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WHAT IS AN "AVOIDANCE TRANSACTION"? THE FEDERAL COURT OF APPEAL FINDS FOR THE TAXPAYER IN *SPRUCE CREDIT UNION*

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The Federal Court of Appeal ("FCA") released its decision in *Spruce Credit Union* (2014 DTC 5079) on May 30, 2014. In it, the Crown's appeal from the Tax Court of Canada's 2012 judgment (2012 DTC 1295) was dismissed. The case provides useful considerations of the meaning of the term "avoidance transaction" for the purposes of the general anti-avoidance rule ("GAAR") in section 245 of the *Income Tax Act* (the "Act") and of the interpretation of certain provisions of the Act specifically relevant to credit unions.

Aside from the taxpayer, another 40 credit unions in British Columbia will be grateful that the FCA found against the Crown; these credit unions had identical assessments held in abeyance pending the outcome of this test case.

Facts

Spruce Credit Union ("Spruce") is one member of a large network of credit unions providing financial services to its members in British Columbia. Two separate provincially owned entities were responsible for insuring the deposits of B.C. credit unions over the relevant period: the Credit Union Deposit Insurance Corporation ("CUDIC") and the Stabilization Central Credit Union of British Columbia ("STAB"). Under the relevant provincial law, CUDIC is required to maintain an insurance fund guaranteeing deposits and non-equity shares in the event of a default or failure of a credit union. STAB performed an oversight function in the credit union marketplace, and each B.C. credit union was required to be a member of STAB and hold such number of Class A shares of STAB as determined by the STAB board of directors. Both agencies were primarily funded by assessments of the provincial credit unions.

For many years, STAB and CUDIC had jointly maintained the deposit insurance protection fund that was ultimately CUDIC's statutory obligation to maintain. In 2003, the provincial agency responsible for overseeing STAB and CUDIC determined that CUDIC was required to maintain exclusive control over a significantly higher proportion of the protection fund; this required that funds currently held by STAB be transferred to CUDIC. After considering alternatives, it was decided that CUDIC would assess the member credit unions the amount in aggregate necessary to meet the fund requirement, and that STAB would pay to the credit unions a dividend on its Class A shares that was roughly equal to the assessment. Two dividends were in fact declared and paid: Dividend A, from STAB's "aggregate cumulative investment income", and Dividend B, from STAB's "aggregate cumulative assessment income".

Under the rules governing credit unions in the Act, Spruce (and presumably all the other affected credit unions) paid its assessment to CUDIC and claimed a deduction for the payment under subsection 137.1(11) of the Act, which provides that a "member institution" (which Spruce was) can deduct premiums or assessments made to deposit insurance corporations in the year (which CUDIC was). Spruce also deducted the dividend in computing its income pursuant to the dividend received deduction in subsection 112(1) of the Act.

The Canada Revenue Agency ("CRA") reassessed Spruce, denying the subsection 112(1) deduction in respect of Dividend B. Dividend A was not reassessed. In the CRA's view, paragraph 137.1(10)(*a*) required Spruce to include the amount received as Dividend B in income as an "allocation in proportion to any premiums or assessments" that Spruce had paid to STAB. The CRA also assessed Spruce using the GAAR.

Tax Court of Canada

At the lower court, the judge held in favour of the taxpayer, finding that neither subsection 137.1(10) of the Act nor the GAAR were applicable. According to the Tax Court judge's reasons, the amount of Dividend B did not satisfy the "proportionate to assessments" test, as Spruce's aggregate amount of STAB's assessments, being 0.26%, did not match the amounts returned to Spruce by way of Dividend B, which amounted to 0.23% of the aggregate amount of STAB assessments. The credit unions held shares in STAB in proportion to their *asset size*, which had recently been rebalanced, and not in proportion to assessments received. As such, the strict wording of subsection 137.1(10) was not met, and Dividend B was instead governed by the ordinary rules in the Act pertaining to intercorporate dividends, namely the subsection 112(1) deduction.

The Tax Court also considered the application of the GAAR to deny the subsection 112(1) deduction. The Tax Court judge found that there was no transaction that was undertaken primarily for a tax purpose; in the parlance of the GAAR, there was no "avoidance transaction" and therefore the GAAR could not apply. Importantly, the Tax Court judge determined that the decision to return the funds to Spruce (and the other member credit unions) by way of dividend and not a return of assessments, for example, was not a transaction.

Federal Court of Appeal

The Crown appealed the Tax Court's decision to the FCA.

