Tax Notes

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FBAR FILING FOR NON-AMERICANS

— *Kevyn Nightingale, MNP LLP*

One of the more annoying facts of life for an American is that holding an account offshore entails the filing of a Report of Foreign Bank and Financial Accounts (FinCEN form 114), commonly known as the Foreign Bank Account Report, or "FBAR".

But what about the FBAR for non-Americans? It has always been a little unclear as to who must file. Part of the reason for this is the lack of clarity concerning the form's purpose.

History of the FBAR filing requirement

In 1970, the *Bank Secrecy Act* ("BSA") was passed, giving rise to the authority for FinCEN form 114.[1] The Department of Treasury was responsible for administration of the BSA.

The BSA was not initially a tax enforcement measure,[2] and there was jurisprudence that demonstrated the government could not conduct a tax examination under the guise of a BSA examination.[3]

In the 1980s, the United States was in the midst of its "war on drugs". The idea was that drug dealers had to hold money and make large cash transactions, so that large holdings in foreign banks were seen as indications of trafficking. Needless to say, that did not work very well, since violent drug dealers were not intimidated by paper-pushing US Treasury agents.

The July 2000 version of the FBAR[4] required only "US persons" to file. It was unclear exactly who was a US person, but as far as individuals went, it was generally understood to be a US citizen or resident. There were supposed to be exemptions to the filing requirements, but those were not listed in the regulations. Instead, this choice was left to the discretion of the Secretary,[5] meaning the exceptions would be described in the form's instructions.

A given individual will almost always know whether he or she is a citizen of a country, but the definition of "US resident" was vague. One could not rely on the tax rules, because the FBAR was not (and is still not) a tax document. However, most of the professionals who prepared this form were accountants, and because accountants are familiar with the tax definition of residency,[6] they commonly used it.

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[1] Originally Treasury form TD F 90-22.1.

[2] Internal Revenue Service IRM 4.26.5.2.1.

[3] *U.S.A. et al. v. Deak Perera & Co.*, 566 F. Supp 1398 (DDC 1983).

[4] TD F 90-22.1.

[5] 31 CFR § 103.24.

[6] IRC § 7701(a)(30).

In 2003, following the 9/11 terror attacks, the Internal Revenue Service ("IRS") was delegated the responsibility for administration of the FBAR.

The *American Jobs Creation Act* of 2004 increased the civil penalties significantly,[7] and this was the beginning of the shift towards using the FBAR for tax enforcement purposes.

In October 2008, the IRS issued a new version of the FBAR. The accompanying instructions greatly expanded its scope, requiring filing by "a citizen or resident of the United States, *or a person in and doing business in the United States*" [emphasis added].

This requirement reflected the wording in the statute more accurately.[8] However, it had the effect of requiring filing by many people who were not Americans and would have no knowledge of the filing requirement. The requirement was conceived in the aftermath of the 9/11 terrorist attacks and in the middle of the war in Afghanistan. The FBAR was seen as part of the search for terrorists' funds — it was still not primarily viewed as a tax enforcement measure.

After a great outcry from the tax community, the IRS suspended the FBAR filing requirement for non-Americans for tax years 2008–10.[9] Filers still had to use the 2008 version of the form, but they could use the "who must file" requirements from the July 2000 version.

Around this time, the US government began a concerted effort to increase tax compliance by Americans with funds abroad. The IRS introduced the Offshore Voluntary Disclosure Program in 2009, and the US Congress passed the *Foreign Account Tax Compliance Act* in 2010.[10]

At this point, the FBAR began to be viewed primarily as a tax-enforcement tool. It may have been poorly designed (for example, a $10,000 account-value threshold is far too low), but unlike drug dealers and terrorists, ordinary Americans are afraid of the IRS and (after learning about the requirement) would attempt to comply.

While filing of the FBAR is far from universal even today, the number of filers has been increasing significantly since 2004.[11]

Tax residency

For tax purposes, an individual is a resident if he or she is a lawful permanent resident ("green-card" holder) or meets the substantial presence test (spends at least a certain amount of time in the United States over a three-year period). You can read about these tests in more detail at http://www.mnp.ca/en/media-centre/blog/2014/12/5/us-taxation-of-snowbirds.

This tax-based approach to the FBAR had no basis in law (remember, the FBAR is not part of taxation law), but it was intuitive and reasonable, especially since FBAR usage had evolved to focus on tax collection. FinCEN (and indirectly the IRS) acquiesced to this approach. In September 2013, the IRS issued detailed instructions specifying the use of the tax definition. These instructions were updated in June 2014.[12]

Residency — The exceptions

Tax law does not easily cross the legislation gap, so the question remained — who is a US resident for the purposes of FBAR? There are two major exceptions to the general residency rules. An individual who would ordinarily be a resident is instead treated as a non-resident where he or she:

(1) would meet the substantial presence test, but

(a) his or her days are exempted (e.g., a student),[13] or

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[7] PL 108-357 Title VIII, §821(a), amending 31 USC §5321(a)(5).

