Tax Notes

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NON-COUNSEL COMMUNICATION: DIRECT NOTIFICATION OF A TAXPAYER NEGATES THE IMPOSSIBILITY OF ACTION

— Jacques Plante, Partner with the Montreal office of Dentons Canada LLP

Wolters Kluwer regularly features Dentons Canada LLP articles examining cases and topics of special interest.

In *Air Canada c. Agence du revenu du Québec* (2014 CCQ 11598), a motion brought by Air Canada to extend the period to appeal an assessment, which was largely confirmed by a decision from the Agence du revenue du Québec's ("Revenue Quebec's") objection division, was dismissed by the Court of Quebec.

Quebec taxpayers who fail to appeal an assessment confirmed or modified by a decision of the Quebec Minister of Revenue within the prescribed 90-day appeal period provided in paragraph 1 of section 93.1.13 of the Quebec *Tax Administration Act* (RLRQ, c. A-6.002) (the "TAA") may apply for an extension of time permitted to appeal under the second paragraph of the same section. The third paragraph of section 93.1.13 of the TAA states that such an application will be granted if the taxpayer demonstrates that (1) it was impossible, in fact, for that person to act; and (2) the application was filed as soon as circumstances permitted.

The relevant facts of the *Air Canada* case are summarized as follows.

On July 31, 2006, Revenue Quebec assessed Air Canada's 2005 taxation year, which indicated an amount of $790,254.17 owed by Air Canada (the "Assessment").

On October 20, 2006, Air Canada's counsel filed a notice of objection regarding the Assessment. Air Canada's counsel also filed a power of attorney along with the notice of objection. This power of attorney specifically authorized Revenue Quebec to communicate information regarding Air Canada to its counsel.

A few days before October 10, 2013, Revenue Quebec's objection officer verbally informed Air Canada's counsel that Revenue Quebec was going to make very minor adjustments to the Assessment and that a written decision and a notice of reassessment giving effect to such decision would soon follow.

On October 10, 2013, Revenue Quebec's objection officer mailed a written decision to both Air Canada and its counsel; this decision decreased Air Canada's amount owing by only $8,069 before penalties and interest.

On October 30, 2013, Revenue Quebec mailed a notice of reassessment with respect to Air Canada's 2005 taxation year to its headquarters, but did not mail a copy of such notice to Air Canada's counsel.

Air Canada did not inform its counsel of the receipt of the October 30, 2013 notice of reassessment.

On May 14, 2014, Air Canada's counsel wrote an email to Revenue Quebec's objection division to inquire about the issuance of the notice of reassessment following the October 10, 2013 decision. Revenue Quebec then promptly sent a copy of the October 30, 2013 notice of reassessment to Air Canada's counsel, which became aware of its existence for the first time — after the prescribed appeal period had elapsed.

In its motion brought before the Court of Quebec regarding the section 93.1.13 TAA application, Air Canada argued that it had been impossible to act within the prescribed 90-day period because its counsel had not received a copy of the October 30, 2013 notice of reassessment and the 90-day period begins on the day that this notice is mailed.

In its decision, the Court of Quebec stated that Revenue Quebec's failure to send a copy of the October 30, 2013 notice of reassessment to Air Canada's counsel did not result in impossibility to act on the part of Air Canada within the meaning of section 93.1.13 of the TAA. In reaching its conclusion, the Court held that nothing in the TAA requires that Revenue Quebec send a copy of the notice of reassessment that follows a decision by its objection division to a taxpayer's counsel. The Court further held that the rules of equity do not require Revenue Quebec to inform a taxpayer that its counsel will not be receiving a copy of the notice of reassessment following the rendering of a decision by its objection division.

The *Air Canada* case serves to demonstrate that the courts generally will analyze the impossibility to act from the perspective of the taxpayer and not that of his or her counsel or representatives.

