Tax Notes

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A FURTHER REVISION TO THE DEFINITION OF TAX SHELTERS

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

***Kinglon Investments Inc. v. R*, 2015 DTC 5064 (Federal Court of Appeal), reversing 2014 DTC 1128 (Tax Court of Canada)**

In *Kinglon Investments*, the Federal Court of Appeal ("FCA") revisited the definition of a "tax shelter" under subsection 237.1(1) of the *Income Tax Act* (Canada) (the "Act")[1] and considered whether it was essential that the Minister specify on whose behalf statements or representations in connection with the property are made or proposed to be made. In doing so, the Court may have limited the applicability of the leading case in the area, *The Queen v. Baxter* (2007 DTC 5199 (FCA) (Eng.)).

Section 237.1 was enacted in 1989 to require a promoter of a tax shelter to acquire an identification number prior to selling, issuing, or accepting consideration for a tax shelter. A person may not deduct or claim an amount with respect to a tax shelter unless a prescribed form is filed with the Minister which includes the issued tax shelter identification number. The section acts as both an administrative and punitive provision, which imposes a penalty on promoters who accept consideration for an unregistered tax shelter of the greater of $500 and 25% of the consideration received for selling the tax shelter.

The definition of a "tax shelter", found in subsection 237.1(1), is general and has created considerable uncertainty about the scope of the definition. Relevant to the tax shelter described in *Kinglon Investments*, a tax shelter means a property in respect of which it can reasonably be considered, having regard to statements or representations made or proposed to be made in connection with the property, that if a person were to acquire an interest in the property, then at the end of a tax year which ends within four years of the acquisition, the total of amounts deductible in respect of the interest would equal or exceed the cost of the interest (less the amount of prescribed benefits). Much of the litigation surrounding the definition focuses on who the "statements or representations" are being made by, to whom they are being made, and their substance and content.

Two earlier cases heard by the FCA, *Jevremovic v. The Queen* (2008 DTC 6263 (Eng.)) (affirming *Maege et al. v. The Queen* (2006 DTC 3193 (Eng.))) and *Baxter*, displayed conflicting interpretations of the nature of the statements or representations required to constitute a tax shelter. In *Maege*, when considering whether interests in a partnership were a tax shelter, Associate Chief Justice Rip of the Tax Court of Canada found that the definition could be reduced to a numerical calculation: where aggregate deductions connected to the acquisition of the property exceeded the investment or cost (less

[1] Unless otherwise noted, all statutory references herein are to the Act.

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prescribed benefits received), the property would be a tax shelter. Further, Rip ACJ found that statements or representations were not a critical aspect of the definition due to their textual modification in the definition by the phrase "having regard to" and that the absence of statements or representations was not determinative of whether the investment was a tax shelter. The Tax Court decision was subsequently affirmed by the FCA in a concise decision.

Baxter has been viewed as the FCA's response and rejection of the interpretation in *Maege*. In *Baxter*, the taxpayer had acquired a computer software licence used to trade futures contracts. In his subsequent two taxation years, the taxpayer claimed capital cost allowance in respect of the licence equal to the acquisition cost of the licence. The Court determined that the licence constituted a tax shelter and engaged in a comprehensive analysis of the elements of the definition. A clear statement was made that a property cannot be a tax shelter if no statements or representations were made to a prospective purchaser and such statements or representations were a required condition of meeting the definition. Such statements were required to be made by a person who could be considered to be a promoter, made by or on behalf of the proposed vendor, and made to prospective purchasers of the property. Satisfaction of a simple numerical formula, as in *Maege*, was not sufficient to meet the definition of a tax shelter.

The existence of two conflicting FCA interpretations, although of contrasting depths of analysis, created uncertainty in what properly constituted a tax shelter under the Act. This uncertainty was seemingly clarified by the FCA in *The Queen v. O'Dwyer* (2013 DTC 5156 (Eng.)). The Court in *O'Dwyer* followed *Baxter's* lead and confirmed that actual statements or representations were required to be made or proposed in order for the property to constitute a tax shelter and that the formula in the definition could not be the sole determinative factor. The Court cited *Baxter* with approval — which has been viewed as a unanimous endorsement of *Baxter* (see Marshall Haughey, "Tax Shelter Statements and Representations" (2014) Vol. 22, No. 5, *Canadian Tax Highlights*, 3-4). The Court went on to expound on the necessary content of the statements or representations, such as a description of the amount that the prospective purchaser of the property will be able to deduct in computing income within the first four taxation years if the property is acquired.