The FCA first considered whether subsection 137.1(10) of the Act applied to Dividend B. The Court noted that the rules surrounding the taxation of credit unions provide member institutions with a deduction for premiums paid in the year, and require the institutions to include any allocations in proportion to those assessments as income when received. Since Dividend B was paid from STAB's aggregate cumulative assessment account, it was assumed that Spruce and the other credit unions received a deduction when these amounts were paid to STAB. Presumably, this was the Minister's objection to the entire planning — the taxpayer received a deduction for premiums paid, but when returned as a dividend, there was no ultimate income inclusion because of the subsection 112(1) deduction *and* the subsequent assessment paid to CUDIC was deductible for the credit unions. Thus, there was an element of "double dipping" to the transactions.

The Crown argued that "allocation" for the purposes of section 137.1 can refer to something less than the member institution's original assessment. The Crown also continued its argument (heard, but not decided in the Tax Court) that section 137.1 of the Act is a "complete code" as regards the taxation of premiums and assessments made and refunded to credit unions. However, the FCA did not accept this reasoning. In its view, because Dividend B was at law and in fact a dividend from a taxable Canadian corporation, and because the dividend was paid in proportion to the member institutions' *shareholdings* and not their assessments or premiums, subsection 137.1(10) simply had no application to the facts.

The FCA also addressed the Crown's argument that the GAAR should be applied to deny Spruce the ability to claim the subsection 112(1) deduction. As noted by the Court, there are three elements necessary for the GAAR to be applicable: (1) there must be a tax benefit; (2) one of the transactions or events giving rise to the tax benefit must be an avoidance transaction; and (3) the tax benefit must result in an abuse or misuse of the object, spirit, or purpose of the provisions relied on by the taxpayer.

Spruce had conceded that it obtained a tax benefit by virtue of claiming the subsection 112(1) deduction. At the Tax Court, the judge held that there was no avoidance transaction and therefore the abuse or misuse analysis was not necessary. The Crown argued that the Tax Court judge's reasoning was flawed in that the Tax Court had held that it was "inappropriate to consider whether the taxpayer chose the particular transaction among alternatives primarily based on tax considerations". In the Crown's view, the FCA decision in *MacKay* (2008 DTC 6238) requires the Court to consider whether the non-tax objective could have been obtained without the particular impugned transaction or through an alternative transaction. The Crown also argued that the Tax Court was incorrect in holding that tax considerations can play a primary role in a taxpayer's choice among several structuring options without necessarily making any particular transaction or event in the series primarily tax-motivated.

The Crown relied heavily on the fact that STAB had paid the dividends at a time when it appears (although not explicitly stated in the Court's reasons) that the Class A STAB shares were "taxable preferred shares" and had later petitioned the Supreme Court of British Columbia to retroactively amend the share terms to avoid a significant tax under Part VI.1 of the Act. In statements made to that court, STAB had indicated that the "dominant consideration" in structuring the transactions was to minimize adverse tax considerations of the member institutions.

The FCA rejected the Crown's reasoning as regards the GAAR. The Court found that when determining whether a particular transaction is an avoidance transaction, the existence of an alternative transaction that may have attracted additional tax is but one factor to consider. The very existence of such alternative transaction is not, in and of itself, determinative that there has been an avoidance transaction. The fact that this alternative transaction exists is only one consideration in determining whether any transaction in a series is an avoidance transaction. In this author's view, this must be correct. As noted by the FCA in its reasons, to contend otherwise would be to undermine the long-standing *Duke of Westminster* principle in Canadian tax law that taxpayers are free to organize their affairs in a manner to pay the least amount of tax within the bounds of the law. The Supreme Court of Canada has affirmed the validity of the *Duke of Westminster* principle in numerous GAAR decisions.

It is not entirely clear what the principled distinction is between this decision and that in *MacKay,* where the FCA found an avoidance transaction, overturning the lower court decision. It may be that in this case, there was a regulatory regime in place that needed to be accommodated and that necessitated moving money around from STAB to CUDIC, whereas *MacKay* involved arguably gratuitous tax-motivated planning based on a voluntary acquisition of certain real property. However, in neither case is this distinction particularly clear. The presence of an accommodating party in *MacKay* may have also played a role. Unfortunately, it may simply be a matter of the FCA finding that the *Spruce Credit Union* transactions "smelled" better than the motivations of certain of the steps in *MacKay*.

It is hoped that future GAAR decisions in which the presence of an avoidance transaction is at issue will help resolve this uncertainty.