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DEDUCTIBILITY OF INTEREST INCURRED TO BUY COMMON SHARES

The Canada Revenue Agency ("CRA") was asked to reconfirm its administrative position concerning the deductibility of interest incurred to acquire common shares as expressed in paragraph 31 of Interpretation Bulletin IT-533, following the release of the decision *Swirsky v. The Queen*, 2014 DTC 5037 (FCA). In that decision, the Federal Court of Appeal maintained the lower court's decision to deny an interest deduction to an individual having borrowed money from a financial institution to acquire common shares in a family small business corporation. To justify the absence of reasonable expectation of profit from the purchase of those common shares, the Court noted the absence of any dividend policy or actual dividend payments in prior years and the use of bonuses to remunerate the shareholders. More specifically, the CRA was asked to confirm its position expressed in paragraph 31 of IT-533 that interest paid on funds borrowed to buy common shares was deductible if it was reasonable at the time the shares were bought that the common shareholders would receive dividends. It was also asked to confirm that several years could pass before a corporation finds itself in a position to be able to pay dividends to its shareholders (e.g., mining or oil corporations).

The CRA reconfirmed its position expressed in paragraph 31 of IT-533 regarding the deductibility of interest paid or payable on money borrowed to acquire common shares. If a taxpayer borrows money to acquire common shares on which no dividends were ever paid, the interest paid or payable on the loan would still be deductible if, at the time, there was a reasonable expectation to eventually receive dividends on those shares. Even if a corporation uses all its liquidities to carry on a business for a certain period of time, this does not prevent one of its shareholders from claiming a tax deduction under subparagraph 20(1)(*c*)(i) of the *Income Tax Act* for the interest paid on a loan

previously borrowed to buy common shares in that corporation. If the facts and official documentation show clearly that the permanent policy of the corporation is never to pay dividends, the CRA could conclude that there is no reasonable expectation to receive any dividend on its common shares.

— Association de planification fiscale et financière (APFF), 2014 Conference, Financial Strategy and Instrument Taxation Roundtable — Question 1, October 10, 2014, Document No. 2014-0534811C6

DEPARTMENT OF FINANCE COMFORT LETTER

In a Comfort Letter dated December 23, 2014, the Department of Finance (the "Department") responded to communication regarding trust loss restriction event ("LRE") measures included in *Economic Action Plan 2014 Act, No. 2*, S.C. 2014, c. 39 (formerly Bill C-43). In brief, the Comfort Letter addresses the Department's willingness to recommend:

- extending the exceptions to the loss restriction event rules in paragraph 251.2(3)(*f*) of the *Income Tax Act* (the "Act") to in effect deem a person or group of persons not to become majority-interest beneficiaries where the particular trust does not cease investment-fund status because of acquisition/disposition;
- expanding the subsection 251.2(7) extended filing deadline provisions by adding applicability to subsection 202(8) of the *Income Tax Regulations* and subsections 204.7(1) and 210.2(5) and paragraph 132(2.1)(*a*) of the Act;
- amending the LRE rules such that to be a trust's majority-interest beneficiary, a person or partnership would have to be both: (1) a beneficiary as defined per the LRE rules; and (2) a subsection 251.1(3) majority-interest beneficiary of the trust;
- changing the coming-into-force rules for LRE amendments such that an election would be available for deferring the amendments' applicability to the first day of a trust's 2014 or 2015 taxation year.

The Comfort Letter also noted the Department's continued consideration of concerns regarding a condition that to access the paragraph 251.2(3)(*f*) relief provisions a trust must be a portfolio investment fund immediately before an LRE-type transaction.

CRA'S 2014 MEAL AND VEHICLE RATES

The Canada Revenue Agency has released the 2014 meal and vehicle rates that can be used by individuals to calculate meal and travel expenses for purposes of the northern residents' deduction, moving expenses, and transportation to obtain medical services. The flat rate meal amount remains at $17 per meal to a maximum of $51 per day. For the simplified method of calculating vehicle expenses, the 2014 per kilometre rates are shown in the chart below.

Province/Territory	*Kilometre*
Alberta	45.5
British Columbia	49.5
Manitoba	48.5
New Brunswick	51.0
Newfoundland and Labrador	53.5
Northwest Territories	63.0
Nova Scotia	51.5
Nunavut	61.0
Ontario	57.5
Prince Edward Island	50.5
Quebec	52.0
Saskatchewan	47.5
Yukon	64.0