In the context of *Maege*, *Baxter*, and *O'Dwyer*, *Kinglon Investments* is an interesting decision: (a) due to the absence of express mention of *O'Dwyer*, although Justice Webb rendered the reasons for judgment for both decisions; and (b) for stating that certain aspects of *Baxter* should be considered as *obiter dicta*.

Kinglon Investments is a procedural appeal of a discretionary interlocutory decision of the Tax Court decision to strike a portion of the Minister's Reply pleadings and to grant the Minister leave to file an amended Reply. Kinglon was reassessed to deny a capital cost allowance claim for numerous reasons with respect to a licence it had acquired from Cardiopharma Inc., including that the licence was an unregistered tax shelter. The contention that the licence was an unregistered tax shelter was struck from the Minister's Reply pleadings because although the Crown identified parties who made the requisite statements or representations, the Crown did not identify the parties on whose behalf the statements or representations had been made.

Kinglon brought the motion to strike the aspect of the Crown's Reply related to whether the licence was a registered tax shelter, at the Tax Court under Rule 53(1)(*d*) of the *Tax Court of Canada Rules (General Procedure*), on the basis that the pleadings disclosed no reasonable cause of action. To support its motion, Kinglon relied on the reasons of the Court in *Baxter* which indicated that the requisite statements or representations intrinsic to a tax shelter must be made by or on behalf of the person who proposes to sell the property:

> while the definition does not specify to whom or by whom the statements or representations must be made, in my view they must be made to the prospective purchasers of the property <u>by or on behalf of the person who proposes to sell the property</u>. [*Baxter* at paragraph 9, emphasis added]

Although the Crown identified that an accountant and lawyer who were associated with Kinglon and Cardiopharma had made statements or representations to Kinglon, the Crown's reply did not clearly identify whether the statements were being made on behalf of Kinglon or Cardiopharma. The Crown, seeking to avoid the conclusion it was required to identify the party on whose behalf the statements were made, relied on a later portion of the reasons in *Baxter* which appears to indicate that it is sufficient that the person making the requisite statements or representations is identifiable as a "promoter" as defined in the same provision:

> [w]hile neither of the parties to this appeal, nor the TCC in its decision, focused much attention on the identity of the party who must have made the statements or representations, in my view, it would be reasonable to conclude <u>that it must be each person who constitutes a promoter</u>, as defined in subsection 237.1(1) (a "promoter"). [*Baxter* at paragraph 44, emphasis added]

A "promoter" is defined in the Act as a person who sells, issues, or promotes the sale or issuance of a tax shelter, or acts as an agent or adviser in respect of the sale or issuance or promotion therein of a tax shelter, or accepts consideration as a principal or agent with respect to a tax shelter.

Justice Graham of the Tax Court of Canada acknowledged the conflict between paragraphs 9 and 44 of *Baxter* and the corresponding broader view of the law advocated by the Crown, and determined that the Crown's view of the law had a reasonable chance of success. However, Graham J determined that the Crown's pleadings were drafted deliberately vaguely "with the intention of fitting into the definition of 'promoter' should that prove necessary without actually committing to any specific aspect of the definition." (paragraph 21, TCC) Regardless of whether the statements or representations had to be established as being made by a promoter or with greater specificity (to include the identification of the party on whose behalf the statements were being made), neither standard was met. The Crown's pleadings were found not to be specific enough to identify a specific promoter and failed to plead any "specific facts necessary to show on whose behalf the statement or representations were made." (paragraph 25, TCC) In other words, Graham J was unconvinced that the Crown's pleadings met either of the criteria outlined in paragraphs 9 and 44 of *Baxter*.

In reasons issued by Webb J, the FCA overturned the findings of Graham J and dismissed Kinglon's motion to strike the portions of the Crown's Reply relating to whether the licence was a tax shelter. Key to this decision was the finding that the reasons of the Court given in *Baxter* at paragraphs 9 and 44 were *obiter* because the "issue before the Court in *Baxter* was not related to whether the person making these statements or representations had to be acting on behalf of any other person." (paragraph 20, FCA) Further, the Court went on to reason that there is no specific requirement in the definitions of promoter or tax shelter that indicates that the statements or representations must be made by or on behalf of the person who is seeking to sell the property. Presumably implicit in this statement is that the statements or representations must be made by a promoter. However, the Court only peripherally addressed the fact that Graham J of the Tax Court also found that the Crown's pleadings were not specific enough to identify the parties who made the statements or representations as promoters, stating that the Crown was granted leave to amend its Reply to clarify its argument that the licence was a tax shelter and that Kinglon could file and serve a demand for particulars if further details were required.

