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CANADA REVENUE AGENCY VIEWS ON TAXABLE CANADIAN PROPERTY DETERMINATIONS INVOLVING SUBSIDIARIES

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A. Introduction

The definition of "taxable Canadian property" ("TCP") in subsection 248(1) of the *Income Tax Act*[1] is relevant primarily to the taxation of non-residents. Paragraph (*d*) of the definition includes shares of privately held corporations and interests in partnerships or trusts if, at any particular time during the past sixty months, more than 50% of the fair market value of the shares or interests, as the case may be, was derived directly or indirectly (otherwise than through a corporation, partnership, or trust the shares or interests in which were not themselves taxable Canadian property at the particular time) from one or any combination of:

(i) real or immovable property situated in Canada,

(ii) Canadian resource properties,

(iii) timber resource properties, or

(iv) options in respect of any of the foregoing, whether or not the property exists (referred to collectively herein as "CRP").

The purpose of this article is to review and consider the appropriateness of the Canada Revenue Agency's ("CRA's") current administrative positions regarding how this provision should be applied where a non-resident disposes of shares in a corporation (the parent) that itself holds shares in one or more subsidiary corporations.

B. Gross Asset Value Approach

At the CRA Roundtable at the 2011 Canadian Tax Foundation Conference, the CRA was asked what approach should be followed to determine whether a share of a company would derive more than 50% of its value from CRP.[2] The CRA stated that it would apply a gross asset value approach for dispositions occurring after December 31, 2012. Pursuant

[1] RSC 1985, c 1 (5th Supplement), as amended, hereinafter referred to as the "Act." Unless otherwise stated, statutory references in this article are to the Act.

[2] François Bordeleau, Pierre Bourgeois, Jim Gauvreau, Claude Jodoin, and Bernard Nolan, "Canada Revenue Agency and Revenu Québec Round Table," *Report of Proceedings of the Sixty-Third Tax Conference*, 2011 Conference Report (Toronto: Canadian Tax Foundation, 2012), 4:1–24, questions 23, 24; CRA Conference Document 2011-0425901C6, "Does share derive value principally from real property" (28 November 2011).

to this approach, it is necessary to calculate the total fair market value of a company's assets, without taking into account its debts or other liabilities.

Notably, this view represented a change in the CRA's approach. Historically, the CRA permitted taxpayers to use either the gross asset value approach, a net asset value approach (which required the assignment of a debt against the asset to which it reasonably related), or some other method that was reasonable in the circumstances.[3] This flexible approach was generally advantageous to the taxpayer and was accepted by the CRA provided there was no evidence of a "questionable transaction" such as manipulation in contemplation of a share sale. The CRA's adoption of the gross asset value approach as the sole method for determining whether a share of a company derives more than 50% of its value from CRP was, at least in part, aimed at aligning Canada with the approach recommended by the OECD Commentary for purposes of tax treaties.[4]

C. The "Look-Through" Approach

The gross asset value approach presents challenges where a parent's property includes shares of one or more subsidiary corporations. To the extent that a subsidiary holds CRP, the parent's shares would derive a portion of their value indirectly from such property. In these circumstances, it must initially be asked whether the shares of the subsidiary would themselves constitute TCP. As discussed below, following amendments to paragraph (*d*) of the definition of TCP in 2012 (referred to herein as the "2012 Amendment"), applicable for TCP determinations after March 4, 2010, where the shares of a subsidiary do not themselves constitute TCP, the full value of the shares will be considered property other than CRP ("non-CRP") when applying the gross asset value approach to the parent.

If a subsidiary's shares are themselves TCP, the CRA has indicated that it will apply a "proportionate value" or "look-through" approach when determining the TCP status of the parent's equity.[5] Under this approach, it is first necessary to determine the proportion of the subsidiary's total gross assets that constitute CRP. Second, an amount equal to that same proportion multiplied by the fair market value of the shares of the subsidiary held by the parent will be considered CRP for the parent. Put differently, a percentage of the total value of the subsidiary's shares held by the parent, equal to the proportion of the subsidiary's total gross assets that are CRP, will be considered CRP for the parent. Expressed formulaically, the look-through approach may be summarized as:

$$\text{Value of CRP of Parent attributable to subsidiary shares} = \text{Fair market value of subsidiary shares for parent} \times \frac{\text{Gross value of subsidiary's CRP}}{\text{Gross value of subsidiary's total assets}}$$

$$\text{Value of non-CRP of Parent attributable to subsidiary shares} = \text{Fair market value of subsidiary shares for parent} \times \frac{\text{Gross value of subsidiary's non-CRP}}{\text{Gross value of subsidiary's total assets}}$$

Thus, if 60% of the subsidiary's gross assets constitute CRP, 60% of the value of the subsidiary's shares will be considered to be derived from CRP for the parent.

[3] E.g., Robert M. Beith, C.A., Donald S. Brooks, Charles W. Mavor, C.A., John R. Robertson, F.C.A., "Revenue Canada Round Table," *Report of the Proceedings of the Thirty-Sixth Tax Conference*, 1984 Conference Report (Toronto: Canadian Tax Foundation, 1985), 783–847, Question 58; Technical Interpretation, Document 2003-0029675 "Article XIII(3)(b)(ii) U.S. Treaty" (5 September 2003)).

[4] OECD Commentaries on the Articles of the Model Tax Convention, commentary on Article XIII at para 28.4: "The determination of whether shares of a company derive more than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State will normally be done by comparing the value of such immovable property to the value of all the property owned by the company without taking into account debts or other liabilities of the company (whether or not secured by mortgages on the relevant immovable property)."

[5] *Supra* note 2.

The look-through approach adopted by the CRA is supported by a number of cases that have interpreted the word "derived" to be a "term of wide import".[6] The courts have interpreted the term broadly to require looking through to an amount's origin or source, even though there may be intervening channels from such origin or source to the final destination.[7] The courts have equated the term "derived" with the phrase "arising from or accruing," which also imports the common idea of origin or source.[8] In addition, the notion of "directly or indirectly", which follows the word "derived" in the definition of TCP, also requires one to analyze not only the assets held by the company, but also those held below the company or "downstream". Accordingly, in assessing whether a company's equity "derives" its value "directly or indirectly" from CRP, it is appropriate to look through to the true source or origin of the value of a company's equity, without regard to intervening channels (i.e., corporate groups should be consolidated). The look-through approach adopted by the CRA attempts to achieve this result.