SUBSECTION 98(3) ELECTION

When a Canadian partnership ceases to exist, subsection 98(3) of the *Income Tax Act* (the "Act") allows a rollover of the partnership property to the partners if certain conditions are met. Each partner must jointly elect on Form T2060, Election for Disposition of Property upon Cessation of Partnership, which, as described in subsection 96(4) of the Act, is to be filed by the earliest deadline for filing an income tax return of any member of the partnership. The Canada Revenue Agency ("CRA") was asked if a subsection 98(3) election is valid if all the requirements are met except that one of the partnership properties was omitted from the election. The CRA replied that the reference in subsection 98(3) to "the property" refers to all the partnership property. Therefore, the CRA's position is that an election under subsection 98(3) is not valid unless the election is made in respect of all of the property of the partnership. Furthermore, a subsection 98(3) election cannot be amended because it is not listed in Regulation 600 of the *Income Tax Regulations* as one of the provisions for which the Minister has discretion to allow an election to be amended or revoked.

— *External Technical Interpretation, International Division, October 6, 2014, Document No. 2014-0540611E5*

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.

Director's Resignation Upheld Despite Tax Court's Belief that Relevant Document Was Backdated

***Bekesinski v. The Queen*, 2014 DTC 1169 (Tax Court of Canada)**

The subject matter of this case is director's liability for a corporation's unremitted employee source deductions pursuant to section 227.1 of the *Income Tax Act* (the "Act"). The sole issue that the Tax Court was required to consider was whether the appellant had resigned as a director of the corporation more than two years before the Minister issued the assessment to the appellant for the corporation's unremitted source deductions such that the assessment was statute-barred pursuant to subsection 227.1(4) of the Act. One interesting aspect of the case was that, even though the Tax Court believed that there was likely backdating of the document that purported to evidence the appellant's resignation more than two years before the date of the assessment, the Tax Court allowed the appellant's appeal, largely due to deficiencies in the Minister's handling of procedural aspects of the appeal.

The appellant was the sole shareholder of the corporation from the time of its acquisition in 1992, and both the appellant and his wife initially served as its directors. The appellant's wife resigned as a director in 2002. The corporation subsequently experienced financial difficulties, and by 2006 the corporation faced the prospect of bankruptcy as well as being struck from the provincial corporate registry.

Between 2003 and 2010, there were occasions when the Canada Revenue Agency ("CRA") met with the appellant and his wife in connection with the tax affairs of the corporation, including the corporation's outstanding tax liabilities. During at least one of those meetings, the CRA informed the appellant's wife that she would not be liable for any unremitted source deductions and associated penalties because she had previously resigned as a corporate director.

In 2010, the Minister assessed the appellant for $477,546.08, consisting of the corporation's unremitted income tax and employer contributions for 2001, 2002, and 2003 and associated interest and penalties. The taxpayer subsequently informed the CRA that he was not liable for the assessed amounts because he had resigned as a director of the corporation in 2006 as evidenced by a written notice of resignation dated July 20, 2006 and, therefore, the Minister was statute-barred from issuing the assessment by virtue of subsection 227.1(4).

On the appeal, the only issue in dispute between the parties was whether the appellant had, in fact, resigned as director of the corporation in 2006. While the appellant was putting forward the notice of resignation dated July 20, 2006 as documentary evidence to support his position, the Minister believed that the document had been backdated and was intending to introduce expert evidence on ink date testing of the document through the CRA's forensic

chemist. However, because the Minister's counsel did not comply with the procedural requirements (set out in the Tax Court rules) for using an expert at trial, the Court ruled that the expert evidence of the CRA's forensic chemist could not be used by the Minister.

With the Minister unable to provide the Court with direct evidence to support a conclusion that the notice of resignation was backdated, the Court was left to decide the issue on the basis of the testimony of the four witnesses: the appellant, his wife, the corporation's solicitor, and the CRA collections officer.

The principal issue that the parties attempted to address through the evidence was the credibility of the appellant's assertion that he had resigned in 2006.

Part of the appellant's story was that a conscious decision was made to resign as a director of the corporation in 2006 because he believed that his resignation was necessary to finalize the corporation's activities in advance of being struck from the provincial registry. He explained that he did not advise creditors of the fact that he had resigned as a director because he knew that the creditors would be relying on his personal guarantee of the corporation's debts, rather than pursuing him in his capacity as director.