[8] BSA §5314(a).

[9] Announcements 2009-51 and 2010-16.

[10] *Hiring Incentives to Restore Employment ("HIRE") Act*, PL 111-147.

[11] Treasury Inspector General for Tax Administration Final Report 2010-09-29, http://www.journalofaccountancy.com/issues/2013/dec/20138321.html.

[12] http://www.fincen.gov/forms/files/FBAR%20Line%20Item%20Filing%20Instructions.pdf, page 6 "United States Resident".

[13] IRC §7701(b)(3)(D), (5).

(b) he or she meets the closer connection exception (there are several criteria, chief among them having a closer connection to a foreign country);[14] or

(2) meets either the substantial presence or green-card holder test, but elects to be treated as a non-resident under the treaty (often called a "treaty non-resident").[15]

It is very likely that in situation 1, the individual is a non-resident for FBAR purposes. US domestic tax law treats that individual as a non-resident alien for all purposes.

The third exception is much more challenging. The Internal Revenue Code says:

> An individual shall cease to be treated as a lawful permanent resident of the United States if such individual commences to be treated as a resident of a foreign country under the provisions of a tax treaty between the United States and the foreign country, does not waive the benefits of such treaty applicable to residents of the foreign country, and notifies the Secretary of the commencement of such treatment.[16]

An individual in this situation is "treated as a non-resident alien of the United States for purposes of computing that individual's United States income tax liability".[17]

It appears to be clear that if you file form 1040NR, a treaty-residency disclosure (form 8833), then you are a non-resident for tax purposes and, therefore, a non-resident for the FBAR. That would make a lot of sense, too — what is the use of an FBAR if the income earned in the foreign accounts is exempt from US tax or subject to US tax withholding at source (i.e., there is no requirement to report the income on a return)? An FBAR from such a person is just as useful as an FBAR from anyone who has no US residency ties at all.

However, the regulations instantly muddy this water:

> If an alien individual is a dual resident taxpayer, then the rules on residency provided in the convention shall apply for purposes of determining the individual's residence for all purposes of that treaty.[18]

This is still not a problem, but the next subparagraph reads as follows:

> Generally, for purposes of the Internal Revenue Code other than the computation of the individual's United States income tax liability, the individual shall be treated as a United States resident. Therefore, for example, the individual shall be treated as a United States resident for purposes of determining whether a foreign corporation is a controlled foreign corporation under section 957.[19]

This means that someone who uses the treaty to file as a non-resident alien *and* who controls a foreign corporation would need to file form 5471 (Information Return of US Persons with Respect to Certain Foreign Corporations). For most other information forms, the interpretation is the same.

So is the FBAR filing requirement based upon the residency treatment for tax calculation or the treatment for reporting? (After all, the FBAR is an information-reporting form and not a tax-calculation form.) The Internal Revenue Code treatment points in one direction, but the regulations could point in the other. Can the tax regulation have an impact on the FBAR filing requirement? Remember, the FBAR is not a tax requirement.

Another interesting point is that the requirement to file the FBAR is supposed to be highlighted on schedule B of one's tax return.[20] But a non-resident alien (including one designated so by virtue of a treaty) does not file this schedule. Interest and dividends are instead listed on page 4 of form 1040NR.[21] So there is nothing to draw one's attention to the need to file the FBAR.

To make things even more opaque, the IRS used to explicitly require form 8938 (Statement of Specified Foreign Financial Assets), often referred to as a "super-FBAR", from taxpayers in this situation. But in October 2014, the IRS decided it would abandon that requirement.[22]

What is the bottom line? For a treaty non-resident, there is still no good answer.

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[14] IRC § 7701(b)(3)(B).

[15] IRC § 7701(b)(6), postamble.

[16] *Ibid*.

[17] Reg § 301.7701(b)-7(a)(1).

[18] Reg § 301.7701(b)-7(a)(2).

[19] Reg § 301.7701(b)-7(a)(3).

[20] Part III, questions 7a, b.

[21] Schedule NEC.

[22] http://www.irs.gov/Businesses/Corporations/Update-to-2014-Instructions-to-Form-8938-1.

What if one chooses not to file the FBAR on this basis?

There is certainly a good argument that a treaty-based non-resident alien does not need to file the FBAR. But the answer is not clear. So the next question is, what happens to an individual who makes the choice not to file?

If the IRS agrees that no filing was required, there is no problem. So let's examine the possibility that the IRS believes filing *is* required.

Where the failure to file the FBAR is not wilful, the maximum penalty is $10,000.[23] This penalty can be levied in respect of each bank account, but most often is levied on a per-year basis. One could argue there is reasonable cause for the failure, but to void the penalty, the balance must have been reported,[24] and of course, here it has not been reported.

It is quite arguable that in this circumstance, the failure to file was wilful. The civil penalty in that case is the greater of $100,000 or 50% of the balance of each account.[25] There is no reasonable cause exception where the failure is wilful.

