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2014 STEP CANADA ROUNDTABLE — PART II

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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. 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 II includes summaries of answers to questions 9–19. Part I included summaries of answers to questions 1–8 and was published in *Tax Notes* No. 618 in July 2014. Where available at the time of publication, the CRA's written response is included under the heading "Key References".

Question 9: Interest and Penalties on Deficient Instalments of *Inter Vivos* Trusts

Issue

Pursuant to subsection 156(1), an individual, including an *inter vivos* trust, is generally required to pay tax in instalments. A testamentary trust, including an estate, is currently exempt from this requirement under paragraph 104(23)(*e*). In its 2014 Budget, the federal government proposes, among other changes to the taxation of testamentary and grandfathered *inter vivos* trusts, to eliminate the exemption from the requirement to pay tax in instalments for testamentary trusts for the 2016 and later taxation years. At the 2010 STEP Canada National Conference, the CRA noted that its administrative policy was not to assess interest and penalties where an *inter vivos* trust fails to make instalment payments as required by subsection 156(1). The CRA was asked to confirm whether this was the current policy.

Discussion

The CRA panellists commented that, although current administrative practice is to not assess penalties or interest when an *inter vivos* trust fails to pay instalments, in preparation for the new rules with respect to the taxation of trusts and estates, all

associated administrative policies will be reviewed. It is expected that any changes will be introduced with the new rules.

Key References

- *Income Tax Act*, s. 104(23)(e); 156(1)
- CCH Special Report No. 076H, *The Federal Budget*, February 11, 2014
- CRA Document No. 2010-0363181C6, STEP Roundtable Q25, September 20, 2010

Question 10: Cancellation of Immigrant Trust Exemption

Issue

In its 2014 Budget, the federal government proposes to eliminate the exemption contained in the section 94 non-resident trust rules for immigration trusts. Under section 94, a non-resident trust may be treated as being resident in Canada if a person resident in Canada contributes property to the trust. The immigration trust exemption currently provides that the deemed residence rules will not apply until the contributor has been resident in Canada for more than 60 months in total.

When section 94 applies to a trust in a taxation year, the trust is deemed resident as of the beginning of the taxation year (see paragraph 94(3)(*a*)). Pursuant to paragraph 249(1)(*b*), an *inter vivos* trust is required to have a taxation year that coincides with the calendar year, and so, if section 94 applies in a taxation year, the trust will be deemed resident in Canada as of January 1 of that taxation year. The CRA was asked whether it agreed that, if an individual first became resident in Canada on August 1, 2009 and remained resident thereafter, such that he or she was resident for 60 months as of August 1, 2014, a non-resident trust to which the individual had contributed would be deemed resident under section 94 as of January 1, 2014.

Discussion

The CRA panellists agreed with the above analysis.

The CRA panellists further noted that, if passed, the proposed amendment eliminating the immigration trust exemption will apply in two manners. If the exemption applied to a trust before February 11, 2014 ("Budget Day") and no contributions are made to the trust on or after that date, the elimination of the exemption will apply to the trust for taxation years ending after 2014. Otherwise, the proposed amendment will apply to a trust for taxation years ending on or after Budget Day. In the example above, assuming the exemption would have instead expired in 2015, if contributions were made to the trust on or after Budget Day, the exemption would cease to apply to the trust as of Budget Day, such that the trust would be deemed resident as of January 1, 2014.

Key References

- CRA Document No. 2014–0529821C6, Cancellation of Immigrant Trust, June 16, 2014
- *Income Tax Act*, s. 94(1) "connected contributor", "resident contributor"; 94(3)(*a*); 249(1)(*b*)
- CCH Special Report No. 076H, *The Federal Budget*, February 11, 2014

Question 11: Cancellation of Immigration Trust Exemption for New Immigrants

Issue

Further to Question 10, above, the CRA was asked whether it agreed that, if the immigration trust exemption in the section 94 non-resident trust rules is eliminated as proposed by the 2014 Budget, a non-resident trust will be deemed to be resident as of January 1 of the year in which an individual who is a contributor becomes resident in Canada, such that, for example, if an individual who established a trust in a foreign jurisdiction immigrates to Canada and becomes

resident as of August 1, 2015, the foreign trust will be deemed resident as of January 1, 2015, prior to the individual's arrival in Canada.