Application of the CRA's look-through approach is likely not restricted to interests in wholly-owned subsidiaries. The approach should seemingly apply in the same manner through multiple levels of subsidiaries and to any corporate holdings or investments that themselves constitute TCP. In addition, at the May 2012 International Fiscal Association Conference, the CRA stated that it would apply the same look-through approach to investments in partnerships for purposes of determining whether a parent's equity constitutes TCP.[9]

Notably, the look-through approach adopted by the CRA is not equivalent to an approach that analyzes the consolidated gross assets of the parent and every lower-tiered company in the corporate group. The difference in these approaches is illustrated in the following example: A parent owns shares of a subsidiary valued at $40 and holds $50 of cash. The subsidiary, in turn, owns CRP of $200, a related mortgage debt of $200, and cash of $40.

If the TCP status of the parent's equity was based on a consolidation of the gross assets of the parent and the subsidiary, the parent's equity would constitute TCP. In these circumstances, the gross assets of the corporate group consist of $200 of CRP (69% of total gross assets) and $90 of non-CRP (31% of total gross assets). Arguably, this outcome is anomalous given that the subsidiary's shares are worth $40 (based on the net value of the underlying assets), which is less than the parent's $50 of non-CRP.

Under the CRA's look-through approach, the subsidiary's assets would be netted against its liabilities such that the weight given to the subsidiary's CRP would be reduced, and the parent's equity would no longer constitute TCP. In these circumstances, $200/$240 of the subsidiary's gross assets constitute CRP, such that 83% and 17% of the fair market value of the subsidiary's shares would be considered CRP and non-CRP, respectively, for the parent. As a result, the parent's gross assets would consist of 37% CRP[10] and 63% non-CRP.[11]

The distinction between a gross asset value approach relative to a net asset value approach takes on new significance in the context of the CRA's look-through approach. Under the look-through approach, it is first necessary to calculate the fair market value of the subsidiary's shares, before applying a gross asset value approach in determining the TCP status of the parent's equity. The fair market value calculation necessitates an analysis of the net value (rather than the gross value) of the subsidiary's equity. If a subsidiary holds CRP that is highly leveraged, the leverage takes on new relevance in that it reduces the fair market value of the subsidiary's shares. Where the subsidiary's liabilities exceed its assets, such that the fair market value of the subsidiary's shares is nil, the CRA's approach disregards the subsidiary's assets entirely. As discussed further below, this may create anomalous results where the subsidiary's principal liability is intercompany debt owing to the parent.

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[6] *Westar Mining Ltd v. The Queen*, 92 DTC 6358 (FCA) at para 24.

[7] *Kemp v. MNR*, 3 DTC 1078 (Ex Ct) at paras 12–14; *Gilhooy v. MNR*, [1945]CTC 203 (Ex Ct) at paras 22–23; *MNR v. Hollinger North Shore Exploration Co.*, [1963] SCR 131.

[8] *Commissioners of Taxation v. Kirk*, [1900] AC 588 (PC) at 592; *MNR v. Hollinger North Shore Exploration Co.*, [1963] SCR 131 at para 12; and *Garcia v. The Queen*, 2007 TCC 548 [Informal Procedure] at paras 28–37.

[9] CRA Conference Document 2012-0444091C6, "Definition of Taxable Canadian Property" (17 May 2012).

[10] Equal to (83% × $40 (value of subsidiary shares)) / $90 (total parent assets).

[11] Equal to (17% × $40 (value of subsidiary shares) + $40 (parent cash)) / $90 (total parent assets).

D. Subsidiary Equity Not Itself Taxable Canadian Property

As noted above, following the 2012 Amendment, where the shares of a subsidiary do not themselves constitute TCP, the full value of the shares will be considered non-CRP when applying the gross asset value approach to the parent. The stated purpose of the 2012 Amendment was ". . .to ensure that the indirect or 'look-through' rule does not extend through shares or other interests that are not themselves taxable Canadian property."

In the Technical Notes accompanying the 2012 Amendment, the Department of Finance gave the specific example of a non-resident owning, through a private holding company, shares of a Canadian public company that derived most of its value from CRP. Public company shares benefit from an extra 25% "ownership threshold" before they constitute TCP. The Department of Finance was concerned that the shares of the private holding company could be considered TCP by virtue of the look-through, even though the public company shares might otherwise not be TCP if they were held directly by the non-resident. In effect, the insertion of the private company between the individual and the publicly-listed shares would transform non-TCP shares into TCP shares. By virtue of the 2012 Amendment, since the public company shares would not themselves constitute TCP, the full value of the shares would be considered non-CRP for the private company. As a result, assuming that the private company shares would only have been TCP as a result of looking-through to the public company's assets, the private company shares would not be TCP.

Of interest to tax practitioners, the carve-out provided by the 2012 Amendment is not restricted to underlying interests in public companies, but rather is broad enough to apply to any shares or interests that are not themselves TCP. The fair market value of shares of a privately held subsidiary can thus be considered non-CRP for the parent, provided the value of the subsidiary's shares have not derived greater than 50% of their value from CRP in the past 60 months. As a result, through proper structuring, it is possible to remove significant amounts of CRP in a corporate group when determining the TCP status of the parent's equity. This provision opens up planning opportunities in certain circumstances to avoid the equity of a parent from constituting TCP.

In a straightforward example, suppose that a parent's only asset is shares of a subsidiary which have a fair market value of $300, while the subsidiary holds $210 of CRP and $90 of cash. Applying the look-through approach, the parent's equity would constitute TCP. Since 70% of the subsidiary's total gross assets would be derived from CRP (i.e., $210/$300), 70% of the parent's equity would be considered to derive its value from CRP.