In addition, there can be a criminal penalty applied.[26] This penalty can be a fine of up to $250,000, a prison term of five years, or both.[27] In a situation like this, where there could not possibly be any tax evasion involved, applying a criminal penalty would be absurd, but the possibility exists.

Recommendation

With the magnitude of these penalties and the veracity of the US government's position unknown, it simply does not make sense for a treaty non-resident to take the risk of not filing an FBAR. In our practice, we recommend that every person who is a US resident under domestic law file an FBAR, regardless of whether a treaty position is taken or not.

THE EFFECTIVE USE OF TRUSTS IN CONNECTION WITH INCOME SPLITTING (PART IV OF IV)

— Michael Goldberg, Tax Partner, Minden Gross LLP, MERITAS law firms worldwide and founder of "Tax Talk with Michael Goldberg", a quarterly conference call about current, relevant and real life tax situations for professional advisors who serve high net worth clients.

Part I of this series of articles reviewed some of the basic tax requirements for using trusts to split income, Part II discussed a number of tax planning opportunities that can be accessible through the use of trusts, and Part III reviewed traditional testamentary trust income splitting planning and the upheaval to all testamentary trust (and lifetime trust) planning caused by the enactment of Bill C-43, *Economic Action Plan 2014 Act, No. 2* ("Bill C-43"). In this the fourth and final instalment of the series, we'll review some of the benefits and risks of planning with trusts resident in Alberta ("Alberta Trusts") and with trusts deemed to be resident under subsection 94(1) of the *Income Tax Act* (Canada) (the "Act").[28]

Alberta Trust Planning

Most of us outside of Alberta look at Alberta tax rates with a combination of awe and wonder. In 2015 the top marginal combined federal and Alberta personal tax rates were as set out below:[29]

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[23] BSA §5321(a)(5)(B)(i).

[24] BSA §5321(a)(5)(B)(i)(II).

[25] BSA §5321(a)(5)(C).

[26] BSA §5321(d).

[27] BSA §5322(a).

[28] Unless otherwise noted all statutory references are to the Act.

[29] Even before the election of the NDP in Alberta, due to proposed tax rate changes in the 2015 Alberta Budget, tax rates were expected to be rising in Alberta beginning in 2016. Due to the change in government it may be a while before the Alberta tax situation becomes clear, though it is hard to imagine that there won't still be a significant continuing Alberta advantage even after all changes are fully phased in. In addition, due to proposed tax rate changes in the 2015 federal Budget, ineligible dividend tax rates are generally expected to increase (actual results may vary in specific provinces).

Ordinary income	39%
Capital gains tax rate	19.5%
Eligible dividend tax rate	19.29%
Ineligible dividend tax rate	29.36%

As a result, it is no surprise that many taxpayers and their advisers have been trying to find acceptable or at least creative ways to shift income from their client's jurisdiction of residence to Alberta for years. Out of this desire a fairly significant interprovincial tax planning sector formed, and many different strategies were generated to accomplish this objective, including strategies involving trusts created to be resident in Alberta for the benefit of residents of other provinces.

Although there are different ways to implement Alberta Trust structures, in general, the intention of using an Alberta Trust will be to have the income of the trust taxed in Alberta at low Alberta tax rates, and to then have capital distributed to non-Alberta resident beneficiaries who should generally not be subject to any additional tax on such capital distributions.

While Alberta Trusts and other interprovincial tax planning has made many clients happy, unfortunately, the other Canadian provinces losing tax base to Alberta have been less happy. The result has been considerable activity involving the tax authorities reviewing and sometimes challenging interprovincial tax plans.

To assist the tax authorities in their efforts to eliminate the benefits of interprovincial tax planning, including the use of Alberta Trusts, provincial legislators have introduced and enacted, sometimes retroactively, a number of provincial anti-avoidance rules, including provincial general anti-avoidance rule (GAAR) provisions. New subsection 104(13.3) of Bill C-43 may also serve to dampen certain types of interprovincial planning strategies that rely on the making of designations under subsections 104(13.1) and (13.2).[30]

In addition, a number of court cases have been heard and have effectively shut down certain types of planning — though not specifically Alberta Trust planning. For example, cases such as the Supreme Court of Canada's *Garron*[31] decision, have caused tax advisers to closely monitor and sometimes adjust their trust plans, including with respect to Alberta Trusts, to ensure that the trusts are resident in Alberta and not elsewhere.

There are also other factors that are or may serve to continue to dampen such planning. For example, there is always the risk that another province outside of Alberta will reassess the Alberta Trust as being taxable in that province. If this were to occur then the income could be subject to double tax unless the matter can be resolved through recourse to the tax collection agreements among the provinces and federal governments. In addition, world events that are intended to limit shifting income between jurisdictions such as the OECD base erosion and profit shifting initiatives could eventually be applied in a domestic context.

Even with all of the risks and issues facing Alberta Trust planning it would appear that Alberta Trust planning continues to be implemented, and — given provincial tax disparities — it is no wonder.