Discussion

The CRA panellists agreed that, if the proposed amendments are passed, the trust in the above example would be deemed resident in Canada as of January 1, 2015.

Key References

- CRA Document No. 2014–0529831C6, STEP — Q 11 — Immigration trust exemption, June 16, 2014
- *Income Tax Act*, s. 94(1) "connected contributor", "resident contributor"; 94(3)(*a*); 249(1)(*b*)
- CCH Special Report No. 076H, *The Federal Budget*, February 11, 2014

Question 12: Non-Resident Trusts and Section 94

Issue

The section 94 non-resident trust rules may apply to deem a foreign trust to be resident in Canada if the trust has a "resident beneficiary" or a "resident contributor" (both defined in subsection 94(1)). For the purposes of section 94, there may be more than one contributor to the same trust.

The CRA was presented with an example wherein an individual died and the deceased's will established a trust for the benefit of a US-resident child and a gift over on death to that child's children. The estate is resident in Canada and the child's trust is resident in the United States. There are no Canadian-resident beneficiaries of the trust (and so no resident beneficiary). The CRA was asked whether the deceased's estate would be considered to be a contributor to the child's trust, in addition to the deceased him or herself.

Discussion

The CRA panellists noted that, pursuant to the definition of "contribution" in subsection 94(1), any transfer of property to a trust, other than an arm's length transfer, will generally constitute a contribution to the trust. Further, paragraph 94(2)(*g*) deems an acquisition of an interest under a trust to be a transfer of property. Note that the definition of "trust" in subsection 248(1) provides that an estate is a trust for the purposes of the Act. As such, when the non-resident trust acquires an interest in the estate, the estate is deemed to transfer the interest to the trust, and so the estate is a contributor. As a result, there will be a resident contributor to the trust and the rules in section 94 may apply to deem the trust to be resident in Canada, at least until the estate is wound up.

Pursuant to paragraph 94(2)(*n*), which provides that a contribution made by a trust to another trust is deemed to be made jointly by the trust and each person or partnership who was a contributor to the trust, the deceased will also be a contributor to the trust. Note that the definition of "contributor" in subsection 94(1) provides that a contributor includes a person who no longer exists who has made a contribution to the trust.

Key References

- CRA Document No. 2014–0523071C6, STEP Q12 — Non-resident trust, June 16, 2014
- *Income Tax Act*, s. 94(1) "contribution", "contributor", "resident beneficiary", "resident contributor", "trust"; 94(2)(*g*), (*n*); 94(3); 248(1) "trust"

Question 13: Voluntary Disclosures

Issue

Under the Minister's Voluntary Disclosures Program, outlined in Information Circular 00-1R4, taxpayers can disclose information that was not previously reported, or correct inaccurate information, and, if the terms of the policy are met, the taxpayer will not be charged penalties or prosecuted. In addition, the Minister may grant relief from interest.

Subsection 220(3.1) grants the Minister statutory authority to waive penalties and interest.

In *Bozzer v. The Queen*, 2011 DTC 5106 ("*Bozzer*"), the Federal Court of Appeal held that subsection 220(3.1) permits the Minister to cancel interest that accrued on a tax debt in the 10 calendar years preceding the taxpayer's application, notwithstanding the taxation year in which the debt arose. In *Bozzer*, the taxpayer incurred tax debts in 1989 and 1990, and applied for a waiver of interest in 2005; therefore, the Minister had discretion to cancel interest that accrued in the period from 1995 to 2004.

The CRA was asked when a determination would be made on how to deal with voluntary disclosures that cover more than 10 years.

Discussion

The CRA panellists advised that voluntary disclosures that cover more than 10 years are currently being processed. The panellists commented that the CRA will apply the decision in *Bozzer*. The limitation period in subsection 220(3.1) provides the Minister with discretion to waive or cancel interest for the 10 calendar years preceding the request, notwithstanding the taxation year in which the debt arose. The panellists further advised that IC 00-1R4 is being revised.