In contrast, if the parent held the same underlying assets through two sister corporations, it may avoid having its equity constitute TCP. Suppose the parent's only assets are shares of subsidiary 1 and subsidiary 2, which have fair market values of $175 and $125, respectively. Subsidiary 1 holds $85 of the $210 of CRP and all of the cash ($90), while subsidiary 2 holds the remainder of the CRP ($125). As a result of the 2012 Amendment, the full fair market value of subsidiary 1's shares (i.e., $175) would be considered non-CRP for the parent. Applying the look-through approach, since 100% of subsidiary 2's gross assets constitute CRP, the full fair market value of subsidiary 2's shares ($125) would be considered CRP for the parent. Applying the gross asset value approach at the parent level, the parent's equity would not constitute TCP since only $125/$300 (41.67%) of the parent's total gross value would be derived from CRP.

E. Intercompany Debt

In circumstances where a parent finances its wholly-owned subsidiary with debt, several options would appear to be available for determining whether the parent's equity constitutes TCP. Under one possible approach, since the value of an intercompany receivable for the parent would not generally fluctuate with the value of its subsidiary's CRP, the value of the receivable might be included as non-CRP for the parent. Alternatively, a look-through approach could apply to determine the value of the subsidiary's debt attributable to CRP, in an analogous manner to that applied by the CRA in determining the value of the subsidiary's equity attributable to CRP.

At the May 2012 International Fiscal Association Conference, the CRA adopted a third approach. According to the CRA, intercompany debt is to be completely ignored as an asset for the parent and as a liability for the subsidiary. According to the CRA's stated purpose, if the shares of a parent would otherwise be considered TCP if the parent had capitalized its wholly-owned subsidiary solely with equity, then the shares should be considered TCP if the parent capitalizes the subsidiary in part with equity and in part with debt. At this point, the CRA's position with respect to intercompany debts is restricted to receivables owing from wholly-owned subsidiaries.

As an illustration of the CRA's selected approach, assume that a parent company held an equity interest in its wholly-owned subsidiary worth \$100, a receivable in the subsidiary worth \$300, and \$40 of cash. Assume further that the subsidiary's assets were comprised of \$300 of CRP and \$100 of cash. In these circumstances, the parent's equity would constitute TCP. Applying the look-through approach to the subsidiary's equity, \$75 of the fair market value of the subsidiary shares would be derived from CRP (i.e., \$300/\$400 x \$100). Applying the gross asset value approach at the parent level, greater than 50% of the parent's total gross assets of \$140 (ignoring the intercompany receivable of \$300) would be derived from CRP (i.e., \$75/\$140).

An application of the CRA's approach was demonstrated in Advanced Tax Ruling 2012-0444431R3 (2013). Non-resident investors held equity and debt (non-interest bearing loans) interests in a foreign partnership ("Foreign Partnership"). Foreign Partnership, in turn, held equity and debt (profit-participating loans and non-interest bearing loans) interests in a foreign corporation ("Foreign Parent"). Foreign Parent, in turn, held equity and debt (interest-bearing loans) interests in a foreign subsidiary ("Foreign Subsidiary"). Foreign Subsidiary held a partnership interest in a Canadian partnership which held CRP. The CRA ruled that the equity interests of the non-resident investors in the Foreign Partnership constituted TCP on the basis that the interests derived, indirectly, all of their value from CRP. It appears that the respective percentage values of the loans relative to the equity interests were not important considerations in the CRA's analysis. The CRA's conclusion that a non-resident's equity interest in Foreign Partnership would ". . .derive, indirectly, all of its value from real property situated in Canada" suggests that the CRA ignored the intercompany debts in determining whether the equity interest constituted TCP.

While the CRA's administrative position on disregarding intercompany debt when determining whether shares of a company constitute TCP should produce logical results in most cases, there may be situations in which it fails to achieve the CRA's stated objective of ensuring consistent treatment between cases where a parent capitalizes its subsidiary solely with equity and cases where a parent capitalizes its subsidiary in part with equity and in part with debt. The technical shortcoming of the CRA's approach is that it ignores the intercompany debt as an asset for the parent and as a liability for the subsidiary, but continues to recognize it in the calculation of the fair market value of the subsidiary's equity. The result is that the value of the parent attributable to the subsidiary's property (whether CRP or not) is reduced relative to the value of the parent attributable to other property (whether CRP or not). The approach may thus produce cases where an equity/debt capital structure of a subsidiary would result in the parent's equity constituting TCP, where a 100% equity structure would otherwise not, and vice versa.

Arguably, if the CRA's goal is to ensure that TCP treatment is consistent between cases where a parent capitalizes its subsidiary solely with equity and cases where a parent capitalizes its subsidiary in part with equity and in part with debt, then the most straightforward approach would be to apply the look-through approach to debt interests in subsidiaries in the same manner as that applied to equity interests. Such an approach would be appropriate in light of the broad scope of the phrase "derived directly or indirectly" which, as discussed above, requires looking through to the true source or origin of the value of a company's equity, without regard to intervening channels. This approach would give proper weight to the value of a subsidiary's assets and would provide consistent treatment between different capital structures. In addition, such an approach would appear to be the most logical and consistent method for discerning the value of a company's equity where that value is derived in whole or in part from debt interests in other companies.

To illustrate the shortcoming of the CRA's approach to intercompany debt relative to a look-through approach, consider a 100% equity structure where a parent's only assets are shares of a subsidiary with fair market value of $100 and cash of $50, while the subsidiary's only asset is CRP of $100. In these circumstances, the parent's equity would constitute TCP since the full value of the subsidiary's equity ($100) would be considered derived from CRP, which is greater than 50% of the parent's total gross assets (i.e., $100/$150). If the parent had instead financed the subsidiary with $40 of equity and $60 debt, and the intercompany debt were ignored as directed by the CRA, the parent's equity would not constitute TCP. In these circumstances, only $40 of the parent's equity in respect of the subsidiary shares would be considered to be derived from CRP, which is less than 50% of the parent's gross assets ($40 / ($40 + $50)). Under a look-through approach to the intercompany debt, the parent's equity would constitute TCP since $40 of the parent's equity and $60 of the parent's debt would be considered derived from CRP, greater than 50% of the parent's total gross assets.