Section 94 Deemed Resident Canadian Trusts

Trust Residency in Canada

Under Canadian taxation principles a trust can be a factual resident in Canada if, pursuant to common law principles, the location of "central management and control" of a trust — which is really a fancy way of saying where the real power to make trust decisions lies — is determined to be in Canada.[32]

While the location of central management and control of a trust will usually be determined by examining where the trustees make their decisions, the test is fact-based so that if the real decision-makers are not the trustees, then it will be the location of those persons that will determine the common law residence of the trust. In this regard, in *Garron*,[33]

[30] As was discussed in Parts II and III of this series of articles, the rules in subsections 104(13.1) and (13.2) can be used to designate amounts paid by a trust to a beneficiary as being taxable only in the trust, which could give rise to a number of income splitting benefits, including allowing designated amounts paid out to beneficiaries to still enjoy the testamentary trust's graduated tax rates. However, due to the enactment of Bill C-43, effective for the 2016 and subsequent taxation years, the ability to utilize the designations provided under these provisions will be restricted so that designations can only be made to permit trusts to use up losses.

[31] *Fundy Settlement v. The Queen*, 2012 DTC 5063 (SCC).

[32] For a more detailed review of trust residency issues in Canada see Michael H. Dolson, "Trust Residence After Garron: Provincial Considerations", (2014) vol. 62, no.3 CTJ.

[33] *Supra*, note 4.

the Supreme Court of Canada found that Mr. Garron, a Canadian resident, had too many powers and had *de facto* control of the trust, causing an otherwise offshore trust to be determined to be factually resident in Canada.

Putting factual Canadian resident situations like *Garron* aside, there continues to be a purely Canadian non-resident category of trust that can have Canadian resident beneficiaries where the trust has only been funded by non-residents of Canada.[34] However, it is possible for these trusts to lose their non-resident status if they are deemed to be resident of Canada pursuant to section 94.

The recently amended provisions of section 94[35] are exceptionally broad and the purpose of the discussion that follows is merely to provide a flavor of just how expansive the amended rules are.

Even where a trust would not be a Canadian resident based on common law principles, with extremely limited exceptions, the rules in section 94 will deem such trusts to be resident in Canada if they have a "resident contributor". A resident contributor is a Canadian resident person, whether an individual, corporation or other entity, that, with limited exceptions, has made a direct or indirect transfer of property to the trust. Such a transfer is referred to as a contribution in section 94 and the scope of the possible types of indirect transfers that can be made to a trust is breathtaking.[36] Furthermore, even if a contributor who was a Canadian resident ceases to exist, for example, on death, section 94 will still generally apply if the trust is considered to have a "resident beneficiary" because the trust has a Canadian resident beneficiary at any particular time.

One exception to these rules that previously was widely used was the so-called "immigrant trust exception". Unfortunately, this exception was eliminated as part of the legislative changes enacted in Bill C-43.[37]

Non-Tax Reasons to Create Non-Resident Trusts

Although there are many evils that the federal government has intended to stop through amendments to section 94, not all non-resident trusts ("NRTs") are evil. For example, a contributor might create an NRT from a desire to benefit non-residents. In addition, structuring a trust outside of Canada may enable the contributor to keep his or her affairs more private, allow for the trust to access investments that are unavailable to Canadian residents, and possibly allow the trust to be governed by more favourable trust and insolvency legislation, such as fraudulent conveyance and other legislation that might better enable the contributor to be assured that the trust property is protected and preserved for the benefit of the trust's beneficiaries.

A Modest Section 94 Trust Tax Benefit (Outside of Alberta)

Interestingly, although there can be some tricks and traps for the unwary, the actual taxation of section 94 trusts will in many cases not be that different or that much more complicated than the taxation of ordinary resident Canadian trusts. In addition, as is shown in the chart below, in 2015 section 94 trusts are actually taxed quite favourably compared to the taxation of ordinary *inter vivos* Canadian trusts outside of Alberta.[38]

	Section 94 Rates	**Alberta Rates**
Ordinary income	42.92%	39%
Capital gains tax rate	21.46%	19.5%
Eligible dividend tax rate	28.55%	19.29%
Ineligible dividend tax rate	31.41%	29.36%

However, because of the even more favourable tax treatment afforded to Alberta trusts, and since administering section 94 trusts is generally a bit more complicated and costly than administering purely Canadian trusts, it appears somewhat unlikely that specific planning will be used to take advantage of these lower rates. Still, for taxpayers outside of Alberta who are using otherwise non-resident trusts and are caught by the section 94 deemed resident trust rules, the tax savings will likely be a pleasant surprise.

[34] Sometimes these trusts are called "granny trusts" and other times "pure offshore trusts".

[35] See Bill C-48, *Technical Tax Amendments Act, 2012*, which received royal assent on June 26, 2013.

[36] See, in particular, the "arm's length transfer" definition in subsection 94(1) and the extended rules of application in subsection 94(2).

[37] The extremely limited grandfathering provisions associated with these changes ceased to apply at the end of calendar 2014.