Key References

- CRA Document No. 2014-0530571C6, Voluntary Disclosures — Q13, June 16, 2014
- *Income Tax Act*, s. 220(3.1)
- Information Circular 00-1R4, Voluntary Disclosures Program, March 21, 2014

Question 14: Registration of Tax Preparers

Issue

Part One

In 2011, the Internal Revenue Service ("IRS") launched new regulations requiring, among other things, that tax return preparers pass an initial certification exam and complete a minimum amount of continuing education each year. In *Sabina Loving et al. v. IRS et al.* ("*Sabina*"), the US Court of Appeals upheld the District Court for the District of Columbia's decision, wherein it found that the IRS does not have authority to regulate the tax preparation industry. The CRA was asked how this decision might affect the CRA's proposed Registration of Tax Preparers Program ("RTPP").

Part Two

The CRA was asked to provide an update on its RTPP consultations.

Discussion

Part One

The CRA panellists noted that the IRS program rejected by the Court in *Sabina* required tax preparers to meet minimum competency and continuing education standards. Although these aspects of the program were rejected by the Court, the District Court's order was modified to clarify that the IRS can request tax preparer numbers.

The panellists noted that the RTPP will not introduce competency standards or continuing education requirements. Rather, the goal of the program is to identify tax preparers making errors and to work with them to correct those errors before future income tax returns are filed. Similar to the US program, the RTPP will require tax preparers to register and obtain a personal identification number.

Part Two

The consultation period for the RTPP ended on May 31, 2014. Feedback and suggestions relate to, among other things, the following key issues: (1) reasons errors are found in income tax returns prepared by tax preparers; (2) the registration process, who would be required to register, and the challenges that might pose for tax preparers; (3) the

need for both a personal and entity identification number, and the burden that might place on tax preparers; (4) the publication of a list of registered tax preparers; (5) the strategic compliance approach, sanctions, and redress process; (6) the types of services that would be beneficial to individual tax preparers and businesses to enhance completeness and accuracy of income tax returns; and (7) the compliance burden of the proposed program for individual tax preparers and businesses. A report on the consultations is expected in summer 2014.

Key References

- CRA Document No. 2014-0523051C6, Registration of Tax Preparers — STEP Q 14, June 16, 2014
- *Sabina Loving et al. v. IRS et al.*, US Court of Appeals for the District of Columbia Circuit, No. 13-5061, February 11, 2014
- Canada Revenue Agency, Proposal — Registration of Tax Preparers Program, Consultation Paper, January 17, 2014

Question 15: Restrictive Covenants

Issue

Restrictive covenants for consideration and restrictive covenants for no consideration are treated differently under the Act. Since a restrictive covenant is typically structured as a contract, and a contract requires consideration, it is common practice to state that the restrictive covenant is for consideration in the amount of $1. The CRA was asked whether in such circumstances the restrictive covenant would be considered to be for consideration, such that, for example, the election under subsection 56.4(7) would not be available.

Discussion

The CRA panellists commented that consideration in the amount of $1 for a restrictive covenant would constitute proceeds received or receivable for granting the restrictive covenant, such that the requirements of paragraphs 56.4(6)(*e*) and (7)(*d*) would not be met. Concerned taxpayers may wish to contact the Department of Finance regarding this issue.

Key References

- CRA Document No. 2014-0522961C6, STEP CRA Roundtable, June 16, 2014
- *Income Tax Act*, s. 56.4(5), (6)(*e*), (7)(*d*); 68

Question 16: Stock Options at Death

Issue

Paragraph 7(1)(*e*) provides that when a taxpayer dies, an employment benefit is deemed to have been received by the taxpayer in the year of death in respect of unexercised employee stock options held by the taxpayer at death equal to the value of the options immediately after death less any amount paid to acquire the options.

Part One

As the benefit is based on the value of the options immediately after death, the CRA was asked to comment on the application of paragraph 7(1)(*e*) where employee stock options held by a taxpayer were unvested at the time of the taxpayer's death, such that they disappear upon death.

Part Two

The CRA was further asked whether an election could be made to carry back a loss in respect of unexercised and unvested employee stock options held by a taxpayer at death under subsection 164(6.1), or if the provision would be inapplicable on the basis that the unvested stock options were extinguished at death, and therefore were not obtained by the estate and could not be disposed of by the taxpayer's representative in the first taxation year of the estate, as required by that provision.