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* 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 Dentons 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.

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DIRECTOR/EXECUTOR LIABILITY

In the situation described, an individual is the executor of an estate. The deceased was the sole shareholder and sole director of a corporation that has not been dissolved but which has no assets. The Canada Revenue Agency's ("CRA's") records show that the corporation owes an amount from a trust account for GST or payroll and that the corporation's tax returns are not up-to-date. The executor has no knowledge of the company, and no records have been found. The CRA was asked what the executor's reporting and other obligations are with respect to the corporation and the estate. The CRA stated that there is no requirement under the *Income Tax Act* (the "Act") for the executor to file the corporation's tax returns. However, it may be advisable to do so in order for the executor to determine the deceased's assets and liabilities. The CRA noted that as the sole director, the deceased taxpayer could be liable under section 227.1 of the Act for unpaid amounts from the corporation, such as payroll. As well, there could be a liability under section 160 of the Act if any property was transferred from the corporation to the deceased shareholder for less than fair market value. The executor would be entitled to object to any assessments that arose under these provisions. The CRA cautioned that the executor should obtain a clearance certificate under subsection 159(2) of the Act before distributing any property from the estate in order to avoid being personally liable for unpaid tax debts.

— *External Technical Interpretation, International Division, March 31, 2014, Document No. 2013-0513191E5*

INCOME TAX FOLIO UPDATE

Effective July 31, 2014, Income Tax Folio S5-F1-C1, Determining an Individual's Residence Status, was updated to improve readability. Changes to the Folio — which replaces and cancels Interpretation Bulletin IT-221R3, *Determination of an Individual's Residence Status* — can be viewed on the Folio's Chapter History page.

Effective August 19, 2014, the Canada Revenue Agency ("CRA") introduced Income Tax Folio S1-F3-C3, Support Payments (the "Folio"). The Folio — which replaces and cancels Interpretation Bulletin IT-530R, *Support Payments* — also incorporates information obtained in *Income Tax Technical News* No. 24; a detailed description of changes made as a result of legislation and precedential court decisions can be viewed on the Folio's Chapter History page. As with all newly introduced Income Tax Folios, there is a three-month comment period during which suggestions about content and structure may be sent to the CRA. Feedback may be emailed to folios@cra-arc.gc.ca until November 19, 2014.

CRA RELEASES FIRST-EVER MOBILE APP

On August 21, 2014, the Honourable Minister of National Revenue, Kerry-Lynne D. Findlay, took part in the launching of the Canada Revenue Agency's ("CRA's") first-ever mobile app. The app is designed to allow business users to create custom reminders and alerts for due dates regarding instalments, payments, and remittances. The app, which is recommended for small and medium-sized businesses, is available free of charge for Apple iOS, Google Android, and Blackberry mobile platforms, and can be found in app stores by searching "Business Tax Reminders" or by visiting the CRA's mobile app page.

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.

Rescission Granted for Mistake of Law

***Re Pallen Trust*, 2014 DTC 5039 (Supreme Court of British Columbia)**

In this case, the applicant trust was successful in having the Supreme Court of British Columbia issue an order to rescind two declarations that a corporation made to pay dividends on shares held by the trust. The interesting aspect

of the case from a tax perspective is that the order was granted because the expected tax treatment of the dividends paid to the trust was a basic feature of the series of transactions the parties implemented, but subsequent case law showed the parties' conclusion as to the taxation of the dividends to be mistaken.

The subject dividends were part of a series of transactions that an individual undertook on the advice of his advisers in connection with his ownership of the company that operated his family business. Under the plan, the individual, David Pallen, transferred his shares of the operating company, Integrated Pest Supplies Ltd., to a newly formed holding company, D.W. Pallen Holdings Ltd. Pallen Trust was formed with David Pallen and his spouse as trustees and D.W. Pallen Holdings Ltd. as one of two beneficiaries. D.W. Pallen Holdings subscribed for Class D shares in Integrated Pest Supplies Ltd. and, in turn, transferred the Class D shares to Pallen Trust for their fair market value.

The dividends at issue in the application were dividends that D.W. Pallen Holdings Ltd. declared and paid on the Class D shares held by Pallen Trust. The first dividend was for $10,000 and was declared and paid in cash at the time the structure was implemented in December 2007. The second dividend was for $1.74 million and was declared and paid by way of a non-interest-bearing promissory note on December 31, 2008.