In light of *Kinglon Investments*, given that *O'Dwyer* was not expressly cited in the judgment and certain aspects of *Baxter* were labelled as *obiter*, what is the current legal state of understanding for what constitutes a tax shelter? Post-*Kinglon Investments*, a distillation of where we are at can be described as follows.

(a) *Kinglon Investments* reinforces the line of case law started with *Baxter* and leading to *O'Dwyer* that statements or representations must be made for a property to be considered to be a tax shelter. Therefore, the numerical formula line of reasoning started in *Maege* appears to be all but forgotten.

(b) We suspect that *O'Dwyer* was in fact alluded to in the opening paragraphs of *Kinglon Investments* (FCA) where the Court stated that certain conditions must be met in order to satisfy the definition of a tax shelter pursuant to the Act: "[i]n particular, certain statements or representations must be made with respect to the amount that would be deductible if the licence is acquired." (paragraph 3, FCA) This appears to have been the *ratio* of *O'Dwyer* although *O'Dwyer* has previously been viewed as a wholesale endorsement of *Baxter*. It seems that the Court might be suggesting, by referring to *O'Dwyer* in this narrow, peripheral manner in the same judgment where certain aspects of *Baxter* are regarded as *obiter*, that *O'Dwyer* should not be viewed as adopting the complete *Baxter* judgment into the common law because *O'Dwyer* was only decided on a narrower issue — that which related to the content of the statements or representations made. In a sense, the *obiter* statements of one court cannot make binding law out of the *obiter* statements of another court.

(c) More troubling is the conclusion that paragraphs 9 and 44 of the FCA in *Baxter* were *obiter* and the limits of this assessment. The FCA stated in *Baxter* that one of the two issues raised on appeal was whether the licence acquired by the taxpayer was a tax shelter. This is a broadly worded issue and consistent with the comprehensive review of the tax shelter definition by the Court. In the author's opinion, the statements of the Court at paragraph 44 should not be regarded as *obiter* because the determination that the statements were made by a promoter was a key determinant in the analysis that the licence in *Baxter* was a tax shelter. The Court goes on to hold in paragraph 45 that the tax opinions and appraisals relied upon by the taxpayer were provided "by or on behalf of TCL Trafalgar to the independent sales agents for use by them in the marketing of TIP licences to prospective purchasers . . . [and that] [e]ach of TCL Trafalgar and the independent sales agents was a promoter." (*Baxter*, FCA, at paragraph 45) Identification of a promoter is clearly a determining factor in the decision, while the party on whose behalf the

statement is made is less critical to the Court's analysis. Had there not been an identifiable promoter who made the statements or representations, it is less likely that the licence would have been determined to be a tax shelter.

Another statement by the FCA in paragraph 9 of *Baxter* that was presumably labelled as *obiter* by the Court in *Kinglon Investments* was that in the view of the Court in *Baxter*, in order to be characterized as a tax shelter, statements or representations had to be made to a prospective purchaser. Again, the Court in *Baxter* is clear in its analysis that the statements or representations had to be made to the prospective purchaser (*Baxter*, FCA at paragraph 43). Further, TCL Trafalgar and the independent sales agents, as promoters, made statements or representations to the potential purchaser (*Baxter*, FCA, at paragraph 45). This is again a key aspect of the decision and it is unclear why this is labelled as *obiter*. On the other hand, the Court in *Kinglon Investments* appeared to cite with approval Graham J's statement, in the Tax Court decision, that the tax shelter could exist so long as the statements or representations were made to the taxpayer (*Kinglon Investments*, FCA, at paragraph 19). This suggests that the FCA in *Kinglon Investments* remains of the view that statements or representations have to be made to the taxpayer. Perhaps this limits the assessment that the comments made in paragraph 9 of *Baxter* are *obiter* to the view that statements or representations must be made by or on behalf of the proposed vendor.