[38] *Supra*, note 2.

CURRENT ITEMS OF INTEREST

CRA Tax Alert — Tax Schemes Can Have Serious Tax Consequences

On May 26, 2015, the Canada Revenue Agency ("CRA") issued a tax alert that draws attention again to the various schemes that continue to emerge to entice taxpayers to withdraw funds from their registered plans to invest in dubious schemes that do not meet the qualified investment tests. Often these schemes will put the taxpayer's entire retirement savings at risk.

The alert highlights the need for investors to be diligent in researching schemes that appear "too good to be true", as they are often found not to be qualified and could lead to fines and penalties equalling 100% of the monies withdrawn and invested.

Canada Signs the Multilateral Competent Authority Agreement

On June 2, 2015, Minister Findlay signed the *Multilateral Competent Authority Agreement* ("MCAA"), which will set the stage for the automatic exchange of financial information with international partners commencing in 2018. This was one of the measures presented in the April 21, 2015 Budget. Canada is one of more than 90 jurisdictions that have, to date, committed to implementing the Common Reporting Standard. As of May 2015, a number of jurisdictions, including Germany, the United Kingdom, and France, have signed the MCAA.

Justice Canada Appoints Two New Tax Court Judges

The Honourable Don R. Sommerfeldt, a counsel with Dentons Canada LLP in Edmonton, is appointed a judge of the Tax Court of Canada, to replace Madam Justice G. Sheridan, who resigned effective May 1, 2014.

The Honourable Henry A. Visser, a lawyer with McInnes Cooper in Halifax, is appointed a judge of the Tax Court of Canada, to replace Madam Justice D. Campbell, who elected supernumerary status as of June 19, 2015. This appointment is effective June 19, 2015.

Standing Committee on Finance Reports on Bill C-59

On June 4, 2015, the Standing Committee on Finance considered Bill C-59; the Committee presented it back to the House on June 5, 2015 without amendment.

CRA Warns about Recent Telephone Scams

On June 10, the Canada Revenue Agency ("CRA") issued a warning that scams where callers claim to be from the CRA are on the rise. The callers are aggressive and threatening and usually request immediate payment of amounts owed. Recipients of such calls are advised to hang up immediately and call the Canadian Anti-Fraud Centre.

Standing Senate Committee on National Finance Reports on Bill C-59

On June 18, 2015, the Standing Senate Committee on National Finance considered Bill C-59 and presented it back to the Senate, without amendment.

Interest Rates for the Third Calendar Quarter of 2015

On June 19, 2015, the Canada Revenue Agency ("CRA") announced the prescribed annual interest rates that will apply to amounts owing to the CRA as well as to amounts that the CRA owes to taxpayers for the period from July 1, 2015 to September 30, 2015. The interest rate remains unchanged for:

- monies owed to the government at 5%;
- monies owed to corporate taxpayers at 1%; and
- monies owed to non-corporate taxpayers at 3%.

The only change is with respect to the prescribed interest rate for corporate taxpayers' pertinent loans or indebtedness, which will be 4.61% for the third quarter of 2015.

Anti-Terrorism Act (Bill C-51) Receives Royal Assent

On June 18, 2015, Bill C-51, *Security of Canada Information Sharing Act*, received royal assent and became Chapter 20 of the Statutes of Canada 2015.

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 Finds Foreign Exchange Gain from the Termination of Swaps To Be a Capital Gain

***George Weston Limited v. The Queen*, 2015 DTC 1079 (Tax Court of Canada)**

This case considers the proper characterization of foreign currency exchange gains arising on termination of certain cross-currency basis swap contracts.

The taxpayer, George Weston Limited, a publicly traded holding company, operated a food processing and distribution business in Canada and the United States through its various direct and indirect subsidiaries. In 2003, the taxpayer terminated a number of cross-currency basis swaps realizing proceeds of $317 million, one-half of which was reported by the taxpayer on its 2003 return as a taxable capital gain. This appeal arose from the Minister's reassessment of the taxpayer's 2003 tax year that treated the full amount of the proceeds realized from the termination of the swaps as income. In the result, the Tax Court reversed the Minister's assessments and held that the gain was indeed on capital account. In doing so, the Court rejected a long-standing position of the Canada Revenue Agency ("CRA") which required, for capital account treatment, that gains or losses from a derivative be linked to an underlying capital transaction that is the purchase or sale of a capital asset, the repayment of a debt denominated in a foreign currency, or the investment of idle capital funds.