It was intended that the plan would provide the individual and his family with some creditor-proofing for a portion of the equity that had accrued in the family business (through the transfer of accrued value in the operating company to Pallen Trust through the dividends). The structure was also expected to yield a tax benefit that relied on the application of subsection 75(2) of the *Income Tax Act* (the "Act") to any dividends paid by the operating company to Pallen Trust. More particularly, it was anticipated that subsection 75(2) would deem any dividends paid to Pallen Trust on the Class D shares to be dividend income of D.W. Pallen Holdings Ltd. rather than Pallen Trust, and that D.W. Pallen Holdings Ltd. would be entitled to claim an offsetting deduction for those dividends under subsection 112(1). The tax benefit resulted from the fact that the dividend income was taxed in the hands of a taxpayer that was entitled to an offsetting deduction while the assets representing the dividend were in a trust and could be transferred to the trust beneficiaries as a tax-free distribution of the capital of the trust.

Subsection 75(2) is one of the rules in the Act that can operate to attribute income from the actual recipient to another taxpayer. In general, the provision is designed to prevent a taxpayer from transferring income-producing assets to a trust to avoid being taxed on the income while retaining the right to recover the property or maintaining control over the disposition of the property. The advisers that had put together the plan were not only aware of the potential application of subsection 75(2) to the dividends, they had structured the transaction to try to ensure that the transfer of Class D shares by D.W. Pallen Holdings Ltd. to Pallen Trust met the statutory requirements to trigger the application of subsection 75(2) to any income received by Pallen Trust on the Class D shares. The way in which the advisers expected subsection 75(2) to apply in these circumstances was consistent with the prevailing view among Canadian tax advisers and the Canada Revenue Agency's ("CRA's") published positions.

In 2011, the Federal Court of Appeal in *Sommerer* (2011 DTC 1162) held that subsection 75(2) does not apply to attribute income on property transferred to a trust where the trust paid fair market value consideration for the transfer. Since the transfer of the Class D shares from D.W. Pallen Holdings Ltd. to Pallen Trust was done for fair market value consideration, this meant that subsection 75(2) would not apply to attribute the dividend income on the Class D shares to someone other than Pallen Trust and, therefore, the dividends received by Pallen Trust in 2007 and 2008 would be taxable in the hands of the trust, subject to tax at the highest marginal rate for individuals.

The CRA audited Pallen Trust post-*Sommerer* and was proposing to reassess the trust to include the 2007 and 2008 dividends in its income. In making the application to the BC Supreme Court to rescind the dividends, Pallen Trust was essentially seeking to have the Court order that the dividends never happened.

At the outset, the Court confirmed that the equitable remedy of rescission is available for both mistakes of fact and mistakes of law and went on to state that the legal principles that apply to the issue of whether a court should grant rescission on a voluntary disposition are outlined in the recent decision of the UK Supreme Court in *Pitt* ([2013] UKSC 26). The Court concluded that the *Pitt* case stood for the proposition that rescission should be available if "a mistake of sufficient causative gravity was made that would make it unconscionable, unjust or unfair to leave the mistake uncorrected".

The issue, then, was whether there was a mistake in the circumstances of the present case that met the *Pitt* standard.

The trust's position was fairly straightforward. It argued that the plan was based on a mistake in law that produced serious, unintended consequences and, had the parties known that subsection 75(2) applied in the manner decided in *Sommerer*, they would not have undertaken the transactions. As to the unconscionability, unjustness, or unfairness of leaving the mistake uncorrected, the trust relied on the fact that the legal interpretation for subsection 75(2) relied on in the planning was consistent with the CRA's published positions at the time the plan was created and implemented.

The main thrust of the Crown's argument was that there was no mistake in law in the circumstances, because the tax analysis communicated to David Pallen at the time of implementation contained the conventional caveats concerning the possibility that the tax results might not be the ones that were anticipated; as a result, the applicant had accepted the disclosed risk that the tax consequence might not be as portrayed by the tax advisers and the remedy of rescission should not be available simply because that assumed risk became a reality. The Court was not persuaded by this argument because on cross-examination the Crown admitted that the plan was acceptable under CRA policy prior to the *Sommerer* case and the expected treatment of the dividends in the circumstances reflected the general understanding of tax professionals in Canada at the time.

The Crown also drew attention to the fact that, in the course of auditing the transaction, the CRA had developed alternative assessing positions that did not rely on the *Sommerer* interpretation of subsection 75(2) to deny the favourable tax benefits from the transaction; therefore, even if the parties were mistaken regarding the interpretation of subsection 75(2), the unintended result did not flow solely from that mistake. However, in response to this argument, the Court concluded that the CRA would not have challenged the transaction at all had it not been for the *Sommerer* decision. Therefore, the mistake was really about how subsection 75(2) would apply to the transaction as a consequence of the *Sommerer* decision.