(d) The conclusion that paragraphs 9 and 44 in *Baxter* are *obiter* can be interpreted to mean that we are back at square one with respect to the identity of the person who makes or proposes to make the statement or representations with respect to the property. On one hand, we could argue that because the Court makes the point in *Kinglon Investments* of stating that the issue before the Court in *Baxter* was not whether the person making the statements had to be making them on behalf of another person, this potentially would only catch the statements made in paragraph 9 of *Baxter*. Further, the Court states that there is not a specific requirement that the person making the statement is the person selling but does not extend this analysis to promoters.

Alternatively, the Court also states that paragraph 44 is *obiter*; this paragraph exclusively deals with the identity of the party making the statements or representations as a promoter. It is now less clear whether the law subsequent to *Kinglon Investments* is that for an investment to be considered a tax shelter, statements or representations are required to have been made or proposed to be made by a promoter. However, the FCA later refers to correcting certain deficiencies in the Crown's pleadings (paragraph 23) and these deficiencies were identified by Graham J in the Tax Court decision as those relating to identifying the party making the statements or representations as a promoter. Accordingly, the author's opinion is that *Kinglon Investments* preserves the requirement that the person making the statements or representations must be a promoter, as defined under the Act, but that it is not critical to take steps to identify a party on whose behalf the promoter is acting. However, this conclusion is far from being crystal clear.

Although *Kinglon Investments* represents more reassurance in the continuum pushing away from the line of reasoning in *Maege*, it erodes the conclusions that were cultivated in *Baxter* and *O'Dwyer* concerning the identity of the crucial parties who are making and to whom are being made the statements or representations with respect to the property. Hopefully, a future case will limit the principle in *Kinglon Investments* and will clarify that the law in *Baxter* has been preserved insofar as statements or representations made with respect to the property are still required to have been made by a promoter to a prospective purchaser in order to be properly categorized as a tax shelter.

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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NEW DISCLOSURE RULES FOR LABOUR ORGANIZATIONS

— John Granelli, CPA, CA, Wolters Kluwer

Rarely does a private member's bill make its way through Parliament. Rarer still is the passing of a private member's bill dealing with income tax matters. There are precedents: some of us will recall that subparagraph 6(1)(*b*)(v.1) made its way into the *Income Tax Act* (the "Act") in 2007 in a private member's bill. It allows junior hockey players (and others) to receive non-taxable accommodation allowances from an employer that is a registered charity or non-profit organization.

Bill C-377 is another income tax provision that was introduced and shepherded through Parliament as a private member's bill, adding section 149.01 to the Act. This section neither imposes nor relieves tax, but requires many labour organizations to provide detailed financial information for public viewing.

Application

Section 149.01 applies to fiscal periods that begin after the day that is sixth months following royal assent. As royal assent was granted on June 30, 2015, fiscal periods starting on or after January 1, 2016 will be subject to the new reporting obligation.

Two types of organizations fall under the rules.

Labour Organizations

A labour organization is defined to include a labour society and any organization formed for purposes which include the regulation of relations between employers and employees. As the definition is inclusive and not exhaustive, it would appear to cover an organization that brings together employers, under the "any organization" rubric, if that group deals with employer-employee relationships. The definition specifically includes a long list of "duly organized" creations of such a society or organization.

Labour Trusts

Labour trusts are also subject to the disclosure rules. The term is defined to include a "trust or fund" in which a labour organization has a "legal, beneficial or financial" interest. A trust or fund will similarly fall under the definition, even if there is no labour organization that has a direct interest, if it is established, in whole or in part, to benefit a labour organization or its members.

A labour trust established solely to administer a deferred profit sharing plan, a registered pension plan, or any one of a number of itemized health and insurance benefit plans is not subject to the new reporting rules, nor is a labour-sponsored venture capital corporation.

Disclosure Required

Section 149.01 specifies twenty-six different reporting requirements that a labour organization or labour trust must meet. Some of these appear to overlap, and it remains to be seen how expenditures that fall under more than one category are to be reported.

For example, a statement of disbursements on conferences and convention facilities is required, as is a statement of disbursements on organizing activities. It is not immediately clear under which category a labour organization would report what it spends to put on a conference on organizing activities, or if it is to be required to report the outlays under both.

A couple of the disclosure requirements generated a fair amount of public debate.

A report is required itemizing transactions with a party with whom the aggregate value of the transactions in the fiscal period exceeds $5,000. For each, the purpose of the transactions is to be listed and, with a few itemized exceptions, the disclosure is to include the name of the payer or the payee.