In 2001, the taxpayer completed its acquisition of Bestfoods Baking, a US-based bakery business, for US$1.765billion. The acquisition resulted in an increase in the taxpayer's indirect net investment in US operations from US$800million to US$2.1billion. This acquisition was financed entirely through Canadian dollar loans to the taxpayer from Canadian banks. The taxpayer invested the funds into its subsidiaries, which used the funds to acquire Bestfoods. The borrowing for the acquisition caused the debt-to-equity ratio of the taxpayer to rise well above the maximum 1:1 ratio required by its internal guidelines. As the taxpayer was required under generally accepted accounting principles to translate its USD net investment in its US subsidiaries to Canadian dollars for its consolidated balance sheet, any appreciation in the Canadian dollar relative to the US dollar would cause the taxpayer's consolidated equity to decrease. Such a decrease would have the effect of eroding the taxpayer's consolidated equity and worsening the debt-to-equity ratio. This currency risk did not go unnoticed by the credit rating agencies, as S&P issued a credit watch stating that the net effect of the Bestfoods acquisition would be detrimental to the taxpayer's capital structure as a result of the high overall leverage. At the time of the acquisition, the Canadian dollar was at historical lows and the taxpayer sought to hedge its currency risk by entering into a series of cross-currency basis swap contracts. The swaps entered into had a notional value that approximated the taxpayer's US dollar net investments in its US subsidiaries. By 2003, the Canadian dollar was then at multi-year highs and the taxpayer's debt-to-equity ratio was expected to fall below the 1:1 maximum target ratio by the end of the year. At this point, the taxpayer concluded that the swaps were no longer needed and terminated the swaps, realizing a gain of $317 million, the proper tax treatment of which was the subject of this appeal.

In respect of the taxpayer's position that the gains realized on the close out of the swaps were properly characterized as capital gains, the taxpayer argued that the swaps were entered into as a hedge and maintained that the swaps had a strong linkage with the investment in its subsidiaries, which were capital in nature. In this regard, not only was there documentary evidence which supported this argument (e.g., publicly available policies, credit facilities, and disclosure documents which either prohibited the taxpayer from entering into the swaps for speculation purposes or stated that the taxpayer had no intention of doing so), the swaps were entered into contemporaneously with and had a notional value that approximated the value of the net investment in its US operations. The taxpayer maintained that the Minister's view that there must be a linkage between the derivative contract and a separate sale or proposed sale of an underlying capital asset would preclude the possibility of hedging (on capital account) an investment that is not intended to be sold or owned indirectly through subsidiaries, and that this position had no legal basis.

The Minister argued that the swaps were not linked to an underlying capital transaction or debt obligation denominated in a foreign currency that exposed the taxpayer to foreign currency risk. In this case, the hedge against the translation exposure of the taxpayer's balance sheet, the Minister contended, was not sufficiently linked to the shares or assets of a subsidiary. In addition, the Minister submitted that the decision to terminate the swaps while they

were "in the money" was speculative and, therefore, evidenced an adventure in the nature of trade such that the gain realized was properly characterized as business income.

In her analysis, Justice Lamarre addressed the issue of whether the cross-currency basis swaps were a hedge by first canvassing statutory, judicial, and commercial sources as to the meaning of a hedge. Lamarre J noted that the word "hedge" is defined in the *Income Tax Act* only for the purposes of subsection 20.3(1) in respect of weak currency loans. Lamarre J indicated that while this provision was not relevant, the definition was nonetheless informative.

Under subsection 20.3(1), a hedge is defined as a derivative entered into primarily to reduce the taxpayer's risk. This aligned with the commercial understanding of a hedge, which, the Court noted, was generally meant to mitigate risk exposure. The Court reviewed the statements of the Supreme Court of Canada as to hedging in *Placer Dome* (2006 DTC 6532). In that case, the Supreme Court considered the definition of hedging for purposes of the *Mining Tax Act* (Ontario) and noted the difference between a hedge and speculation. A transaction would be a hedge where a party to the hedge genuinely has assets or liabilities that are exposed to market fluctuations. On the other hand, where a hedger engages in derivative transactions where the notional value exceeds the risk exposure, that activity would be considered to be speculation.

The Court concluded that the swaps at issue were a hedge based on the evidence presented by the taxpayer, including that: (i) the taxpayer had a formal derivative policy and credit facilities which prohibited it from speculating in derivatives; (ii) the taxpayer's contemporaneous annual reports and corporate records indicated an intention that the swaps were entered into to hedge the risk associated with the investment in its US operations; (iii) expert evidence supported the notion that the particular swaps at issue were inappropriate for speculative purposes (given the high transaction costs and long-term nature of the swaps); (iv) the notional amount of the swaps equated with the amount of net US investments; and (v) the swaps were terminated at a time when the currency risk on its US investments had subsided and when its debt-to-equity ratio had returned to normal levels.

Having found that the swaps were a hedge, the Court proceeded to characterize the hedging gain as either income or a capital gain. The Court rejected the Minister's contention that for a foreign exchange gain to be on capital account, the gain must be linked to a capital transaction or debt obligation denominated in a foreign currency risk, agreeing with the taxpayer that such approach had no legal basis and was unsupported by case law. Lamarre J accepted the taxpayer's proposition that if a derivative were used to hedge a capital investment, any gain derived from the derivative would be on capital account. The Court rejected the Minister's alternative argument that the entering into of the swaps by the taxpayer was an adventure in the nature of trade. On the evidence, the taxpayer's intention was not to speculate in derivatives but, rather, to hedge the foreign exchange risk of its US dollar investments which were required to be translated into Canadian dollars. The Court allowed the appeal and held that the gain was properly characterized as a capital gain.