Ultimately, the Court held that, in the present circumstances, the mistake in law as to the application of subsection 75(2) met the *Pitt* standard and granted the order sought. The tax aspects of the plan were a basic feature of the transaction structure and the gravity of the mistake was significant. The faulty interpretation was based on the common and general understanding by income tax professionals and the CRA's published position at the time of implementation. Moreover, the CRA would not have proposed the reassessments in the absence of the *Sommerer* decision. Further, there was no prejudice to the CRA, as there was no dispute that, with the rescission of the dividends, the monies would be subject to eventual taxation.

Although the applicant trust received the order it sought in this case, the Court was careful to caution that its decision to grant the remedy was strongly influenced by the fact that (1) the mistaken interpretation was in accordance with the common understanding at the time; and (2) the CRA would not have sought to challenge the tax consequences under other possible avoidance provisions were it not for the release of the *Sommerer* decision. Presumably, the Court's observations are directed at discouraging future applications for similar relief where the applicant's mistake as to the interpretation of the tax law was not based on an interpretation that was widely held among Canadian tax professionals and/or consistent with the CRA's published positions at the time.

This case is a welcome example that equitable relief may be available in situations where a widely held understanding of the law turns out to be incorrect as a consequence of subsequent case law.

The Crown has appealed the decision to the British Columbia Court of Appeal.

— *Brandon Siegal and John Yuan*

Taxpayer Liable under Subsection 160(1) in Respect of Cheques Received from Common-Law Spouse

***Connolly v. The Queen*, 2014 DTC 1084 (Tax Court of Canada)**

This case dealt with the application of the transferee liability provisions in subsection 160(1) of the *Income Tax Act* (the "Act"). More particularly, the Minister assessed the taxpayer for $76,884.17 of the tax debt of her common-law spouse because the spouse had endorsed to the taxpayer certain cheques that were payable to him while he was a tax debtor.

Subsection 160(1) allows the Minister to assess a taxpayer for property received from a non-arm's length person who, at the time of the transfer, owes taxes. To assess a taxpayer for such amounts, the following requirements must be met: (1) there must be a transfer of property; (2) the transferor and transferee must not have been dealing at arm's length; (3) there was no or inadequate consideration flowing from the transferee to the transferor; and (4) the transferor must have been liable for tax when the property was transferred.

In this case, the cheques in question were issued to the spouse/tax debtor but endorsed to the taxpayer and deposited to the taxpayer's bank account during a time when the spouse owed $102,059.89 of tax arrears. The taxpayer claimed that the amount of the cheques represented the repayment of loans that the taxpayer had previously made to her spouse to finance his painting and restaurant businesses as well as his personal living expenses and, therefore, subsection 160(1) should not apply in the taxpayer's circumstances because the tax debtor received consideration for the transfer of the cheques though a corresponding reduction in the outstanding loan balance.

The Minister submitted that the funds were not transferred in repayment of any loan since, in the Minister's view, there was no loan arrangement between the parties. Even if the loan existed, it was not, the Minister argued, legally enforceable because there was only a moral obligation to repay the funds. Therefore, the loan could not constitute consideration for the transfer of the funds for the purposes of subsection 160(1).

At the conclusion of the hearing, counsel for the taxpayer requested that the Court reserve its decision until the Federal Court of Appeal ("FCA") released its decision in *Lemire* (2013 DTC 5171), which also dealt with the application of subsection 160(1) in a transfer of funds between spouses. Both the taxpayer and the Minister filed written submissions on the issue of whether *Lemire* applied to the present appeal.

The FCA in *Lemire* upheld the Tax Court's decision to allow the taxpayer's appeal of a reassessment under subsection 160(1). In that case, the tax debtor endorsed certain cheques to his common-law spouse, Ms. Lemire, which were deposited to Ms. Lemire's personal bank account. However, the evidence showed that the tax debtor instructed Ms. Lemire to withdraw the funds in cash and give them to the tax debtor. In addition, Ms. Lemire stopped facilitating the arrangement when she was advised by Revenu Québec that she would be assessed. The FCA held that such a transaction did not constitute a "transfer of property" for the purposes of subsection 160(1). The Court based its decision on the fact that the transaction occurred in the course of a mandate, a civil law equivalent of agency, which obliged Ms. Lemire to return the money to the tax debtor after depositing the cheques to her personal bank account.