The opposite result can occur if the subsidiary holds substantial non-CRP. In a 100% equity structure, assume the parent's only assets are shares of the subsidiary with fair market value of $100 and CRP of $50, while the subsidiary's only asset is cash of $100. The parent's equity would not constitute TCP since less than 50% of the parent's total gross assets would be considered to be derived from CRP ($50 / ($50 + $100)). If the parent had instead financed the subsidiary with $40 of equity and $60 of debt, and the intercompany debt were ignored as directed by the CRA, the parent's equity would constitute TCP. In these circumstances, only $40 of the parent's equity in respect of the subsidiary shares would be considered to be derived from non-CRP and, accordingly, greater than 50% of the parent's total gross assets would be CRP ($50 / ($40 + $50)).[12] Under a look-through approach to the intercompany debt, the parent's equity would not constitute TCP since less than 50% of the parent's total gross assets would be considered to be derived from CRP ($50 / ($50 + $40 + $60)).

F. Conclusion

The CRA's administrative positions regarding how the TCP definition should be applied in circumstances where a company's property includes equity or debt interests in one or more subsidiary corporations continue to evolve. While the CRA's approaches are relatively straightforward at first blush, they become increasingly complex when applied to multi-tiered corporate structures, particularly those financed with a combination of equity and debt. Careful diligence is recommended in these circumstances. Difficult practical issues may also arise when the CRA's approaches are applied to arm's length ownership interests, particularly where a non-resident may not have the ability to access information regarding an entity's underlying property holdings.

It is hoped that the CRA's guidance in this area continues to develop. In the meantime, the technical nature of the CRA's administrative positions may occasionally produce anomalous results, but also opens up many planning opportunities for practitioners.

CURRENT ITEMS OF INTEREST

Department of Finance Releases GST/HST Draft Proposals

On July 22, 2016, the Department of Finance released draft legislative and regulatory proposals relating to GST/HST for consultation. These proposed amendments relate to pension plans, financial institutions, the drop shipment rules, municipal transit services, and "housekeeping" amendments to improve the GST/HST legislation. Comments on these proposals will be accepted until August 31, 2016.

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[12] The technical flaw in the CRA's approach is that if the intercompany debt is ignored the subsidiary should be left with net assets of $100 ($40 + $60) and the subsidiary's equity should accordingly be increased to $100 ($40 + $60), thereby giving appropriate weight to the subsidiary's CRP. This is effectively the same outcome as would be seen if the look-through approach were applied to the intercompany debt.

On the same day, the Department of Finance also released a consultation paper on proposed changes to the GST/HST rules with respect to certain limited partnerships and investment plans. Comment submissions will be accepted until November 30, 2016.

The draft proposals and consultation paper are available on IntelliConnect. Print copies (Special Report 092H) are available by calling 1-800-268-4522 or emailing cservice@wolterskluwer.com.

SR&ED Program Service Standards

On July 7, 2016, the CRA released modified SR&ED Program Service Standards setting out both the service standards and the CRA's success rate in meeting those standards for the current fiscal year.

Benefits and Allowances Received From Employment

The CRA released Folio S2-F3-C2, Benefits and Allowances Received from Employment, which replaces and cancels Interpretation Bulletin IT-470R effective July 7, 2016. The folio explains the federal income tax treatment of benefits and allowances received from employment, the specific provisions of the Act and the principles developed by the courts that establish which benefits and allowances are included in an employee's income, and the amount to be included. As with all newly published income tax folios, this folio has a 3-month comment period to allow for feedback from the tax community.

Prescribed Interest Rates for Leasing Rules

The CRA released updated prescribed monthly interest rates for leasing rules on July 4, 2016.

About the Underground Economy

The CRA released a Tax Alert on the underground economy on July 4, 2016, outlining what the underground economy is, the consequences of participating in it, and what the CRA is doing to fight it.

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 Awarded Significant Costs After CRA Disregards Reasonable Settlement Offers

***ACSIS EHR (Electronic Health Record) Inc. v. The Queen*, 2016 DTC 1047 (Tax Court of Canada)**

The awarding of costs is an increasingly important tool used by the Tax Court of Canada to encourage negotiations and settlements. Disregarding a reasonable settlement offer may prejudice a party in a later application for an increased award of costs, especially if a judgment is more favourable to a party than prior settlement offers.

Section 18.26 of the *Tax Court of Canada Act* allows the Tax Court to discretionarily award costs and states that when deciding whether to award costs, and the quantum, the court may consider any written settlement offers made after the notice of appeal is filed. Rule 147(3) in the *Tax Court of Canada Rules (General Procedure)* (the "Rules") lists several other factors the court may consider in exercising its discretion, including (in addition to other factors):

- the result of the proceeding;
- the importance of the issues;
- the conduct of any party that shortened or unnecessarily lengthened the duration of the proceeding; and
- the complexity of the issues.

In this case, the Minister denied a taxpayer's claimed scientific research and experimental development ("SR&ED") expenditures. The taxpayer appealed and made a settlement offer on May 2, 2014, which the Minister ignored for 10 months and then rejected without making a counter offer. The taxpayer soon after made a second settlement offer that was quickly declined; the Minister countered with an offer to consent to the taxpayer discontinuing the appeal on a without costs basis. Both of the taxpayer's settlement proposals were for amounts below the total amount of credits at issue.

In the judgment in *ACSIS EHR (Electronic Health Record) Inc. (2015) v. The Queen*, 2015 DTC 1212 (TCC), Campbell J. determined that the appellant taxpayer was entitled to claim all of the SR&ED expenditures, a result more favourable than either of its settlement offers. Based on that success, the appellant sought an increased discretionary cost award pursuant to Rule 147(7). Specifically, the appellant requested both costs before May 2, 2014, as calculated according to the tariff and, on and after that date, 95% of all invoiced fees and disbursements or, alternatively, no less than 80% of its solicitor and client costs.