As with Ontario's "Sunshine List", a reporting organization will also be required to disclose compensation to individuals who receive more than $100,000 a year. The provision applies to payment to individuals who do not hold a formal office, and includes those who "are in a position of authority" and could reasonably be expected to have access to the organization's affairs. For each individual, an estimate is to be provided of the proportion of his or her time that is devoted to political activities, lobbying, or non-labour relations activities.

Filing and Publication

A labour organization or trust subject to these requirements is required to file a prescribed return within six months of the end of its fiscal period. The return is to be filed electronically and is to be made available "in a searchable format" on the Canada Revenue Agency ("CRA") website. Presumably the CRA is now developing the prescribed return and the instructions that accompany it may well clear up some of the ambiguity in the legislation.

As a final point, both the Liberal Party and the New Democratic Party have proposed to repeal this provision, should either form the next government, so its future may be contingent on October's election.

CURRENT ITEMS OF INTEREST

CRA Issues Advance Pricing Arrangement Program Report for 2014-2015

On August 17, 2015, the Canada Revenue Agency ("CRA") issued its report on the Advance Pricing Arrangement ("APA") program, which is a proactive service offered by the CRA to assist taxpayers in resolving transfer pricing disputes that may arise in future tax years. The primary objective of the program is to provide increased certainty with respect to future transfer pricing issues in a manner consistent with the *Income Tax Act*, and guidance delivered through the CRA's information circulars and by the Organization for Economic Co-operation and Development ("OECD").

The key objectives of the report include:

- enhancing awareness of the CRA's APA program;
- notifying readers of changes to the APA program;
- providing an operational status update; and
- identifying issues that may impact the APA program in future years.

CRA Releases Report on the Mutual Agreement Procedure Program for 2014-2015

On August 18, 2015, the CRA released its annual Mutual Agreement Procedure Program report. The Mutual Agreement Procedure ("MAP") Program is a mandatory service program provided by the CRA to assist taxpayers with the resolution of cases of double taxation or taxation not in accordance with the provisions of a tax convention. The MAP process requires co-operation from taxpayers to achieve the goal of resolving these cases.

The report provides a summary of the MAP Program for the period from April 1, 2014, to March 31, 2015.

Taxpayers subject to double taxation or taxation not in accordance with an income tax convention are encouraged to consider applying through the MAP Program.

For more information, please consult the current version of Information Circular 71-17R5, Guidance on Competent Authority Assistance Under Canada's Tax Conventions, or contact a MAP manager in the Competent Authority Services Division ("CASD"). Please refer to page 17 of the Mutual Agreement Procedure Program Report 2014-2015 for a list of the MAP managers and their telephone numbers.

Department of Finance Releases Draft Legislation

On July 31, 2015, the Department of Finance released some new draft legislation dealing with certain income tax measures included in the 2015 Budget.

Repeated Failure To Report Income Penalty

Subsection 163(1) of the *Income Tax Act* is amended to provide that the penalty for repeated failures to report income applies only where the unreported amount is at least $500 in both the year in which the penalty applies and in any of the three preceding years. The penalty is to be revised to the lesser of 10% of the unreported income and 50% of the difference between the understatement of tax and the tax that was actually paid on the income (such as tax withheld at source).

These changes apply to taxation years beginning after 2014.

Charities

Section 38 is amended and new sections 38.3 and 38.4 are introduced to deal with a gift to a qualified donee funded from the disposition of real property or shares of a private corporation ("private assets"). Where the gift is made within 30 days of the disposition of the private assets, none of the gain is included in income.

These changes apply to 2017 and subsequent years.

In addition, sections 149.1 and 253.1 are amended to permit a registered charity or a registered Canadian amateur athletic association to hold an interest in a partnership without being deemed to be carrying on the business of the partnership.

These changes apply after April 20, 2015.

Synthetic Equity Arrangements

Section 112 and the definitions in section 248 are to be amended to deny the dividend deduction where the dividend arises under a synthetic equity arrangement.

The Budget originally proposed that the revisions would apply after October 31, 2015. The draft legislation has more complex coming-into-force provisions and will generally apply after April 2017, unless a synthetic arrangement is entered into, extended, or renewed after April 21, 2015, in which case the changes will apply after October 2015.

Capital Gain Converted to a Dividend

Subsections 55(2) and (3) and certain other related sections are amended, and subsections 55(2.1) to (2.4) are added, to clarify the circumstances under which subsection 55(2) applies. These revisions are to apply to dispositions made after April 20, 2015.