Counsel for the taxpayer argued, through written submissions, that the decision in *Lemire* was applicable to the present case. Like in *Lemire*, the taxpayer had received the cheques in question and, as a result of the instructions from the tax debtor, paid the tax debtor's business expenses for him, with any amounts in excess of the business expenses being applied as repayment of the outstanding loan. Further, an officer with the Canada Revenue Agency ("CRA"), the taxpayer claimed, had represented to her that she would not be assessed under subsection 160(1), and as such, the Minister should be prevented from assessing the taxpayer under subsection 160(1).

The Minister took the position that *Lemire* was distinguishable. In that case, the Court had to consider whether a mandatary relationship existed between the tax debtor and the taxpayer under the *Civil Code of Quebec*. However, in the present case, agency, the equivalent concept in the common law jurisdictions, was not argued at the hearing, and as such, could not be brought forward in written submissions after the conclusion of the hearing of the appeal.

The Court agreed with the Minister. Justice Miller held that the taxpayer was precluded from raising an agency argument after the hearing because such argument was neither pleaded nor argued at the hearing. In any event, the evidence did not support the taxpayer's contention that the tax debtor had endorsed the cheques in question to the taxpayer with instructions for her to pay his business expenses, since the evidence from both the taxpayer and the tax debtor was that the funds from the cheques were meant to repay the taxpayer for the loan. In addition, there was no evidence to suggest that the CRA had informed the taxpayer that she would not be assessed under subsection 160(1). The Court also noted that, in the present case, the taxpayer's argument that the cheques were deposited as repayment of the loans meant that the taxpayer had both beneficial and legal ownership of the cheques upon receipt. The taxpayer testified that she used a portion of the funds to purchase guaranteed investment certificates in her own name. It would then necessarily follow that the funds were transferred to the taxpayer. On the evidence, the Court concluded that there was a transfer of property.

After addressing the arguments raised by the taxpayer relating to the *Lemire* decision, the Court went on to address the main issue raised at the hearing of the appeal, namely, whether the taxpayer gave adequate consideration for the funds she received from the tax debtor at the time of the transfer. While a loan repayment can constitute consideration for the purposes of subsection 160(1), the onus lies with the taxpayer to prove both the existence of a loan and its fair market value. In this case, the Court concluded that the taxpayer failed to meet this onus. The Court noted that the fact that the alleged loan arrangement was undocumented was not by itself fatal to the taxpayer's case. However, there were too many inconsistencies and too little corroborating documentary evidence to adequately support the existence of a loan between the parties. The taxpayer's evidence simply was not credible.

The Court found that the taxpayer and the tax debtor were not credible for several reasons. The taxpayer claimed that the spreadsheet she created in 2011 for CRA appeals purporting to summarize the loan amounts outstanding and payments in respect thereof were based on actual banking records. However, copies of the banking records were not themselves tendered into evidence, and, more suspiciously, the tax debtor testified that he had destroyed the same banking records in 2004, seven years prior to the time the taxpayer created the spreadsheet. The taxpayer also admitted to having "guessed" the balance outstanding on the tax debtor's indebtedness as either $47,309.07 or $106,890.57. When the tax debtor declared bankruptcy in 2004, he did not include a debt to the taxpayer as one of his liabilities. As the Court stated, "there were too many inconsistencies; no reliable documentary evidence of a loan; and, only her unsupported statement of a loan". The Court dismissed the appeal with costs to the Minister.

This case illustrates the application of subsection 160(1) and, in particular, the onus on the taxpayer to demolish the assumptions of fact of the Minister. Had the taxpayer proved the existence of the loan arrangement, the Minister's assessment pursuant to subsection 160(1) may well have been vacated to the extent that the amounts deposited were in repayment of the loan. In the end, however, the evidence tendered by the taxpayer and the tax debtor was insufficient, contradictory, and not credible. The Tax Court's decision may not be the last word in this case, as the taxpayer has filed an appeal with the FCA. Nonetheless, it is unlikely that the taxpayer will be successful on an appeal to the FCA since the Tax Court's decision was based on a finding of fact that no loan arrangement existed due to a lack of evidence.

— *Jeremy Ho*

Rectification Request Denied on Basis of Retroactive Tax Planning

***Graymar Equipment (2008) Inc. v. The Attorney General of Canada*, 2014 DTC 5051 (Court of Queen's Bench of Alberta)**

In this case, an application for rectification was denied by an Alberta court on the basis that the applicants could not establish a common and continuing intention to avoid taxes at the time of a restructuring.