Part Three

Although not included in the released questions, the panellists also commented briefly on the paragraph 110(1)(*d*) deduction, which may be available where a benefit is deemed to have been received by a taxpayer under subsection 7(1), and requires the taxpayer to have acquired shares under the employee stock option agreement. The issue is that when a benefit is deemed to have been received under paragraph 7(1)(*e*), the taxpayer is deceased, and so cannot acquire shares.

Discussion

Part One

With respect to the first question, the CRA panellists commented that, in the case of an unexercised employee stock option with terms that provide for extinguishment on death, the benefit under paragraph 7(1)(*e*) would be nil since the benefit is based on the value of the option after death. The panellists further commented that if an employee stock option has not vested prior to death, the employee does not own the option at death, and so there is no paragraph 7(1)(*e*) benefit to consider.

Part Two

The panellists noted that options sometimes have terms allowing the estate to exercise the option for a period of time after death. In such cases, the election under subsection 164(6.1) may be available.

Part Three

The CRA and Department of Finance are in discussion regarding the issue raised by the paragraph 110(1)(*d*) requirements, which, as discussed above, include that the taxpayer must acquire shares under the stock option agreement.

Key References

- CRA Document No. 2014-0523011C6, STEP Roundtable 2014 — 7(1)(e), June 16, 2014
- *Income Tax Act*, s. 7(1)(*e*); 110(1)(*d*); 164(6.1)
- CRA Document No. 2009-0327221I7, Paragraph 7(1)(*e*) — Death of a Taxpayer, December 21, 2012, wherein the paragraph 110(1)(*d*) issue is considered

Question 17: Capital Interest in a Trust — Is It "Eligible Property"?

Issue

The CRA was asked to comment on whether a capital interest in a personal trust could qualify as eligible property for the purposes of the rollover rules in section 85.

Discussion

The CRA panellists noted that subsection 85(1) provides that, for the purposes of section 85, eligible property includes capital property (with some exceptions). The panellists noted that it will be a question of fact whether a capital interest in a trust is a capital property of a taxpayer, but, provided the capital interest is a capital property of the taxpayer, it will qualify as eligible property under section 85.

Key References

- CRA Document No. 2014-0526561C6, Capital interest as eligible property for s 85, June 16, 2014
- *Income Tax Act*, s. 54 "capital property"; 85(1); 107(1); 108(1) "capital interest"; 248(1) "property"

Question 18: Electing To Have Subsection 107(2.1) Apply

Issue

Subsection 107(2) provides rules under which property of a personal trust can be rolled out to a beneficiary in full or partial satisfaction of his or her capital interest in the trust. A trust resident in Canada may, in certain circumstances, elect out of subsection 107(2) by filing an election under subsection 107(2.001), in which case the rules in subsection 107(2.1) will apply instead. A beneficiary of a non-resident trust may also elect out of subsection 107(2), such that the rules in subsection 107(2.1) will apply, by filing an election under subsection 107(2.002). Subsection 107(2.11) provides that where subsection 107(2.1) applies to a distribution by a Canadian-resident trust, the trust can file an election for certain distributions such that gains will be included in the trust's income, rather than the beneficiary's income.

Part One

The CRA was asked whether the subsection 107(2.001) election applied to all property distributed to a beneficiary in full or partial satisfaction of the beneficiary's capital interest, or whether the trust could make the election on a property-by-property basis.

Part Two

The CRA was asked how the elections under subsections 107(2.001), (2.002), and (2.11), each of which requires the election to be made in prescribed form, should be made.

Discussion

Part One

The CRA panellists commented that the election under subsection 107(2.001), which refers to "a" property, can be made on a property-by-property basis.

Part Two

The CRA panellists noted that there is no prescribed form for any of the elections in subsections 107(2.001), (2.002), and (2.11). In order to make an election under one of these provisions, the trust or beneficiary must attach a letter to the relevant income tax return. The information that should be included in the letter in respect of each election will be included in the CRA's written response, expected in fall 2014.

Key References

- *Income Tax Act*, s. 107(2), (2.001), (2.002), (2.1), (2.11)

Question 19: Multiple Assessments

Issue

The CRA was presented with a scenario wherein a taxpayer carries out a series of transactions where the tax consequences of each transaction are relevant to the next. The CRA reassesses the transactions on the basis that they constitute tax avoidance. The CRA reassesses each transaction independently of the others, since it is uncertain which transaction should be reassessed. As a result, there are a series of tax reassessments, arguably only one of which, at most, can be correct. It may even be possible that the total tax liability assessed exceeds the value of the series of transactions, such that it may be impossible for the taxpayer to pay. The CRA was asked how the taxpayer should proceed in order to minimize the interest expense, and whether a waiver of interest may be considered under the fairness provisions in such circumstances.

