Balboa apparently lent $2 million to a relative of the taxpayers, in respect of whom the Minister had also obtained a jeopardy order. The taxpayers' relative was alleged to owe several million dollars in unpaid taxes, but granted Balboa mortgages on Canadian properties held by non-arm's length parties, thereby preventing the Minister from realizing on those assets. The only Canadian asset of the taxpayers that the Minister was able to identify was a Toronto house in the wife's name with an assessed value of $1.2 million.

Faced with these facts, the Minister had sought and obtained an *ex parte* jeopardy order, arguing that the taxpayers might sell or encumber their assets if the Minister was forced to provide notice to the taxpayers under section 225.1 of the *Income Tax Act*.

In support of this application, the Minister noted that the husband had denied knowing anything about Balboa, even though he had previously served as the company's president. Balboa had itself participated in a scheme to frustrate the Minister's collection efforts in respect of the taxpayers' relative. The taxpayers had a long record of failing to file tax returns, despite having significant net worth and expenses and representing to creditors that they earned employment income. The Minister noted that there were several large unexplained deposits and withdrawals in the applicants' Canadian bank and brokerage accounts that the Minister could not trace. The Minister's affidavit also contained

evidence that the taxpayers had operated Balboa as something of a sham, using the company to pay for expenses related to their Canadian businesses and personal expenses. Finally, the Minister noted that the husband had previously failed to pay approximately $9,000 in taxes until the Minister garnished his brokerage accounts.

Gleason J reviewed the tests: (1) for making an *ex parte* jeopardy order; and (2) for setting aside such an order on a review. She noted that an *ex parte* jeopardy order can be set aside if the Minister failed to make "full and frank" disclosure, even if otherwise there were grounds for issuing such an order. However, the Minister is not required to disclose information that is irrelevant to whether the collection of taxes might be jeopardized.

To issue the *ex parte* jeopardy order, the judge must "be satisfied that there are reasonable grounds to believe that the collection of all or any part of an amount assessed in respect of a taxpayer would be jeopardised by a delay in the collection of that amount". The standard of proof on an application to issue the *ex parte* order is not a balance of probabilities, but rather "a *bona fide* belief in a serious possibility based on credible evidence" (*Re Papa*, 2009 DTC 5045).

The taxpayers argued that the Minister had failed to disclose two things: (1) the auditor's working papers; and (2) the fact that a significant part of the expenditures attributed to the taxpayers came from share transfers between two Balboa accounts in Panama.

Gleason J rejected both of these submissions, finding that the Minister had provided full and frank disclosure. The working papers were relevant only to the amount of the assessment, and not whether the collection on that assessment would be jeopardized by notice. As a result, they did not need to be disclosed to the court. As to the share transfers, those had in fact been disclosed by the Minister in the application materials.

Gleason J then reviewed the taxpayers' challenge to the basis for the jeopardy orders themselves. She applied the two-step test from *Minister of National Revenue v. Reddy* (2008 DTC 6185) as to whether an *ex parte* order should be set aside: (1) the taxpayer must establish that there are "reasonable grounds to doubt that the collection of all or any part of the amount assessed would be jeopardised by a delay in the collection of that amount"; and (2) if the taxpayer succeeds at the first stage, the Minister must justify "the jeopardy order by demonstrating that, on a balance of probabilities, it is more likely than not that the collection of the amount would be jeopardised by delay".

Gleason J concluded that the taxpayers' challenge failed at the first stage. There was ample evidence that collection might be jeopardized, including the taxpayers' failure to report income despite significant assets and expenditures, as well as significant income amounts included on credit applications, and their use of Balboa for their personal purposes and to assist their relative in avoiding collection. While this is not proof that the taxpayers would encumber their home, it was enough to prevent the taxpayers from satisfying the "reasonable grounds" standard. The judge noted these facts were similar to the facts in *144945 Canada Inc.* (2003 DTC 5409) where a jeopardy order was upheld.

The taxpayers' application to set aside the jeopardy orders was dismissed.

— *Julia Lockhart*

RECENT CASES

Dividends paid to trust under a tax plan rescinded

A tax plan (the "Plan") was developed that involved the creation of three corporations and a discretionary trust (the "Trust"). The Plan was predicated on the understanding that (a) the property disposition and reversion provisions of subsection 75(2) of the *Income Tax Act* would apply no matter how property was transferred to the Trust (whether for free or by sale); and (b) the Trust would, therefore, not be taxable on certain dividends that it received (the "Dividends"). Following the advent of *Sommerer v. The Queen*, 2012 DTC 5126, the Minister determined that subsection 75(2) would not apply to the Trust because, in *Sommerer*, the Court determined that subsection 75(2) does not apply when property is sold to a trust. The Minister proposed to reassess, taxing the Trust at the highest possible rate on the Dividends. The Trust applied for an order rescinding the Dividends.