In 2010, the applicants entered into a complex debt restructuring involving at least 141 steps (the "2010 Restructuring"). As part of the 2010 Restructuring, a loan was established (the "Loan") between Graymar and its limited partnership parent ("LP").

The undisputed evidence was that the joint intention of the parties involved in the 2010 Restructuring was to settle external debt and to reduce the interest amounts paid to the LP partners. The applicants did not consider, and were unaware, that the LP needed to repay the Loan prior to December 31, 2011 to avoid an income inclusion under subsection 15(2) of the *Income Tax Act*. The Loan was not repaid in that year, and taxes resulted. The applicants' evidence was unchallenged, and it was accepted that had the applicants been aware of the possibility of taxation under subsection 15(2), they "would have agreed to have [the loan] repaid".

The applicants sought the Court's assistance through rectification to have the loan satisfied effective June 4, 2010 to avoid an income inclusion pursuant to subsection 15(2). The rectification request proposed that Graymar be considered to have returned capital to the LP and that this capital be considered to have been set off against the Loan.

Justice Brown of the Alberta Court of Queen's Bench noted that rectification cases are "exceedingly fact-driven". In considering the unique facts of the Graymar application, he focused on the applicants' position that the intention of the parties involved in the 2010 Restructuring was to achieve "tax avoidance". He concluded there was no evidentiary

basis to support the inference that the applicants had a common and continuing intention to avoid tax as part of the 2010 Restructuring. Rather, the facts indicated that the applicants' actual intention for the 2010 Restructuring was to satisfy external debt and to reduce the interest paid to the partners of the LP.

The Court went further in its comments, stating that the proposal for rectification had no valid business purpose but, rather, involved retroactive tax planning. This was not a case in which the applicants' clear intention to avoid tax at the time of the original transaction had been frustrated; rather, it was a case in which the applicants only "belatedly recognized" an "unanticipated consequence" of the 2010 Restructuring. As a result, Brown J determined that rectification was not available and dismissed the application.

This case is a strong reminder that rectification, though a powerful tool, is limited in its application in circumstances in which a pre-existing common and continuing intention to avoid taxation cannot be established. Rectification cannot be used where to do so would constitute retroactive tax planning.

— *Brandon Siegal*

RECENT CASES

Some costs related to *in vitro* fertilization treatments did not qualify for METC treatment

The taxpayer received unsuccessful *in vitro* fertilization treatments in Syracuse, New York and then looked to obtain similar treatments in Ukraine. She claimed medical expense tax credits ("METCs") for 2011 relating to her costs for these *in vitro* treatments and for her various transportation and accommodation costs, all of which the Minister disallowed. On the taxpayer's appeal to the Tax Court of Canada, the Minister conceded that certain amounts paid by the taxpayer to the treatment clinics in both the United States and Ukraine qualified for METC treatment. This left open for analysis whether the taxpayer's egg donor fees; her transportation, food, and accommodation costs; and her wiring and banking charges qualified as METC expenses.

The taxpayer's appeal was allowed in part. The definition in subsection 118.2(2) of the *Income Tax Act* of "medical expenses" that qualify for METC treatment is exhaustive, so if any expense is not specifically identified in subsection 118.2(2), it will not qualify (see *Bekker v. The Queen*, 2004 DTC 6404, and *Ray v. The Queen*, 2009 DTC 1104). According to dictionary definitions, an ovum is a cell but not an organ, so the taxpayer's cost of an egg donation was not the cost of an "organ transplant" qualifying for METC treatment under paragraph 118.2(2)(*l*.1). Treatments that were substantially similar to what the taxpayer received in the United States and Ukraine were available in Canada, so transportation, food, and accommodation costs for the taxpayer and her husband did not qualify for METC treatment under paragraph 118.2(2)(*g*) or (*h*). The taxpayer's wiring and banking charges did not qualify either, because these types of charges are not mentioned in subsection 118.2(2). The taxpayer's appeal was, therefore, allowed, but only to give effect to the Minister's concessions.