Although the appellant testified that his wife likely prompted him to resign in 2006 and she would have prepared the written notice of resignation, his wife testified that she could barely remember the facts concerning her own resignation and did not have a present recollection of any of the facts concerning her spouse's resignation. She could only advise that her husband's description of her involvement in his resignation is probably what happened. The corporation's solicitor was not involved with drafting the notice of resignation and had no present recollection of any discussions with the appellant during 2006 concerning his resignation as a director of the corporation, although he believed that he likely would have had a conversation with him around that time.

The thrust of the Minister's evidence through the witnesses was to have them confirm that the appellant never mentioned his 2006 resignation to anyone, including the CRA, until after the notice of assessment was issued in 2010. The fact that he did not do so, in the Minister's view, made his assertion that he had resigned in 2006 unbelievable. This was because he already knew from his earlier meetings with the CRA that the fact of his resignation would be relevant to determining whether he would be subject to director's liability for the corporation's employee source deductions, and it would have been logical for him to have identified this fact earlier in his dealings with the CRA.

The Tax Court (per Campbell J) found that the appellant's testimony was generally consistent with the testimonies of the other witnesses.

The Tax Court accepted the appellant's reasons for not having disclosed his resignation to the corporation's creditors and noted that the Minister did not call any of the corporation's creditors to potentially rebut the appellant's testimony that the creditors would not have cared to know that he had resigned as a director.

The Tax Court was troubled by the fact that the appellant had not disclosed his resignation to the CRA earlier in light of the fact that the CRA had told him earlier that his wife escaped director's liability by virtue of her 2002 resignation. However, the Court ultimately accepted as plausible the taxpayer's testimony that, early on, his belief was that resigning as a director would only have protected him from liability for corporate obligations arising after the resignation and, since the assessed amounts related to years before 2006, he did not think at that time that his 2006 resignation would have affected his liability for the pre-2006 amounts.

Having made these findings, the outcome of the case was decided by the operation of the rules regarding which party has the burden of proof in a tax case. The relevant jurisprudence establishes that in an appeal of an assessment, the initial evidentiary burden on the appellant is to demolish the Minister's assumptions of fact by making out a *prima facie* case, and if the appellant is able to do so, the burden shifts to the Minister to prove the assumptions.

Here, in the Minister's pleading in the Tax Court (the "Reply"), the principal assumption supporting the assessment was the assumption that the appellant was the sole director of the corporation. No factual assumptions were made concerning the authenticity or backdating of the notice of resignation or other facts concerning the appellant's allegations that he ceased being a director of the corporation in 2006.

Given this state of pleadings, the Tax Court concluded that the taxpayer had at least made out a *prima facie* case (through his testimony and the written notice of resignation) that had the effect of demolishing the assumption that he was a director in 2006. Therefore, the burden of proof shifted to the Minister to demonstrate on a balance of

probabilities that the appellant's evidence was rebutted or untrue. While the Minister sought to do so by trying to show that the notice of resignation was backdated, the Minister's evidence did not demonstrate that this was likely the case on a balance of probabilities. The Tax Court reached this conclusion despite expressing its belief that the notice of resignation was backdated.

This case highlights the importance of understanding the Minister's assumptions in the Reply, as the appellant's success in this case was largely a product of what the Tax Court considered to be deficient pleadings on the part of the Minister. Had those pleadings been more detailed in outlining the factual basis for the Minister's position, the appellant would have had a more difficult evidentiary burden to make out his *prima facie* case and the Tax Court likely would have ruled in the Minister's favour in this case.

The case has been appealed to the Federal Court of Appeal.

— *Sherena Hussain*

RECENT CASES

Taxpayer not entitled to ABIL deduction claim or deduction of interest expense incurred to make loan to his CCPC