Discussion

The CRA panellists noted that subsection 220(3.1) provides the Minister with discretion to waive or cancel interest and penalties. Information Circular 07-1 provides that such discretion may be exercised in cases of inability to pay or

financial hardship. With respect to individuals, this generally requires that payment would make the taxpayer unable to pay for basic living requirements such as food or shelter. Where the taxpayer is a corporation, the continuity of business operations, continued employment of employees, or community welfare must be jeopardized by payment. In addition, relief may be provided where the taxpayer makes a *bona fide* attempt to pay the tax balance, but high interest absorbs a significant amount of the taxpayer's payments, making it difficult for the taxpayer to eliminate the balance. A request for relief based on financial hardship requires full financial disclosure.

Key References

- CRA Document No. 2014-0523021C6, Multiple Assessments — STEP Q19, June 16, 2014
- *Income Tax Act*, s. 220(3.1)
- Information Circular 07-1, Taxpayer Relief Provisions, May 31, 2007

ONTARIO BUDGET

On July 14, 2014, the Government of Ontario tabled its post-election 2014 Budget. The Budget effectively reintroduced the pre-election measures outlined in *Tax Notes* No. 617 (dated June 2014), including changes to personal income tax brackets, phase-out of the small business deduction for larger businesses, and increases in tobacco tax rates and the fuel tax rate for aviation fuel. Similarly, the Budget again introduced a general anti-avoidance rule for land transfer tax, as well as a proposal for the Ontario Retirement Pension Plan. Budget documents are posted on the provincial News Tracker on CCH Online and are also available in the *Ontario Tax Reporter* online and on DVD. Wolters Kluwer CCH commentary on provincial budgets is available in the *Ontario Tax Reporter* online and on DVD, under the heading Budgets.

INTERGOVERNMENTAL AGREEMENT BETWEEN CANADA AND THE UNITED STATES ENTERS INTO FORCE

Its provisions generally having effect on July 1, 2014, the intergovernmental "Agreement Between the Government of the United States of America and the Government of Canada to Improve International Tax Compliance through Enhanced Exchange of Information under the Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital" ("IGA") entered into force on June 27, 2014. Signed on February 5, 2014, the IGA is pursuant to the *Foreign Account Tax Compliance Act* legislation enacted by the United States in March 2010.

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.

Tax Court Upholds the Minister's Assertion that Treaty Tie-Breaker Rule Does Not Determine Residency for Purposes of the *Income Tax Act*

***Black v. The Queen*, 2014 DTC 1046 (Tax Court of Canada)**

Where a taxpayer is a tax resident in both Canada and another jurisdiction with which Canada has entered into a tax treaty, a residency "tie-breaker" rule in the tax treaty normally applies to deem the taxpayer to be resident in one jurisdiction but not the other for the purposes of the particular tax treaty. This case considered whether a determination of residency under the *Canada-United Kingdom Income Tax Convention* (the "Convention") was also applicable in determining residency for purposes of the *Income Tax Act* (the "Act"), in a situation where subsection 250(5) of the Act did not apply; subsection 250(5) deems a person who would otherwise be a resident of Canada to be a non-resident of Canada if a tax treaty determines the person is resident in another jurisdiction.

The taxpayer, Lord Conrad Black, a former Canadian newspaper publisher and member of the British House of Lords, had a substantial enough presence in the United Kingdom that he was considered a UK resident under UK tax law during the period from 1992 through 2002. In 2002, the Minister assessed the taxpayer for tax under Part I of the Act in respect of certain income from employment performed in the United States, as well as Canadian-source dividend and interest income. The Minister acknowledged that the taxpayer was a UK resident in 2002 for the purposes of the Convention by virtue of the residency tie-breaker rule set out in Article 4 of the Convention. However, the Minister took the position that the treaty tie-breaker rule only determined residency for purposes of the Convention and that, under the Act, the taxpayer was a resident of Canada. As such, the Minister contended that the taxpayer was subject to Canadian income tax on his worldwide income.