The Trust's application was granted. In *Gibbon v. Mitchell*, [1990] 1 WLR 1304, the Court determined that rescission of a voluntary disposition will be granted for mistake where "the mistake is as to the effect of the transaction itself and

not merely as to its consequences or the advantages to be gained by entering into it". In addition, *Gibbon* has been followed by Canadian courts. In *Pitt v. Commissioners for Her Majesty's Revenue and Customs*, [2013] UKSC 26, however, the UK's House of Lords concluded that the true requirement for rescission is "simply for there to be a causative mistake of sufficient gravity", and that the test for rescission will normally be satisfied "only when there is a mistake either as to the legal character or nature of a transaction, or as to some matter of fact or law which is basic to the transaction." Additionally, in *Pitt*, the House of Lords noted that the decision in *Gibbon* has been criticized by legal scholars and in more recent decisions of the Court, and that the distinction between effect and consequences set out in *Gibbon* should be rejected. The *Pitt* case is persuasive and should be applied in the present proceedings. As a result, the rescission of the Dividends sought by the Trust was the appropriate remedy for the following reasons: (a) the tax implications were basic to the Plan; (b) there had been a causative mistake, the gravity of which was significant; (c) rescission of the Dividends would cause no prejudice to any third party affected by the Plan, since the monies remained within the various entities and remained subject to tax; (d) prior to the appearance of the *Sommerer* decision, there was a common understanding among income tax professionals and the CRA as to the operation of subsection 75(2); (e) the Minister would not have proposed to reassess the Trust were it not for the appearance of the *Sommerer* decision; and (f) to deny the rescission of the Dividends being sought by the Trust under the circumstances of this case would, therefore, be unfair.

Re Pallen Trust, 2014 DTC 5039

Funds withdrawn from RRSP not annuity payments, did not qualify for pension tax credit

The taxpayer was appealing the denial of a pension tax credit for her RRSP withdrawals in 2011. She began making withdrawals from the RRSP when her spouse died in 2008. Under the terms of the RRSP, the taxpayer had complete discretion with respect to the timing of the RRSP withdrawals. She argued that she qualified for the pension tax credit once she turned 65 in 2011.

The appeal was dismissed. To qualify for the pension tax credit, the RRSP withdrawals must be annuity payments. The ordinary definition (as well as the *Income Tax Act* definition) of annuity payments is that they are amounts payable on a periodic basis. As the taxpayer had full discretion as to timing and amounts of withdrawal, the Minister correctly argued such withdrawals did not qualify for the pension credit. As the purpose of the pension tax credit is to provide tax relief to pensioners, the taxpayer argued for a generous interpretation of an "annuity". The taxpayer argued that the payments were payable on a periodic basis because they were payable on a recurring basis at the direction of the taxpayer. While sympathetic to the taxpayer's argument, had Parliament intended RRSP withdrawals made at the discretion of the holder to qualify for the pension credit, it would have clearly provided for that. Given that the taxpayer had discretion as to when and how much was to be withdrawn from the RRSP and there was no obligation that the withdrawals be made on a recurring basis, such withdrawals did not qualify for the pension credit.

Taylor, 2014 DTC 1108

Despite filing inflated charitable donation receipts, taxpayers still entitled to portion of donation tax credits claimed

CanAfrica was a registered charity during 2006, although its registration was revoked by the Minister in 2007. Its president pleaded guilty to selling false donation receipts for 2005 and prior years. The Minister disallowed, in their entirety, the charitable donation tax credits claimed by the taxpayers for 2006 related to cash donations made during 2006 to CanAfrica. The Minister's position was that the taxpayers were involved in a scheme with their tax return preparer and had purchased charitable donation tax receipts for 10% of the value shown thereon, and since the taxpayers had made their so-called donations expecting a benefit in the form of inflated donation receipts, there could be no valid gift for tax purposes. The taxpayers appealed to the Tax Court of Canada.

The taxpayers' appeals were allowed in part. The taxpayers did make donations to CanAfrica during 2006 that were equal to 10% of the amounts shown on their donation receipts, plus an unspecified amount as a commission. Although some of the taxpayers alleged that they donated household goods in addition to cash, there was insufficient evidence of this. The receipt of a benefit will negate the existence of a gift for tax purposes (see *Berg v. The Queen*, 2014 DTC 5028). The issuance of an inflated tax receipt, however, should not usually be considered a benefit negating the gift,

despite the Minister's argument to the contrary (see *The Queen v. Doubinin*, 2005 DTC 5624). Accordingly, although the taxpayers likely knew that they were claiming inflated tax credits, this was no reason to deny them tax credits altogether. They were, therefore, entitled to tax credits equal to 10% of the amounts shown in their donation receipts and to a remission of any penalties that may have been imposed.