Withholding by Non-Resident Employers

Section 153 is to be amended to provide a blanket exemption from withholding on payments made by a qualifying non-resident employer to a qualifying non-resident employee. This change applies to payments made after 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.

Taxpayer Permitted to Claim SR&ED Investment Tax Credits for Work Performed After a Printer's Commercial Release

***6379249 Canada Inc. v. The Queen*, 2015 DTC 1109 (Tax Court of Canada)**

In *6379249 Canada Inc.*, the Tax Court was asked to determine whether a taxpayer is entitled to claim a scientific research and experimental development ("SR&ED") investment tax credit ("ITC") for work performed after a product is commercially released. The success of the taxpayer in this case may be of interest to taxpayers intending to commercially release products where the work performed to bring them to market may otherwise qualify for an SR&ED ITC.

The taxpayer, 6379249 Canada Inc., undertook to develop a miniature wireless portable printer which, at the time, would have been the smallest printer in the world. The taxpayer intended to design a self-contained printer that would have the capacity to print 20 pages using a single battery charge. During the taxpayer's 2006-2008 taxation years, the taxpayer's CEO and well-known developer of miniaturized computer and high-tech office equipment products, Mr. Raja Tuli, directed the taxpayer's development process. The Minister granted SR&ED ITCs for work performed to develop the printer during those taxation years.

By the end of 2008, Mr. Tuli and his engineering team were of the view that the technological objectives of the printer had been met in prototypes developed to date. Following this determination, 200 printers were manufactured and sold to the public.

Following the printer's commercial release, the taxpayer was notified of several complaints received from the printer's end consumers. These complaints related to the printer's limited battery life and the frequent curling of printed pages. The taxpayer verified these complaints and decided to remove the printer from the market until the identified deficiencies could be rectified.

In 2009 the taxpayer undertook a new SR&ED project for the printer and claimed SR&ED ITCs in the amount of $103,628 and $49,688 for its 2009 and 2010 taxation years, respectively. By notices of assessment, the Minister denied the taxpayer's claim for the SR&ED ITCs in the relevant taxation years.

The taxpayer appealed the Minister's assessments to the Tax Court.

The taxpayer submitted that technological uncertainties still remained with the printer in 2009 and 2010, such that it should be entitled to claim SR&ED ITCs for work performed during those taxation years. The Minister submitted that at the time of commercial production there were no longer any technological uncertainties with the printer. As a result, in the Minister's view, work performed on the printer in 2009 and 2010 related to routine engineering which did not qualify for an SR&ED ITC. In addition, the Minister submitted that the taxpayer did not file the prescribed information within the appropriate time limits in order to claim an SR&ED ITC for its 2010 taxation year.

Justice D'Auray of the Tax Court allowed the taxpayer's appeal, finding that the subsequent work performed at the printer level qualified for SR&ED ITCs in the taxpayer's 2009 and 2010 taxation years.

Section 37 and subsection 127(5) of the *Income Tax Act* (the "Act") permit a taxpayer carrying on business in Canada to deduct certain expenditures incurred to perform SR&ED in computing income from business and, in certain circumstances, credit a specified percentage of qualifying expenditures against taxes payable. SR&ED is defined in subsection 248(1) of the Act and means, generally, systematic investigations or searches that are undertaken in the field of science or technology by means of experiment or analysis, and includes experimental development, namely work undertaken for the purpose of achieving technological advancement for the purpose of creating or improving existing products or processes, including incremental improvements. Courts have liberally interpreted sections of the Act related to SR&ED in order to advance Parliament's objective of encouraging scientific research in Canada.

Justice D'Auray outlined the three elements which the taxpayer had to prove in order to receive SR&ED ITCs for work performed on the printer in 2009 and 2010: (i) there must have been scientific or technological uncertainty, (ii) the taxpayer must have carried out a systematic investigation in the field of technology or analysis, and (iii) the work must have been undertaken for the purpose of achieving technological advancement for the purpose of creating new, or improving existing, materials, devices, products, or processes.

The Tax Court found that there was technological uncertainty in 2009 and 2010. The Court accepted that technological risk or uncertainty does not exist when there is a resolution to a problem that is reasonably predictable through the use of standard procedure or routine engineering. Following a review of the testimony of Mr. Tuli and expert witnesses called by both parties, Justice D'Auray accepted that the paper and battery deficiencies experienced in the commercially released printers were the same technological uncertainties experienced in 2006 and 2007, and she determined that existing standard engineering procedures were not available to competent professionals in the field of engineering to solve these problems. The Tax Court placed limited emphasis on the commercial release of the printer as an indicator that technological uncertainty did not exist in 2009 and 2010.