The taxpayer appealed the Minister's assessment and then brought a motion to the Tax Court pursuant to section 58 of the *Tax Court of Canada Rules (General Procedure)* to have the Court determine a question of law that would dispose of the appeal or shorten the hearing. The question of law was whether the Minister could assess the taxpayer on the basis that the taxpayer was a resident of Canada for purposes of the Act without having regard to the provisions of the Convention. The Tax Court agreed to consider the question and concluded that the answer to the question required the following two issues to be addressed: first, whether the operation of the tie-breaker rule in Article 27(2) of the Convention to deem an individual to be a UK resident for purposes of the Convention applied to deem the individual to be a non-resident of Canada for purposes of the Act, so as to preclude the Minister from assessing the individual as a resident of Canada; and second, whether Article 27(2) of the Convention could apply to enable the Minister to assess the taxpayer under Part I of the Act. As applicable in 2002, Article 27(2) provided that where one contracting state (i.e., Canada) was required to relieve a taxpayer from tax under the Convention and, under the laws of the other contracting state (i.e., the United Kingdom), the taxpayer was subject to tax only to the extent that such amounts were remitted to or received in that other state, the relief provided by the first contracting state (i.e., Canada) was only applicable to the extent of the amounts so remitted or received in the other contracting state.

The taxpayer's position was that, where the tie-breaker rule in Article 4(2) of the Convention deems the taxpayer to be a resident of the United Kingdom, the taxpayer must also be considered to be a non-resident of Canada for purposes of the Act because it would be a "clear inconsistency" for an individual to be considered to be a resident of Canada for purposes of the Act without taking into account the residency tie-breaker rule in the Convention. Relying on the paramountcy rule in subsection 30(2) of the *Canada-United Kingdom Income Tax Convention Act 1980* (the "Convention Act"), such an inconsistency would, the taxpayer contended, warrant the determination of residency under the Convention prevailing over the Act. In this case, to resolve the inconsistency, the taxpayer argued that he should be considered a resident of the United Kingdom and not of Canada for the purposes of both the Act and the Convention.

The Minister's position, on the other hand, was simply that the taxpayer was a resident of Canada for the purposes of the Act, notwithstanding the application of the tie-breaker rule for purposes of the Convention and, thus, was subject to Canadian income tax on his worldwide income. The Minister also argued that Article 27(2) of the Convention nonetheless applied to allow the Minister to assess tax on any amounts not remitted or received in the United Kingdom.

In the Court's analysis, Chief Justice Rip first reiterated that the proper approach to interpreting a tax treaty, like the Convention, and its interaction with the Act was to take a liberal and purposive approach rather than a strict, mechanical application of the words used in the treaty. As stipulated by the Supreme Court of Canada in *Crown Forest Industries Ltd.* (95 DTC 5389), "[the] process involves looking into the language used and the intention of the parties".

The Court noted that the purpose of the Convention was "to avoid double taxation", as stated in the Convention's full title. However, the Act has since been revised to provide relief from double taxation under Canadian domestic law through the availability of credits, deductions, or exemptions under the provisions of the Act. As such, the Court stated that the principal purpose of a tax treaty would be the allocation of taxing power between the country of the source of income and the country in which the taxpayer is resident. Article 4 of the Convention determines residency for "purposes of the Convention". The Court pointed to the dictionary definitions of the word "purposes" and the French equivalent, "sens", which stress a "particular object", and held that the object or purpose of Article 4 was restricted to the Convention and "nothing else".

With the purpose of Article 4 of the Convention in mind, the Court disagreed with the taxpayer's position that being concurrently a resident of Canada under the Act and a resident of the United Kingdom under the Convention gave rise

to a "clear inconsistency" which would necessitate the provisions of the Convention overriding the Act pursuant to subsection 30(2) of the Convention Act. Chief Justice Rip opined that the threshold for such an inconsistency is one that produces a conflict between the operation of the Act and the purposes of the Convention. The Court pointed to the Organisation for Economic Co-operation and Development Commentaries, which stated that Article 4(2) of the Convention merely gives a "preference" to the claim of a particular state over another state. The Court determined that the intention of the drafters of the Convention was not to extinguish a particular state's claim to tax but rather to give a priority to the claim of one state over another in order to avoid double taxation. Since the income amounts in question were not remitted to or received in the United Kingdom and thus, were not subject to tax in the United Kingdom, double taxation was not an issue. As such, the Court concluded that there was no such inconsistency, and the taxpayer was subject to tax under Part I of the Act by virtue of being a resident of Canada.