This case is important as it refutes a long-standing practice of the CRA to require, for capital account purposes, "linkage" between the gain or loss arising from the hedge and a gain or loss from another transaction or debt obligation. Rather, the Court was clear in stating that if the derivative were used to hedge a capital investment, rather than for the purpose of speculation, any gain derived from that derivative would be on capital account. Interestingly, the Minister has chosen not to appeal the Tax Court's decision.

— *Jeremy Ho*

RECENT CASES

Life insurer failed to meet statutory and factual requirements and was not entitled to bump in cost of assets

The taxpayer was appealing reassessments for 2006 and 2007 that reduced the cost base of designated insurance property which led to a considerable increase in taxable income. The taxpayer is a Canadian life insurance corporation. Where a Canadian life insurance corporation which carries on business in Canada and in another country designates property as designated insurance property, it may be entitled to a bump in the cost base of such property for the purpose of calculating gains and losses. Such property must be owned by the insurer at the end of a preceding year but it cannot be designated property in the preceding year. The taxpayer argued that it was entitled to the cost bump, as it designated property in 2006 and 2007 and was carrying on business in Canada and Bermuda at the time.

The appeals were dismissed. Most of the facts and evidence in dispute relate to whether the taxpayer was carrying on business in Bermuda in 2006 and 2007. The respondent correctly argued that in order to make a designation, the insurer must be a multinational life insurer in the year of designation and the preceding year. As both parties agreed that the taxpayer did not carry on business in Bermuda in 2005, the taxpayer did not qualify for the bump in 2006. As well, the bump is only permitted if there is a change in the investment assets forming part of the designated insurance property or a change in their use. The taxpayer designated the same assets (100% of its investment assets) in 2006 and 2007. The legislative requirements are not met if the same property is designated two years in a row. As there was no change in the designated assets, the bump rules did not apply. The assets that were designated in 2007, the first year it was possible for the taxpayer to be a multinational corporation, retain their existing cost base when determining gains and losses. The respondent's argument succeeded on a plain meaning of the legislation as well as on a contextual and purposive analysis. The bump rules are part of special rules designed to ensure that Canadian-resident multinational life insurers are not taxed on income from their foreign insurance business. The multinational Canadian insurer must designate a minimum level of investment assets as a reserve to ensure that it can meet its Canadian liabilities under its policies. Such designated property is entitled to a bump in its cost base when the property either became or ceases to become designated property. The taxpayer did not make serious or continuous efforts to set up business in Bermuda in 2006 and 2007, although since 2008 there has been activity in Bermuda. There was conflicting evidence as to when a license to operate in Bermuda was acquired. The stated intention of the taxpayer was to set up a life insurance reinsurance business in Bermuda to hedge against its longevity risks from its annuity policies. The evidence presented showed that the taxpayer entered into contracts in Bermuda re-insuring annuities, which went against their stated intention. Qualified people were not hired in 2006 and 2007 in Bermuda nor was there proper office space. The taxpayer's activities were designed to give the appearance of carrying on business in Bermuda so that it would get the tax benefit of the bump in cost base. The taxpayer failed to meet the legal requirements to be entitled to the bump in 2006 and 2007. It also did not meet the factual requirements of carrying on business in Bermuda in 2006 and 2007.

The Standard Life Assurance Company, 2015 DTC 1113

Personal loan cannot qualify as allowable business investment loss

The taxpayer was appealing a reassessment that denied his claim for allowable business investment losses ("ABILs") in 2011. The taxpayer testified that he made various loans to Nicholas Austin to enable Austin's company, Whitesand Group of Companies, to publish a travel magazine. He had known Austin since the 1980s. Austin had initially asked the taxpayer to co-sign a loan but the bank did not grant the loan. The loans were made from 2007 through 2009 and totalled approximately $75,000. By 2010, it was clear that the business venture had failed and that the loans would not be repaid.

The appeal was dismissed. There are various conditions that must be met before an ABIL can be claimed. The debt must be owed to the taxpayer by a Canadian-controlled private corporation ("CCPC"). The cheques for the loans were all made out to Austin personally and Austin personally signed the promissory notes. The taxpayer argued that Austin was the alter ego of his corporation and that the loans were to enable the corporation to publish the travel magazine. The form of the transactions matters and while some deficiencies are acceptable, the taxpayer was asking the court to ignore the legal steps that were taken. The taxpayer was aware that Austin had incorporated a company, as that was necessary in order to apply for grants. He acknowledged making loans to another company in 2010 and that the cheques in that instance were payable to the corporation and not an individual. The evidence is clear that the cheques were made out to Austin personally. Although Austin was the director and officer of Whitesand, the corporation has a legal identity different than that of its officers. There was no evidence that Austin was acting as an agent for his company. The subjective intent of the taxpayer that the loans were for the corporation was not sufficient. The loans to Austin did not create a debt owing to the taxpayer by a CCPC.