The Tax Court found that the taxpayer carried out a systematic investigation to diagnose printer deficiencies and to develop potential solutions for each deficiency. The Tax Court recognized that systematic investigation is an approach that includes the definition of a problem, the formulation of clear objectives, the identification of technological uncertainties, and the development of one or more hypothesis to resolve the technological uncertainty. For purposes of the Act, this investigation must operate within the scientific method, which is characterized by trained and systematic observation, measurement, and experiment. The Tax Court accepted the testimony of Mr. Tuli, which outlined the manner in which the taxpayer carried out each hypothesis for solving the technological uncertainties related to the printer's battery life and paper quality, and for achieving technological advancement. The Tax Court noted that it would have been helpful if the taxpayer submitted documentation detailing the investigations described in Mr. Tuli's testimony.

Finally, the Tax Court found that the work undertaken by the taxpayer achieved a technological advancement through the improvement of the printer. Following a review of the Act's English and French definition of SR&ED, the Tax Court held that work will qualify for an SR&ED ITC even if there is only a slight improvement to materials, devices, products, or processes. The Tax Court was satisfied that work performed in 2009 and 2010 resulted in a technological advancement as the overall device was improved. The Court rejected the Minister's approach which would have required the Tax Court to analyze each activity undertaken by the taxpayer in order to determine whether a technological advancement occurred after each activity was performed.

The Tax Court further rejected the Minister's submission that the taxpayer failed to file the prescribed information within the appropriate time limits in order to claim an SR&ED ITC for its 2010 taxation year. Subsections 37(11) and 37(12) of the Act deny a taxpayer's claim to deduct SR&ED expenditures if the taxpayer does not file certain information related to work performed within 12 months after the taxpayer's filing due date for the relevant taxation year. The taxpayer relied upon the testimony of Mr. Tuli to argue that it did file all necessary information for its 2010 SR&ED ITC within the prescribed time frame. Since the evidence presented by both parties was hearsay, and no evidence was presented to raise doubts about the credibility of Mr. Tuli's testimony, the Tax Court held, on a balance of probabilities, that the necessary information had been filed within the appropriate time frame.

Accordingly, the taxpayer successfully obtained an SR&ED ITC for work performed to rectify deficiencies in a product following its commercial release. The taxpayer was ultimately successful through its introduction of credible testimony which confirmed (i) the product's deficiencies were related to genuine technological uncertainties, and (ii) work performed following the product's commercial release involved systematic investigations to rectify the deficiencies in order to (iii) achieve a technological advancement. To better ensure that work performed after a product's commercial release will qualify for an SR&ED ITC, taxpayers should be cognizant of the framework outlined by the Tax Court in this case. In addition, taxpayers should heed the Tax Court's preference for reviewing written documentation related to the performance of systematic investigations. In this regard, given the lack of written documentation, it is unclear whether the outcome in the case would have been the same if the taxpayer did not present the testimony of its involved CEO, a well-respected developer in the engineering field, to substantiate its claim for an SR&ED ITC.

— *Sherena Hussain*

RECENT CASES

Taxpayer entitled to have return assessed without waiting for audit results

The taxpayer was seeking an order compelling the Minister to examine and assess his 2012 return. He was claiming a donation tax credit for participating in a gifting tax shelter, the EquiGenesis 2012 Investment and Donation program. The taxpayer was a partner and senior valuation consultant at a large chartered accountancy and business advisory firm. The program involved investing in units of a limited partnership and using those units as security for a loan, the proceeds of which were used to make a cash donation to a registered Canadian charity. His return was timely filed in April 2013 and the taxpayer received a letter in June 2013 stating that the return would not be assessed until an audit of the tax shelter was complete. The program the taxpayer was involved with has been in existence since 2003 (except for 2007 and 2008). The 2003, 2004, and 2009 programs were audited and the donation claims disallowed while no challenges were made to the 2005 and 2006 programs. The taxpayer argued that he relied on the 2005 and 2006 programs when he invested in the program from 2009–2012. The taxpayer argued that he was certain the credit claimed in 2012 would be disallowed but that until an assessment was issued the objection process cannot begin, nor can other credits such as the child benefit tax credit or the GST credit be claimed.