The respondent proposed that the cost award be limited to 50% of the fees and disbursements, apparently based on its opinion that the appellant's claims lacked sufficient documentation to support SR&ED entitlement, which put the Minister in a "legal disability" in accepting the claim.

Campbell J. stated that the Minister has a statutory duty to assess tax payable and held that both documentary and oral evidence should have been considered to negotiate the SR&ED claims, which the Tax Court would do if the matter was not resolved prior to going to court. Campbell J. determined that, based on the facts, there was room to negotiate as to the quantum of qualifying expenses.

Campbell J. discussed the evolving importance of settlement offers in determining awards of solicitor and client costs in the civil context as well as in recent Tax Court decisions and the statutory authority. For example, Rule 147(3.1) entitles appellants who make settlement offers and receive more favourable subsequent judgments to "substantial indemnity costs" following the settlement offer date. Rule 147(3.5) provides that "substantial indemnity costs" means 80% of solicitor and client costs.

Aside from the appellant's reasonable written settlement offers, factors that supported a high costs award included that the appellant was wholly successful and the importance of the credits to the appellant's business.

Campbell J. awarded enhanced costs in the amounts requested by the appellant: costs before May 2, 2014, (the date of the appellant's first offer) as calculated according to the tariff and 95% of all invoiced fees and disbursements from May 2, 2014, onward. Campbell J. noted that the award percentage may have been lower as the appellant had initially not provided sufficient detail in respect of the invoices from the appellant's legal counsel; however, that deficiency had been corrected following a request by the respondent for more detail, which the appellant provided.

Although Campbell J. in this case in effect chastised the CRA for disregarding settlement offers, taxpayers as well should consider these principles in deciding whether to negotiate with or accept settlement offers from the CRA. As with Rule 147(3.1) for appellants, Rule 147(3.2) allows a court to grant a respondent "substantial indemnity costs" if a judgment is as or less favourable than an earlier settlement offer.

— *Alyssa Novoselac, Summer Student*

Documentary Evidence Not Mandatory in Establishing Consideration Provided Pursuant to a Valid Verbal Agreement

***Connolly v. The Queen*, 2016 DTC 1094 (Tax Court of Canada)**

The *Connolly* case provides an interesting example of a court's willingness to find that payments were made pursuant to a verbal agreement notwithstanding a lack of documentary evidence.

The taxpayer was assessed, pursuant to section 160 of the *Income Tax Act* (the "Act"), for approximately $77,000 in respect of amounts that were transferred to the taxpayer by her common-law spouse. The transfers to the taxpayer were made at a time when the spouse was liable under the Act for an amount at least equal to the amount assessed.

The taxpayer appealed the assessment, maintaining that she and her spouse had made a legally binding agreement under which the taxpayer agreed to advance funds to her spouse for his business operations. According to the taxpayer, these funds were to be repaid to her by the spouse when he had sufficient funds. The taxpayer contended that because the funds she received represented the repayment of funds advanced by her pursuant to verbal agreements between the parties, subsection 160(1) of the Act did not apply.

In his reasons for judgment, Favreau J. noted that in order for subsection 160(1) to apply four conditions must be met:

(1) there must be a transfer of property;

(2) the transferor must be liable to pay tax under the Act at the time of the transfer;

(3) the transferee must be a person not dealing at arm's length with the transferor; and

(4) the fair market value of the property transferred must exceed the fair market value of the consideration given by the transferee.

As the parties agreed that the first three conditions were met, the issue in the case was whether fair market value consideration was provided by the taxpayer in exchange for the transfer of property from her spouse.

The Minister argued that there was no consideration provided for the amounts the taxpayer received or, in the alternative, that the loans (if so construed) made by the taxpayer were not legally enforceable. The Minister noted that there was no written agreement, there were no terms of repayment, and the purported loans did not carry interest. Furthermore, the Minister pointed out that no up-to-date record was kept of the loans and their repayment, and that the taxpayer relied principally on a spreadsheet prepared after the relevant period. As a result, the Minister asserted that the taxpayer had not established the fair market value of any consideration provided by her.

In addressing the Minister's assertions, Favreau J. distinguished the case at bar from his decision in *Pelletier v. The Queen* (2009 DTC 1365), where he held that the Minister was warranted in requiring documentary evidence pertaining to the repayment of loans purportedly made. In *Pelletier*, the taxpayer had not kept any record and, in addition, there were contradictions in the information that the taxpayer provided. Quoting from his decision in *Pelletier*, Favreau J. noted that:

> In tax matters, documentary evidence is almost always required from taxpayers where the evidence submitted is not sufficient or is vague, where the witnesses are not credible or where there are contradictions in the information provided by the taxpayers.

However, Favreau J. emphasized in this case that documentary evidence is not always required given that verbal agreements are generally valid. The existence of a verbal agreement, Favreau J. noted, is determined based upon the credibility and testimony of witnesses. Thus, despite the fact that the onus was on the taxpayer to establish the fair market value of the consideration given by her for the amounts paid to her, that onus was held not to be insurmountable. Favreau J. further noted that:

> Even if it is preferable that all agreements be put in writing, it is not up to this Court to dictate so. As the appellant was able to provide credible evidence of the existence of such an agreement, I believe she successfully refuted the Minister's assumption that she provided no consideration in exchange of the funds from her common-law partner that were deposited in her bank account.
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> The appellant appeared to me as a highly credible witness that, unfortunately, had a conjugal relationship with a recurrent tax debtor [. . .] The evidence revealed that, during those years, the appellant had effectively advanced funds to [. . . her spouse] for both businesses and for his personal expenses.
>
> Under the terms of the verbal agreement, he had the legal obligation to reimburse her whenever he would have money available and which he did during the Period.

The Court concluded that the taxpayer provided consideration, in the form of advances and loans for the spouse's business payroll, rent, and miscellaneous business and personal expenses, in exchange for the transfer of property to her from her spouse. Favreau J. indicated that whether the advances and loans were used for business or personal purposes was irrelevant to the broader determination of whether adequate consideration had been provided. Instead, the proper focus of enquiry in this matter was whether the property was transferred pursuant to a legal rather than a moral obligation.