Barnwell, 2015 DTC 1114

Changes made to printer after being brought to market qualified for SR&ED credits

The taxpayer began to develop a miniature wireless portable printer in 2006 and was granted scientific research and development investment tax credits ("SR&ED ITCs") for 2006, 2007, and 2008. The objective for the printer was for it to be able to print 20 pages on one battery charge. It was brought to market in 2008 but more than 50 complaints were received, that the paper was curling and the battery was not lasting. Changes were made in 2009 and 2010. The taxpayer was denied an SR&ED credit for 2009 and 2010 on the basis that there were no longer technological uncertainties, the work done was routine engineering, and, for 2010, the taxpayer failed to file the prescribed forms on time.

The appeals from the assessments were allowed. Mr. Raja Tuli, the chief executive officer of the taxpayer, is the world's leading expert with respect to the miniaturization of high-tech equipment. He was a very credible witness. To qualify for the SR&ED credit there must be a scientific or technological uncertainty, a systematic investigation by experiment or analysis must be carried out, and the work must be undertaken to achieve technological advancement. The respondent argued that by bringing the printer to market there were no longer technological uncertainties but bringing the printer to market did not preclude technological uncertainty, as problems continued to exist. Tuli testified as to the detailed systematic investigations carried out to solve the curling and battery issues. It would have been helpful to have documentation detailing the investigations, but Tuli provided the detailed steps undertaken. They defined the problems, that of curling paper and a reduced battery life, put forward hypotheses for solving the problems, and conducted numerous experiments to try to resolve the problems. A new clutch design improved the curling issue and a new printer driver was developed that helped improve the battery life. Those were technological advancements that improved the printer and qualified for SR&ED credits. The work done was not just routine engineering. There was mainly hearsay evidence as to whether the prescribed information (a scientific report) was filed in a timely fashion. The appeals officer testified that the report was not attached to the return although it is possible that it had been detached. The respondent claimed it sent a letter to the taxpayer that the report had not been filed but it did not file that letter as evidence. Letters were filed by the taxpayer indicating that the report had been filed. Given that the 2010 return indicated a loss and the SR&ED credit was a major incentive, it is hard to believe that the report would not have been filed. On a balance of probabilities, there was no reason to doubt Tuli's testimony that the papers were filed in a timely fashion.

6379249 Canada Inc., 2015 DTC 1109

Denied dividend refund amount not to be used in calculating dividend refund for future years

The taxpayer was appealing a reassessment that denied amendments to his tax returns to allow for a greater dividend refund ("DR"). The taxpayer was a Canadian-controlled private corporation which had paid taxable dividends to its shareholders in 2007, 2008, 2010, and 2011. Its DR claims for 2010 and 2011 were assessed as claimed in February 2012. The taxpayer had calculated its DR claims for 2010 and 2011 on the basis that it would receive a DR for 2007 and 2008. Its DR claims for 2007 and 2008 were denied in March 2012, as it had filed those returns late. In assessing the taxpayer's 2010 and 2011 returns, the MNR deducted the amount of the denied DR from 2007 and 2008 from the refundable dividend tax on hand ("RDTOH") account. The taxpayer was appealing, arguing that as it did not receive a DR in 2007 and 2008, the denied amounts should not reduce the RDTOH account.

The appeal was allowed with costs. The statutory scheme involving DRs and RDTOH accounts is complex and technical. Its purpose is to prevent the deferral of tax by earning income inside a corporation and to have integration of tax between a corporation and its shareholders. Its goal is to have neutrality whether one earns investment income inside a corporation or earns it personally. A corporation's RDTOH account is a notional account that determines the maximum amount of a DR that a corporation may receive on its payment of taxable dividends to its shareholders. The DR for preceding years is a component of the RDTOH calculation. The DR is an amount available for monetary refund or credit when certain conditions are met: (a) that taxable dividends are paid; and (b) that tax returns are filed within three years. The respondent argued that the DR is a notional calculation and even though the amounts were denied for the taxpayer's 2007 and 2008 years, the amounts should be used in calculating the RDTOH account. It also argued that there would be no limits on integration if the taxpayer's argument prevailed. In actuality, there are limits, as the

DR is only available if the conditions are filed. If the DR is not available to a taxpayer, there are consequences. There is double taxation, as the corporation does not get a DR and the shareholder does not get credit for the tax paid. The corporation is also liable for late-filing penalties and arrears interest. Based on a textual, contextual, and purposive analysis, the definition of a DR is an amount actually received and not a notional amount. While the RDTOH account is notional, the components comprising the RDTOH, such as the DR, is not notional. As the taxpayer did not receive a DR in 2007 and 2008, those denied amounts cannot be used to reduce the RDTOH calculation for 2010 and 2011. The taxpayer was entitled to the higher DR for 2010 and 2011.

Nanica Holdings Limited, 2015 DTC 1111

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