It was accepted by all parties that subsection 250(5) of the Act did not apply because of the transitional rules that accompanied the enactment of subsection 250(5). Subsection 250(5) of the Act does not apply to a Canadian-resident individual who was a treaty resident of another country at the time the provision became applicable after February 24, 1998. As the taxpayer was resident in the United Kingdom from 1992 and remained so throughout 2002, subsection 250(5) did not apply.

Having concluded that the taxpayer was resident in Canada for purposes of the Act notwithstanding Article 4(2) of the Convention, the Court noted that it was "debatable" as to whether it needed to address the applicability of Article 27(2). Nevertheless, the Court addressed the parties' submission on this issue. The taxpayer submitted that Article 27(2) did not allow the Minister to assess Part I tax on the income in question on the basis that there was "no 'tax in Canada' from which the [taxpayer] was 'relieved' under any provision of [the] Convention".

The Court's ruling that the taxpayer was subject to Part I tax vitiated the taxpayer's argument. Further, Article 27(2) of the Convention was not restricted to income "arising in Canada" and, as the Court noted, any such reading in of that phrase would distort the intended meaning of the provision. The Court held that Article 27(2) of the Convention restricted the tax relief afforded by Canada under the Convention to relief on income amounts that were subject to tax in the United Kingdom. In other words, the tax relief available under the Convention only applied to amounts actually taxed in the United Kingdom. The Court stated that the Minister was free to assess the taxpayer for Canadian income tax on income not subject to tax in the United Kingdom (i.e., amounts of income of a non-domiciled UK resident that were not received in or remitted to the United Kingdom) on the basis of the taxpayer being a resident of Canada under the Act without having regard to the residency tie-breaker rule in the Convention.

This case considered the interaction of the residency provisions of the Act and a tax treaty in the situation where subsection 250(5) of the Act did not apply. Had subsection 250(5) of the Act been applicable, the Court would have likely come to a much different conclusion in that subsection 250(5) would have deemed the residency of the taxpayer as determined by the Convention to be residency for purposes of the Act. In any event, the Tax Court's decision is likely not the last word in this case. The taxpayer has filed an appeal of the decision with the Federal Court of Appeal.

— *Jeremy Ho*

RECENT CASES

Taxpayers entitled to deduction offsetting dividends received from foreign affiliate

Lehigh Cement Limited ("Lehigh"), a cement and building products manufacturer in Canada, and its wholly owned subsidiary, CBR Alberta Limited ("CBR") (together, the "taxpayers") belonged to a corporate group operating internationally whose parent company was based in Belgium. A sister US-incorporated company of the taxpayers incurred operating losses that led to a complex restructuring. As part of the restructuring, the taxpayers set up a Delaware limited liability company, NAM LLC, and made capital contributions of $1 million to NAM. NAM was a foreign affiliate of the taxpayers and paid $15 million in dividends to the taxpayers, who claimed a deduction offsetting the amount of dividends they received from NAM. The Minister disallowed the deduction on the basis of section 95 of the *Income Tax Act*, an anti-avoidance provision, arguing that the principal purpose of the taxpayers' acquisition of shares in NAM was to avoid taxes otherwise payable. The Tax Court of Canada (the "TCC") allowed the

taxpayers' appeal, finding that there were no taxes otherwise payable (2013 DTC 1139). The TCC also accepted the taxpayers' argument that the purpose of acquiring shares in NAM was to avoid US taxes, not Canadian taxes. The Crown appealed the TCC decision, arguing that the anti-avoidance provision should be applied broadly to deny the deduction to the taxpayers.