In respect of the lack of interest on the loans and the fact that the taxpayer had not been identified as a creditor of her spouse in her spouse's 2004 bankruptcy documents (in respect of the amounts that had not previously been repaid to her), these facts were stated by Favreau J. to be inconclusive as to the validity and enforceability of the loans and advances. The Court thus concluded that the taxpayer had provided adequate consideration for the transfers received. As a result, the taxpayer's appeal was allowed and the assessment vacated.

Connolly illustrates that the lack of documentary evidence will not preclude a court from finding that consideration was delivered pursuant to an enforceable verbal agreement where a witness is credible as to the existence and terms of the agreement.

— *Krupa Kotecha, Law Student*

Taxpayer's Right to Amend Return to Claim SR&ED Expenditures Subject to Ministerial Discretion

***AFD Petroleum Ltd. v. AG of Canada*, 2016 DTC 5063 (Federal Court)**

The *AFD Petroleum* case underscores the necessity of complying with filing requirements and deadlines when submitting claims for eligible Scientific Research and Experimental Development ("SR&ED") expenditures. The taxpayer corporation had requested, on December 31, 2013, that its 2012 income tax return be amended to include a claim for SR&ED expenditures in order to obtain a deduction from its 2012 income under section 37 of the *Income Tax Act* (the "Act"). Pursuant to this request, the taxpayer submitted a T661 form and related supporting schedules in order to claim expenditures of approximately $375,000.

The taxpayer submitted the T661 form on the last day available under the extended due date of 12 months after the T2 tax return due date, with only two of the seven pages comprising Part Two of the T661 form completed. Consequently, the Minister denied the taxpayer's request for an adjustment to its 2012 tax return to claim the SR&ED tax credit, given that the required information was not filed by the extended due date.

The taxpayer challenged the Minister's decision on the basis that the T661 form was properly filed, arguing that all required information was included in the form viewed as a whole, despite the fact that specific sections of the form were incomplete. The Minister responded to the taxpayer's contentions in a letter explaining that specific lines of the T661 form submitted by the taxpayer corporation were not adequately addressed in other sections of the submitted T661 form. The taxpayer subsequently brought an application pursuant to section 18.1 of the *Federal Courts Act* for judicial review of the Minister's decision rejecting its SR&ED claim for the 2012 taxation year.

In considering the taxpayer's assertions, Boswell J. concluded that the taxpayer's judicial review application and request that the Federal Court quash the Minister's decision involved a remedy within the Federal Court's jurisdiction, pursuant to the *Federal Courts Act*. Furthermore, Boswell J. held that the substantive issues raised by the taxpayer also fell within the purview of the Federal Court. In this regard, although taxpayers are normally able to appeal decisions denying SR&ED claims to the Tax Court of Canada after a taxpayer's income tax return for a given taxation year is assessed by the Minister (and objected to by the taxpayer), Boswell J. distinguished the case at bar from such situations by noting that the taxpayer's SR&ED claim had not been assessed on its merits or evaluated by the Minister at all, as the SR&ED claim had not been made until after the T2 return had been filed and assessed. Boswell J. also noted that the objection period for the taxpayer's 2012 taxation year had expired, precluding the possibility of the taxpayer objecting or appealing in respect of the claim.

Boswell J. asserted that because the decision in question involved the interpretation of the Minister's "home statute", the Act, the Minister possessed the requisite expertise and was, as a result, entitled to due deference. Boswell J. concluded that the appropriate standard of review for assessing the Minister's decision was therefore one of "deferential reasonableness". On the other hand, in respect of the questions of procedural fairness raised by the taxpayer, Boswell J. relied on the decision of the Supreme Court of Canada in *Mission Institution v. Khela* ([2014] 1 SCR 502) in determining that the appropriate standard of review was one of correctness.

Boswell J. then turned to consider whether the Minister's decision was substantively unreasonable, such that it should be quashed. The taxpayer contended that the Minister failed to properly take into account section 32 of the *Interpretation Act* which states that "where a form is prescribed, deviations from that form, not affecting the substance or calculated to mislead, do not invalidate the form used." Relying on *Mitchell v. Canada* (2002 DTC 7502), a decision involving a waiver in respect of which the prescribed form was not used, the taxpayer argued that the T661 form filed included, on line 240, the information that would normally have been contained in the two missing lines (lines 242 and 244). The taxpayer further submitted that no basic information was missing from the form so as to make review and assessment of its claim impossible; it was further asserted that the Minister had any missing information available through the taxpayer's claim for the 2013 year.

In addressing the taxpayer's assertions, Boswell J. distinguished *Mitchell* from the case at bar. Boswell J. noted that the taxpayer's letter in *Mitchell*, unlike the form submitted by the taxpayer in *AFD Petroleum*, contained all of the required information and thus constituted a valid waiver despite the fact that a prescribed form of waiver was not used. Boswell J. held that the information provided in line 240 of the taxpayer's form did not supply the information requested in lines 242 and 244.

The taxpayer's argument that the missing information was available to the Minister in connection with its 2013 claim, and that such information should have been used for the purposes of supplementing the 2012 claim, was also dismissed. Specifically, Boswell J. held that:

> [N]othing in [the Act] requires the Minister to check a taxpayer's filings for other taxation years before determining whether prescribed information for a different taxation year is missing in a Form T661. It is significant that Form T661 specifically requests information in relation to only the one tax year for which the SR&ED claim is made. In view of the possibility that the technological obstacles and uncertainties a taxpayer faced and what work was performed to overcome them in one tax year could readily change from one year to the next, the Minister should not be obligated to adopt and accept information from another SR&ED claim in determining that prescribed information is missing from the claim for the taxation year in question.

The Minister's decision to refuse the taxpayer's T661 form for the 2012 year on the basis of incompleteness was thus determined to be reasonable and was held to fall within a range of justifiable outcomes.