David, 2014 DTC 1111

Arrangement rescinding previous issue of corporate shares was retroactive tax planning, so not approved

The applicant partnership, FRPDI LP, which was the sole shareholder of the corporate applicant, Graymar, acquired a marine contractor business. A substantial portion of the purchase price was funded at arm's length with debt provided by a syndicate led by CIBC. Because the marine business did not fare well, negotiations ensued with CIBC, resulting in a debt restructuring agreement (the "2010 Debt Restructuring") under which the partners of FRPDI LP would contribute an additional $10 million of partnership capital to reduce the debt owed to the lending syndicate. The 2010 Debt Restructuring concluded with an increased subscription by FRPDI LP of $14,390,921 in Graymar's common shares and a corresponding increase in debt in the form of a $14,390,921 shareholder's loan owed to Graymar by FRPDI LP. Through inadvertence, FRPDI LP failed to repay this loan by December 31, 2011 (i.e., at the end of the taxation year following the year in which the loan was made). This prompted the CRA to reassess FRPDI LP's direct partners and others under the unpaid shareholder loan income inclusion provisions of subsection 15(2) of the *Income Tax Act*. These reassessments prompted FRPDI LP and Graymar to apply for retroactive approval of an arrangement (the "Arrangement") under which Graymar's directors would make a resolution to return $14,390,921 of Graymar's capital to FRPDI LP in respect of Graymar's issued common shares, and FRPDI LP would make a payment of the same amount by way of a set off against the $14,390,921 shareholder's loan owing to Graymar.

The application was dismissed. Despite the respondent Attorney General's argument to the contrary, the Tax Court of Canada did not have sole authority to evaluate the operation of the *Income Tax Act* in this case; the Alberta Court of Queen's Bench also has jurisdiction to interpret provisions of the *Income Tax Act* if necessary to decide issues that are properly before it (see *783783 Alberta Ltd. v. Canada (AG)*, 2010 DTC 5125). Additionally, section 244 of the *Business Corporations Act* (the "Act"), which deals with the rectification of corporate registers where persons' names have been wrongly recorded, was of no assistance to the applicants in this case. Nor was it appropriate or necessary for the court to invoke its inherent jurisdiction to grant the relief being sought in this case where an alternative statutory mechanism for approving arrangements already existed under section 193 of the Act. For that section to apply, however, the applicants had to demonstrate that they had satisfied the statutory procedural requirements of the section (which all parties agreed that they had), that they were acting in good faith with respect to the purpose of the 2010 Debt Restructuring (which was undisputed), and that the Arrangement was fair and reasonable. A fair and reasonable arrangement has a valid business purpose and resolves the objections of those whose legal rights are being arranged. In addition, both the applicants and the Attorney General agreed that it was necessary to determine whether the Arrangement had a valid legal purpose and that this determination depended, in turn, upon whether the applicants were entitled to rectification. Rectification requires, however, that the original documentation be shown not to accord with the parties' true intention (see, for example, *McPeake v. Canada (AG)*, 2012 DTC 5042). Conversely, in the present proceedings, the applicants could not show that the omission from the 2010 Debt Restructuring of a provision requiring the repayment of FRPDI LP's shareholder's loan was an error that obstructed their true original intentions underlying the 2010 Debt Restructuring. The Arrangement, therefore, was merely an attempt at retroactive tax planning through rectification — which courts discourage — and could not be approved.

Graymar Equipment (2008) Inc., 2014 DTC 5051

Minister permitted to issue inconsistent assessments against two taxpayers until underlying matter resolved

The taxpayer appealed a Tax Court order dismissing the taxpayer's motion to strike the Crown's reply to a notice of appeal against a reassessment issued under the *Income Tax Act* (the "Act") for 2001. In that year, the taxpayer had settled a spousal trust and later transferred corporate shares to the trust. Those shares were redeemed soon after,

which gave rise to a deemed dividend to the trust for which the trust paid tax. The Minister took the position that the trust was a sham and that the dividend was taxable to the taxpayer and not the trust. The taxpayer argued, on the motion, that the Minister's reply was a collateral attack on the assessment of the trust's tax liability for 2001, which, under subsection 152(8) of the Act, was valid and binding on all parties including the Minister, unless that assessment was varied or vacated, or the trust was reassessed.

The taxpayer's appeal was dismissed. It was not plain and obvious that the reassessment under appeal was an impermissible collateral attack by the Minister on the initial assessment of the trust. The Court has previously held that where the facts are in dispute, the Minister may issue inconsistent assessments pending the resolution of the dispute. The Minister was not, therefore, precluded from reassessing the taxpayer despite the trust having filed and paid tax on the deemed dividend in 2001.

McAdams, 2014 DTC 5053

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