The appeal was dismissed. The taxation of income received by Canadian taxpayers from non-resident corporations depends on the type of income and the ownership status of the non-resident corporation. Dividends received by Canadian taxpayers must be included in income, but the taxpayers may claim a deduction offsetting the dividends if they are received by a foreign affiliate. As taxpayers could manipulate shareholdings to ensure they get the deduction, anti-avoidance provisions have been enacted; these are to be interpreted according to their text, context, and purpose, and some have broader implications than others. Section 95 is precise and unequivocal, and deals with the manipulation of share ownership in non-resident corporations for the primary purpose of avoiding tax, unlike section 245, which deals more broadly with a series of transactions. For section 95 to apply, obtaining the tax benefit must be the principal purpose of the share acquisition. The Crown argued that section 95 should be applied where tax avoidance is unacceptable. That is a subjective argument and could lead to taxpayers being treated differently, which violates the concept of tax law applying equally to all taxpayers. All the circumstances must be considered in determining whether section 95 applies. The taxpayers successfully showed that their main purpose in acquiring shares in NAM was not to avoid Canadian taxes but to achieve overall US tax savings. The Canadian tax savings could have been accomplished without acquiring shares in NAM. There was no reason to interfere with the findings of the TCC.

Lehigh Cement Limited, 2014 DTC 5058

Director exercised due diligence — Not liable for corporation's failures to remit tax

The Minister assessed the taxpayer under section 227.1 of the *Income Tax Act* for director's liability for 2006 and 2007. The Minister issued seven assessments to Roy's Electric Company (the "Corporation") for late-remitted or unremitted federal and provincial income taxes, Employment Insurance premiums, and Canada Pension Plan contributions, plus penalties and interest. The taxpayer made a lump-sum payment in January 2009 in respect of the principal owing by the Corporation but did not pay the interest and penalties.

In 2005, the taxpayer hired a bookkeeper to handle payroll and source deductions, among other tasks, for the Corporation. The taxpayer oversaw the bookkeeper's work but relied on the bookkeeper to complete and file the necessary remittances on time. Some years later, there was a confrontation with the bookkeeper that caused her to leave her position. After her departure, the taxpayer became aware that remittances were not current, and those amounts were later paid. At issue was whether the taxpayer, as director of the Corporation, exercised the degree of care, diligence, and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances.

The taxpayer's appeal was allowed. While the applicable standard is an objective one, it does not demand perfection from a director. The taxpayer could not reasonably have known or be expected to have known that the bookkeeper would engage in fraudulent and misleading actions. Moreover, there was no evidence that the taxpayer encouraged or condoned the use of source remittances for other purposes. The taxpayer met his burden of establishing that he took proactive steps to prevent the Corporation's failure to remit and also met the due diligence defence.

Roitelman, 2014 DTC 1129

Capital loss sustained by taxpayer on sale of common shares of corporation disallowed under GAAR

The taxpayer, who was in the real estate business, sold certain properties during 2005, 2006, and 2007, realizing sizable capital gains. In December 2005 he incorporated a corporation, "Immeubles Molibec", under the Quebec *Companies Act*. Immeubles Molibec issued Class A common shares to the taxpayer in return for a non-interest bearing sight bill payable on demand in the amount of $22.5 million, and then issued a stock dividend to the taxpayer in the form of 100 Class H preferred shares with a redemption value of $22.5 million and paid-up capital ("PUC") of $100. The

taxpayer then sold his Class A common shares of Immeubles Molibec to each of his two sons for nominal consideration, realizing a capital loss of $22,499,900. All of these transactions took place in December 2005. The taxpayer engaged in a similar series of transactions generating similar capital losses in December 2006 and again in December 2007. In reassessments based on the GAAR, the Minister disallowed the deduction of all of these capital loss deductions claimed. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was dismissed. The transactions in issue in this case were all similar in that the taxpayer incorporated a new corporation, received its common shares at their fair market value, received a preferred share stock dividend (on the common shares) with a high redemptive value and a low PUC, and then disposed of the common shares at a loss. In *1207192 Ontario Ltd. v. The Queen*, 2012 DTC 5157 (FCA) and in *Triad Gestco Ltd. v. The Queen*, 2012 DTC 5156 (FCA), this type of transaction was held to constitute an abuse of paragraphs 34(*b*), 38(*b*), and 39(1)(*b*) of the *Income Tax Act* contrary to the GAAR, because of the transfer of the value of the common shares to the preferred shares. The situation in the present proceedings was not distinguishable from the *1207192* and *Triad Gestco* cases. The Minister's reassessments were affirmed accordingly.

Barrasso, 2014 DTC 1130

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