Lastly, the Court held that the Minister's decision to not accept the T661 form submitted by the taxpayer was not procedurally unfair. As stated by Boswell J.:

> Not only was this determination reasonable [. . .], it did not, as the Applicant contends, wrongfully convert an appealable SR&ED claim into a non-appealable non-filing. The Minister did not deprive the Applicant of any procedural rights because the Applicant could have filed the Form some 12 months earlier than it did when it filed its income tax return for 2012.

In considering the issue of procedural unfairness, the Court also noted that there is generally no mechanism in the Act compelling the Minister to act upon an amended return.

Although the decision is under appeal, the *AFD Petroleum* case underscores the importance of complying with procedural requirements when submitting claims for SR&ED deductions. Despite the fact that section 37 of the Act allows taxpayers to file T661 forms in the 12 months following taxpayers' filing due-dates, this course of action should be undertaken with caution; making a claim during this period may preclude a taxpayer from recourse in the event that the T661 form is rejected by the Minister due to incompleteness.

— *Krupa Kotecha, Law Student*

Taxpayer Permitted To Claim Substantial Accrued Loss on Foreign Exchange Options

***Kruger Incorporated v. The Queen*, 2016 DTC 5079 (Federal Court of Appeal)**

The issue in *Kruger* was the method by which the appellant computed its income for purposes of the *Income Tax Act* (the "Act") arising in respect of foreign exchange options. The appellant had computed its income arising from its dealings in foreign exchange options using the mark-to-market accounting method, which produced a very substantial loss as the options that it held had declined significantly in value.

The Minister disallowed the claimed business loss, aggregating $91,104,379 resulting from the appellant's dealings in foreign exchange options. The Minister maintained that, in the absence of express statutory provisions, the mark-to-market accounting method was not a valid method of computing the appellant's income for the purposes of the Act. Rather, the Minister insisted that the appellant had to compute its income using the realization method, such that any loss from the foreign exchange options could not be recognized until the contracts were disposed of or expired.

The appellant is a manufacturer of newsprint and other paper products. Traditionally, approximately 80% of its receivables have been in US dollars. As such, in the 1980s, the appellant began both purchasing from third parties and issuing foreign currency option contracts to reduce its exposure to foreign currencies. Dealing in such contracts had since become an individual profit centre for the appellant.

Since 1997, the appellant had computed its income from dealing in foreign exchange options using mark-to-market accounting. For its 1998 taxation year, the appellant suffered large accrued losses due to the large number of contracts held by it at the time and the decline in the value of the Canadian dollar against the US dollar.

In computing its income for its 1998 taxation year, the appellant marked to market the value of each of the contracts and deducted a loss based on the difference between the value of each contract at inception and its value at the end of the appellant's 1998 taxation year. The Minister, in turn, denied the loss claimed by the appellant.

Chief Justice Rip (as he then was), at the Tax Court level, determined that there was a general principle under the Act that losses and gains must be realized in order to be recognized under the Act, other than in situations in which there is an express exception to that general principle (such as for financial institutions that are required to use mark-to-market accounting in valuing most shares and debt obligations that they hold). Therefore, notwithstanding that Rip C.J. determined that mark-to-market accounting was consistent with both well-accepted business principles and generally accepted accounting principles, he concluded that mark-to-market was not an acceptable method under the Act in the absence of express provisions providing otherwise.

At the Tax Court level, in respect of the foreign exchange contracts that had been acquired by the appellant from third parties (as opposed to the contracts written by the appellant itself), Rip C.J. found that those contracts were inventory. The judge observed that, unlike the contracts that the appellant wrote itself (which were liabilities), the purchased contracts conveyed rights and, as such, constituted "property" within the meaning of subsection 248(1) of the Act. This finding led to Rip C.J. determining that the purchased foreign exchange contracts were inventory while the written contracts were not. In reaching this conclusion, Rip C.J. determined that there was no requirement that property be held for sale to constitute inventory.

In allowing the appeal, Noël C.J., writing for a unanimous Federal Court of Appeal, found that the Tax Court judge had not followed the Supreme Court of Canada's decision in *Canderel Ltd. v. Canada* (98 DTC 6100) in determining that the mark-to-market method was not an acceptable method of computing income under the Act. In *Canderel*, the Supreme Court stated that a court must first determine whether a method employed to compute income provides an "accurate picture of profit" of the taxpayer for the year under assessment. In addition, Noël C.J. determined the *Canderel* decision made it clear that the realization principle is not an overarching principle as other methods of determining income can provide a more "accurate picture of profit".

Noël C.J. referred to the Supreme Court of Canada's decision in *Canadian General Electric Co. Ltd. v. Minister of National Revenue* (61 DTC 1300), in which the Court rejected the Minister's position that the realization principle was mandatory. The Court in *Canadian General Electric* noted that the taxpayer may choose the method of computation used in determining income for purposes of the Act provided that it represents an "accurate picture of income" of the taxpayer.

Noël C.J. found that the Tax Court judge in *Kruger* erred in relying on *Friedberg v. Canada* (93 DTC 5507) and *Friesen v. Canada* (95 DTC 5551) in determining that an overarching principle in taxation was realization. Noël C.J. noted that the Supreme Court of Canada in *Friedberg* did not overturn the decision in *Canadian General Electric* as it made no reference to that decision; thus, the principles in *Canadian General Electric* remained applicable. Furthermore, in *Friesen*, the Supreme Court of Canada did not endorse realization as an overarching principle that could not be departed from.

Having determined that the appellant had demonstrated that the mark-to-market accounting method provided an "accurate picture of profit" for the 1998 taxation year, Noël C.J. considered whether the Crown had discharged the onus of showing that the realization method provided a better picture of the appellant's income. However, as the respondent had focused in this matter on arguing that the mark-to-market method was not an acceptable approach under the Act, it had not even attempted to demonstrate that the realization method provided a better picture of the appellant's income than mark-to-market.

Relying on the analysis in *Canderel*, Noël C.J. found that the mark-to-market value accounting provided an "accurate picture of income" for the 1998 taxation year of the taxpayer and that the Tax Court judge erred in determining that the method was not valid under the Act in computing income from the taxpayer's dealing in foreign exchange options.