The application for judicial review was granted and the Minister was ordered to examine the taxpayer's 2012 return and issue an assessment within thirty days. The issue is not whether the tax shelter complies with the *Income Tax Act* but whether the Minister was in breach of the duty to assess "with all due dispatch". The Canada Revenue Agency ("CRA") believes that widely marketed tax shelters are invalid and has published Fact Sheets warning of the risks and noting that billions of dollars of claimed credits have been denied. The CRA used to do a cursory examination of a taxpayer's return, allow the charitable donation tax credit, conduct an audit of the shelter, and then reassess and disallow the credit. It changed its policy such that it does not assess until after the audit has been conducted. The Minister owes a statutory duty to the taxpayer to examine his return with all due dispatch. There is discretion involved in determining what "with all due dispatch" means but it is not unfettered; it must be reasonable and for the purpose

of ascertaining and fixing the taxpayer's liability. Taxpayers need certainty with respect to their financial affairs. No objections can be made until an initial assessment is made. There may be a basis for waiting for an audit before assessing but the decision to audit was tainted by the reason for the audit. The Minister admitted that the reason for the audit was to delay and discourage taxpayers from participating in the shelters. An earlier case held that the Minister had failed to assess with all due dispatch in a similar delay. The audit was an excuse for the delay and not a reason for the delay. The delay was capricious and not reasonable.

McNally, 2015 DTC 5075

Payments received from leasing cars considered to be on income account; liability for capital tax accrues in relevant year, not in year of assessment

The taxpayer was in the car leasing business. General Motors would sell cars to its dealerships, which would then enter into leases with their customers. The dealers would sell the cars to the taxpayer, who administered the leases. At the end of the lease, the customer would either purchase the car or return it to the dealership. There were three issues: the treatment of (1) excess kilometre charges; (2) residual value support payments ("RVSPs"); and (3) Ontario capital taxes paid for the 2007 taxation year. If a customer went over the allotted kilometrage allowed in the lease, there was an excess kilometre charge. The taxpayer treated it as being on capital account, arguing that the excess kilometrage reduced the value of the car. In an effort to increase the number of leases, GM would pay the taxpayer an RVSP in exchange for the taxpayer accepting a higher contract residual value (the amount to be paid if the customer purchased the car at the end of the lease). That would decrease the lease payments. The taxpayer treated the RVSPs as being on capital account. It treated the payments as reducing the undepreciated capital cost in the year in which the lease in respect of which payment was received ended. The Minister reassessed to include the amounts in income in the year in which they were received. The taxpayer amended its 2007 Ontario capital tax return in 2011 which led to it filing an amended 2007 federal tax return in which it deducted additional Ontario capital tax. The Minister denied the deduction in the 2007 taxation year, arguing it could only be deducted in 2011.

The appeal was allowed on the basis that the RVSPs were taxable as income (either in the year received for payments before the corporate restructuring or at the end of the lease after the restructuring). The taxpayer was entitled to deduct its additional capital tax in its 2007 taxation year. Various factors determine the amount of the lease payments. The higher the purchase price that the taxpayer was willing to pay for the car, the higher the lease payments would be. Higher interest rates meant higher lease payments. Factors affecting the residual value at the end of the contract would be the kilometres used and the lease term (more kilometres and lengthier terms would reduce the residual). Essentially, the taxpayer was receiving the difference between the purchase price and the contract residual value as well as the interest on the anticipated loss of value. The taxpayer accepted the residual value risk, as it was possible the cars would be sold for less than their residual value. The Minister correctly assessed the excess kilometre charges and RVSPs as being on income account. Those payments were not made to compensate for any decreased value in the cars. Just as lease payments received for anticipated loss of value amounts were treated as income, so too should be payments received for excess kilometre usage. The RVSPs replaced any lost income the taxpayer incurred due to lower lease payments. Until a corporate restructuring, the taxpayer would keep the RVSP whether the customers returned or bought the cars at the end of a lease. After the restructuring, the taxpayer was dealing at arm's length with GM and any RVSPs had to be returned if the customer bought the car at the end of the lease. The RVSPs were on income account before and after the restructuring, although after, the RVSPs were to be included in income in the year the lease ended. The liability for capital tax accrues in the relevant year, regardless of when it is assessed.

GMAC Leaseco Corporation, 2015 DTC 1141

TAX NOTES

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