Ismael, 2014 DTC 1140

Travel expenses to warm climates qualified for medical expense tax credits

The taxpayer was appealing the denial of a portion of medical expense tax credits ("METCs") claimed for travel expenses in 2009. The taxpayer lived in Thunder Bay and suffered from severe chronic pain. On medical advice, she spends winters in warmer climates such as Thailand, Cambodia, the Philippines, and Ecuador. She does not go to the United States as it is not warm enough and the medical costs are too high. In 2009, the taxpayer and her husband had planned to go to the Dominican Republic, but adverse weather conditions forced them to change their plans and go to Thailand and Indonesia. At issue were expenses for flights, accommodations, and meals totalling $17,494 for the taxpayer and her husband. The Crown also argued that the taxpayer did not provide the proper documentation to allow expenses to be claimed for her husband.

The appeal was allowed and the matter referred back on the basis that the taxpayer was entitled to METCs for travel expenses of $17,494. For the travel expenses to qualify for METCs, the medical services must not be available locally, the route taken must be direct, and it must be reasonable for the taxpayer to travel to obtain the services. Expenses can be claimed for an accompanying person if a medical certificate is obtained stating that the taxpayer cannot travel on his or her own. The Crown argued that the expenses were not incurred to obtain medical services as is required by the legislation, basing the argument on a 2001 case that held that exposure to the sun is not a medical service. The taxpayer relied on more recent case law that has given a broader meaning to medical services. The Court was being asked by the Crown to disagree with a judgment involving the same taxpayer and the same facts. To do that, the Court would have to carefully examine the reasons of the previous judge, but no transcript was provided. The costs and time involved in ordering a transcript were not justified, and it was appropriate to follow the previous decision. The letter provided by the taxpayer from her doctor met the requirements of establishing that the taxpayer could not travel on her own. The fact that the taxpayer went on her own to an appointment in Texas is not the same as being alone for an entire winter. The number of countries visited by the taxpayer raised the question as to whether the locations were chosen solely for medical purposes, but the Crown did not argue that the reasonableness requirement was not satisfied.

Tallon, 2014 DTC 1148

Fees paid to private instructors not eligible for tuition credit

The taxpayer was appealing a 2011 reassessment that dismissed his claim for $8,095 in tuition credits for fees paid to private instructors who provided piano lessons for his two daughters. The taxpayer had claimed $10,000 as tuition or education amounts transferred to him by his children, of which $1,095 was allowed for tuition fees for music classes and examination fees paid to the Royal Conservatory of Music ("RCM"). A credit for tuition fees can be claimed if a student is enrolled in an educational institution providing courses at a post-secondary level. The Ministry of Education in Alberta grants a Grade 12 high school credit upon successful completion of the RCM Grade 8 piano examinations, a level both of the taxpayer's daughters had achieved. The taxpayer argued that the piano instructors should be considered an educational institution, as they provided the same educational experience as an institution, basing that argument on *Tarkowski v. The Queen* (2007 DTC 1555).

The appeal was dismissed. The respondent did not dispute whether the taxpayer's daughters were taking courses at a post-secondary level, but did dispute the amount of fees paid and argued that private teachers do not qualify as an educational institution. There was no documentary evidence to support the taxpayer's claim that he paid $8,095 to the instructors, although the respondent produced receipts totalling $3,117 paid for piano lessons. The taxpayer failed to produce any receipts for fees actually paid in 2011. In *Tarkowski*, the Court found that a school of music qualified as an educational institution, but that case is not binding as it was held under the informal procedure. A case more on point for the taxpayer's situation was *Kam v. The Queen* (2013 DTC 1218), in which the Court held that the tuition credit was not available for fees paid to private instructors, because they cannot be considered an educational institution. Parliament's intent in enacting the tuition fee credit was to make post-secondary education more affordable. While the legislation is to be interpreted broadly, it does not apply to fees paid to private instructors in their homes.

Van Helden, 2014 DTC 1156

Minister's decision to reverse acceptance of voluntary disclosure application was invalid

The Minister appealed a Federal Court order dismissing the Minister's appeal of two applications for judicial review related to a dispute under the *Income Tax Act*. The Minister took the position that it was plain and obvious that the entire dispute would fall within the exclusive jurisdiction of the Tax Court of Canada. The underlying dispute was related to the transfer price of rock salt. The taxpayer had made a voluntary disclosure to the Minister and later entered into an agreement with the Minister about its income tax liability for 2004 to 2006 under the Canada-US tax treaty. The Minister later informed the taxpayer that she was not bound by the agreement and that the reassessments based on a different transfer price would stand.

The Minister's appeal was dismissed. Based on the record, there was no basis for interfering with the lower court's decision. While the Court cannot invalidate a tax assessment, it may grant a declaration based on administrative law principles that the Minister acted unreasonably.

Sifto Canada Corp., 2014 DTC 5083

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