Finally, Noël C.J. found that the Tax Court judge erred in determining that the purchased options were inventory. Noël C.J. determined that it was implicit in the Act's treatment of inventory that the property in issue be held for sale. As the appellant did not hold the purchased options (or the options that it had written) for sale, Noël C.J. decided that they were not inventory.

Noël C.J. noted that, although the Act generally recognizes two types of property (i.e., capital property and inventory), the options fell in neither category as they were another type of property for purposes of the Act.

Having concluded that the Tax Court judge erred in determining that the mark-to-market method was not valid under the Act for the computation of income from the appellant's dealing in foreign exchange options, Noël C.J. referred the reassessment back to the Minister.

— *Brianne Paulin, Summer Student*

RECENT CASES

Additional amount received by taxpayer in respect of retroactive salary adjustment interest and not damages as she had contended

The taxpayer was a Quebec Court judge. In reassessing the taxpayer for 2008, the Minister included in her income a retroactive salary adjustment received from the government of Quebec in the amount of $153,375 plus interest of $25,473.02. On her appeal to the Tax Court of Canada, the taxpayer took the position that $22,290.49 of this $25,473.02 represented an award of damages (paid to her by the Quebec government following its failure to respect its constitutional obligations) which ought not to have been included in her income.

The taxpayer's appeal was dismissed. To qualify as "interest" under paragraph 12(1)(*c*) of the Act, an amount must, among other things, relate to a debt owing (see *Brenda J. Miller v. The Queen* , (1986) 1 C.F. 382). The Quebec government was indebted to the judges of the Quebec Court in this case, affirmed by Auclair J. of the Quebec Superior Court in a judgment rendered on June 4, 2007, relating to the Quebec judges' entitlement to compensation under the terms of a certain report that had been submitted to the Quebec legislature. The $22,290.49 in issue in this case therefore qualified as "interest" on the Quebec government's indebtedness and, in any event, it could not be deducted from the $25,473.02 under paragraph 12(1)(*c*) as the taxpayer had sought to do. In addition, even if the $22,290.49 were not "interest", but damages as the taxpayer had contended, such damages were intended to compensate the taxpayer with respect to the salary owing to her. They were therefore required to be given the same treatment for tax purposes as that salary, and hence were subject to tax under the Act. The Minister's reassessment was affirmed accordingly.

Gaboury v. The Queen

2016 DTC 1093

Proceeds obtained by appellants pursuant to loan agreements not subject to a *Quistclose* trust

The Court was asked to provide a determination under Rule 58(1) as to whether funds obtained by each of four appellant taxpayers pursuant to a loan agreement executed in connection with a charitable donation arrangement were subject to a *Quistclose* trust. The respondent in the application disputed whether the Tax Court possessed the jurisdiction to make such a determination.

The Court had the requisite jurisdiction and determined that the funds at issue were not subject to a *Quistclose* trust. The Court first considered whether it had jurisdiction to provide the determination requested, and held that it did. The respondent had argued that a *Quistclose* trust was an equitable remedy, created to provide priority to a lender over other creditors and that such remedy was available to a lender only in a court of equity, which the Tax Court was not. The Tax Court held, however, that its role was to determine a correct assessment. While it could not provide the remedies available to a court of equity, it could consider a taxpayer's legal, contractual and equitable rights in arriving at a correct assessment. The Court then considered whether a *Quistclose* trust existed on the facts before it, and concluded that it did not. Rather, the appellants and the lender were in a contractual arrangement under which the funds were put by the lender into its law firm's trust account, with the lender holding an irrevocable authority and direction from the borrower to immediately deliver funds to a charity. The funds did not vest in the appellant borrowers prior to their delivery to the charity. Until the funds were delivered to the charity's lawyers, the appellants had no legal title or beneficial interest in the funds at issue: rather, what they had was a right to sue the lender for breach of contract should it have directed that the funds not be delivered to the charity for which those funds were intended. There was also no need for the lender to turn to the equitable remedy of a *Quistclose* trust, as it had never divested itself of control of the funds and was also protected by the contractual arrangement already in place. The Court concluded that the arrangements made by the parties did not give rise to the creation of a *Quistclose* trust.

Markou, Henderson, Olivanti and Petriello v. The Queen

2016 DTC 1095

Minister's transferor transferee tax liability assessment affirmed despite taxpayer's argument that no transfer took place

Under the terms of her mother's will, the taxpayer and her three siblings, including Robert, inherited a residence from their mother's estate in equal shares. The mother had died in 2008, Robert died intestate on November 20, 2011, and the shares in the residence were transferred from the mother's estate on January 16, 2012, to her four children including the taxpayer and Robert (but after Robert's death). On the same day, Robert's interest in the residence was also transferred to the taxpayer and her two siblings in equal shares without consideration at a time when Robert and his estate owed tax. On appeal to the Tax Court of Canada from the Minister's section 160 transferor transferee liability assessment, the taxpayer argued, in part, that: (a) she had renounced her entitlement to any portion of Robert's estate in a document executed on January 14, 2013, as soon as she discovered such entitlement, and hence was not affected by the transfer to her of Robert's interest in the residence, or by his tax indebtedness; (b) Robert never actually received a transfer of his interest in the residence from his mother's estate in any event because he died before the transfer of such interest was registered; and (c) the mother's will contained a provision stipulating that bequests to beneficiaries were not subject to seizures related to any debts owed by those beneficiaries.

The taxpayer's appeal was dismissed. The taxpayer's arguments were untenable. Her renunciation of her interest in Robert's estate was ineffectual, inasmuch as she had already accepted a transfer to her and her two siblings of that interest on January 16, 2012. By virtue of article 615 of the *Quebec Civil Code*, moreover, Robert became the owner of his one quarter interest in the residence on the date of his mother's death, regardless of the fact that he died before the transfer of that interest to him was formally documented. In addition the operation of section 160 of the Act is unaffected by non-seizure clauses in wills such as the one in the mother's will in this case. The Minister's assessment thus fell within the purview of section 160, and was affirmed accordingly.

Baker v. The Queen

2016 DTC 1091

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