The taxpayer owned all of the shares of a Canadian-controlled private corporation ("CCPC") that was carrying on a small business (the "Corporation"). He made a series of advances to the Corporation totalling $253,985 and also incurred interest expenses in borrowing funds to provide these advances. The Corporation made a proposal to its creditors that was approved by the Quebec Superior Court on October 9, 2008. To get this approval, the taxpayer waived all loan repayments owing to him by the Corporation. In its financial statements for 2008, the Corporation removed its debt of $253,985 previously shown as owing to the taxpayer. In reassessing the taxpayer for 2005, 2006, and 2008 to 2010, the Minister disallowed (a) an ABIL deduction of $253,985 claimed by the taxpayer for 2008; (b) non-capital loss deductions claimed for 2005 and 2006 relating to the ABIL deduction claimed for 2008; and (c) interest expense deductions claimed for 2008 to 2010 that the taxpayer had characterized as "financial expenses" relating to his cost of borrowing the $253,985 that he had advanced to the Corporation. The Minister's position, in essence, was that the taxpayer did not "dispose" of the $253,985 owing to him by the Corporation in the course of an arm's length transaction and the $253,985 was no longer owing to the taxpayer at the end of 2008, since it had been written off by the Corporation by then. Therefore, the taxpayer was no longer entitled to interest from the Corporation on his $253,985 loan after it had been written off and, as a consequence, the taxpayer was not entitled to the ABIL deduction, the related non-capital loss deductions, or the related interest expense deductions he had claimed in view of the statutory requirements in paragraphs 20(1)(*c*), 39(1)(*c*), and 50(1)(*a*) of the *Income Tax Act* (the "Act").

The taxpayer's appeal was dismissed. To qualify for the ABIL deduction claim, the taxpayer had to demonstrate, under sections 38 and 39 of the Act, that he had sustained a capital loss resulting from the disposition of an asset. Under section 50 of the Act, a taxpayer is deemed to have disposed of a debt that is owing to him at the end of a taxation year for nil proceeds where that debt has proved to be irrecoverable during that year. The deeming provisions of section 50, however, were unavailable to the taxpayer in this case since the $253,985 in issue was not owing to him at the end of 2008. In addition, because the $253,985 had been written off by the Corporation before the end of 2008, and the taxpayer had renounced his right to any repayment through the proposal made to the Corporation's creditors, he was not entitled to the interest expense deductions relating to the $253,985 that he had claimed. The Minister's reassessments were affirmed accordingly.

St-Hilaire, 2015 DTC 1006

Rectification order granted to allow taxpayer to maintain CCPC status

The applicant, Kaleidescape Canada Inc. ("K-Can"), was seeking rectification of an amended deed of trust to maintain its status as a Canadian-controlled private corporation ("CCPC"). K-Can, a CCPC, was a research and development company incorporated in Ontario in 2001 that benefited from SR&ED credits. A CCPC is a private Canadian corporation that is not controlled by a non-resident. K-Can was set up as a deadlock corporation that could not be controlled by a

non-resident to ensure that it remained a CCPC. Its voting shares were owned equally by C, a Canadian citizen, and by Kaleidescape Inc. ("K-US"), a US company. When C left the company, a trust was created to replace him as a shareholder, with the trustees being one Canadian and one American citizen. Provision was made for a third institutional trustee, which was to be a corporation that was resident in Canada. After a corporate reorganization in 2007, Computershare, a Canadian company, became the institutional trustee; in 2008, it became the sole trustee. Amendments were made to the trust to deal with how Computershare would take direction on voting matters. After concerns that the amended trust was vague, it was amended to reflect that the trustee would only accept direction in writing from the CEO or President of the Settlor. The Canada Revenue Agency ("CRA") subsequently advised K-Can that it no longer qualified as a CCPC as the terms of the revised amended trust could be read as giving K-US, a non-resident, *de jure* control of K-Can. The applicant argued that the intent was always to have K-Can maintain its status as a CCPC and that the purpose of the amendments was only to provide certainty as to how Computershare would receive direction. The deed of rectification was drafted such that the trustee would only take direction from the Board of Directors, which was a deadlock body and could not be controlled by non-residents.

The rectification order was granted. A rectification order is appropriate as a remedy to allow retroactive correction of written documents to reflect the actual intent of the parties. It does not change a legal relationship and merely restores the parties to their original positions. The respondent argued there should be no rectification, as the taxpayers were business people who were reasonably sophisticated and relied on expert advice in structuring the company. The respondent also claimed there was no common intent to have K-Can remain a CCPC. However, based on the evidence, there was an inadvertent mistake in the way the deed was drafted. The common intention was to ensure that K-Can maintained its CCPC status and there was no intention to give K-US *de jure* control. The deed of rectification made it clear that the board of directors, as a deadlock body, would be the ones giving direction, so the CCPC status would be maintained.

Kaleidescape Inc., 2015 DTC 5001

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