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DAVID LOUIS

We have sad news to report in this issue of Tax Notes: David Louis, our friend and long-time contributor to Tax Notes and many other Wolters Kluwer publications, passed away suddenly on September 16, 2016.

David's extensive tax knowledge, incisive articles, humour, and attention-grabbing headlines were the highlight of many publications, sporting titles such as "Buckaroo Bureaucracy" (Tax Notes, May 2005, Number 507), "Magical Mystery Tour — The Supreme Court's GAAR Cases" (Tax Topics, November 10, 2005, No.1757), and "Kill Bill: Is C-10 on the Ropes?" (Tax Notes, August 2008, Number 547).

Thank you, David, for your valuable contribution to our products and our company over many, many years. Your knowledge, generosity, easy kindness, wit, and keen insights will be greatly missed.

DIVORCING UNCLE SAM: THE TAX AND IMMIGRATION PROCESS OF RENOUNCING US CITIZENSHIP

— *Max Reed*[1]

Some people line up for years to marry Uncle Sam, but thanks to FATCA and onerous tax requirements, the divorce rate is on the rise.[2] In 2012, the Department of Homeland Security reported 932 renunciations, compared to 2,999 in 2013, 3,415 in 2014, and 1,355 in the **first quarter** of 2015 alone.[3] The final number for 2015 is thought to be 4,279 — a 43% increase from 2013.[4] Breaking up with Uncle Sam requires special attention to both the US federal tax consequences and the US federal immigration consequences. With proper planning, it should be possible for most people to renounce without tax or immigration consequences. Here, I discuss the tax aspects first, followed by the immigration aspects.

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[1] Max Reed is a cross-border tax lawyer at SKL Tax in Vancouver. He can be reached at max@skltax.com.

[2] For a discussion of FATCA's application in the Canadian context, see Roy A. Berg and Paul M. Barba, "FATCA in Canada: The Restriction on the Class of Entities Subject to FATCA", 62 *Canadian Tax Journal/ Revue Fiscale Canadienne* 3 (2014) at 587-633 ["Berg and Barba"].

[3] Department of Homeland Security, *Report on Inadmissibility of Tax-Based Citizenship Renunciants*, November 30, 2015. Part of the Fiscal Year 2015 Report to Congress by the Department of Homeland Security ["DHS Report"].

[4] Barrie McKenna, "Delays, Costs Mount for Canadians Renouncing U.S. Citizenship," *Globe and Mail* February 9, 2016 (online at http://www.theglobeandmail.com/news/politics/ delays-costs-mount-for-canadians-renouncing-us-citizenship/article28688026/) ["McKenna"].

1. Renouncing Without Tax Consequences

In order to renounce US citizenship without tax consequences, a taxpayer must not be classified as a covered expatriate. A full discussion of the US exit tax and other consequences of "covered expatriate" ("CE") status is not the task here, as this topic has been very thoroughly covered elsewhere.[5] To put it simply, CE status includes a deemed disposition on all assets, as well as possible future tax to US beneficiaries. CE status should be avoided where possible.

"Covered expatriates" are those individuals who meet one or more of the following criteria:

- A net worth exceeding US$2 million on the date of expatriation (the "asset" test);[6]
- Average annual US income tax liability for the five years preceding the year of expatriation exceeding US$161,000 (indexed to inflation) (the "tax liability" test);[7] and
- Failure to certify full compliance with US tax obligations for each of the five years preceding expatriation, with tax obligations comprised of all tax and information returns and payment of all tax amounts on account of income, employment, estate, gifts, interest, and penalties (the "noncompliance" test).[8]

There are two exceptions to being a CE even if the US citizen has a net worth over US$2 million or an average annual tax liability of over US$161,000.

First, dual citizens since birth can in some cases be exempt from the exit tax regime. This applies if these individuals were resident in the US for no more than 10 years of the last 15 tax years ending with the year in which the renunciation occurs.[9] The individual must also be a tax resident of the country of their other citizenship at the time of renunciation. The dual citizen at birth exemption has become more powerful with recent retroactive grants of Canadian citizenship.

Second, there is an exception for individuals who renounce citizenship prior to attaining the age of 18.5 and who have been residents of the US for not more than 10 taxable years before the date of renunciation.[10] In both cases, the citizen must still certify on Form 8854, under penalties of perjury, that they have been US tax compliant for the past five years in order to renounce US citizenship on a "tax free" basis.

If a US citizen cannot qualify for one of these options, then some pre-expatriation tax planning may be necessary. The tax liability test is generally not a concern for Canadian-resident US citizens. They in most cases should not have a high average annual US tax liability because the US will grant a foreign tax credit for every dollar of tax paid to Canada on Canadian-sourced income.

The asset test is a different matter. While other planning may be available, the simplest way to be below US$2 million on the date of expatriation is to make a pre-expatriation gift to a spouse. This means that a potential renunciant who has a net worth of up to US$7.45 million may be able to renounce without being classified as a CE, by gifting up to US$5.45 million to his/her spouse (the 2016 amount of the US lifetime estate and gift tax exemption). Such gifts would not attract Canadian tax because of the spousal rollover available under the Canadian *Income Tax Act*.[11]

The US tax consequences of pre-expatriation gifts will depend on the immigration status of the spouse in question. Gifts to a US-citizen spouse are unlimited and require no reporting. Conversely, gifts from a US-citizen to a non-US-citizen spouse in excess of US$148,000 may trigger the US estate and gift tax. This may reduce a US citizen's lifetime estate and gift tax exemption and require disclosure on Form 709.[12] Any reduction in a lifetime estate and gift tax exemption would not be tremendously important to a person about to expatriate because once an individual terminates their US citizenship, that individual no longer has US estate and gift tax exposure on their non-US assets.[13]

There are some risks to making pre-expatriation gifts to a spouse or other family members. First, the tax advisor should consider whether a gift to a spouse would change the nature of the asset for family law purposes and make it divisible upon divorce when it might not otherwise be.

Second, the instructions to Form 8854 need to be considered. Those instructions request that, "if there have been significant changes in your assets and liabilities for the period that began 5 years before your expatriation and ended

[5] For greater detail, see: Kevyn Nightingale and David Turchen, "The American's Tax Experience in Canada", *Canadian Tax Journal/Revue Fiscale Canadienne*, 61:1 (2013) pp. 1-40 ["Nightingale and Turchen"].

[6] Internal Revenue Code of 1986, as amended ["IRC" or "Code"] §877(a)(2)(B).

[7] IRC §877(a)(2)(A).

[8] IRC §877(a)(2)(C).

[9] IRC §877A(g)(1)(B)(i)(I).

[10] IRC §877A(g)(1)(B)(i)(II).

[11] *Income Tax Act* ["ITA"] s. 73(1).

[12] IRC §2523(i) and Rev. Proc. 2015-53.

[13] Note that any individual has potential US gift and estate tax exposure on their US-situs assets, including U.S. stocks and real estate.

on the date that you first filed Form 8854, you must attach a statement explaining the changes."[14] This request lacks legal foundation and may not have to be followed, though the cautious taxpayer may not want to rock the boat.

The requirements of the Internal Revenue Code ("Code") section 8854 are set out in Code section 6039G. Changes in net worth over the past 5 years are not included. Section 6039G(b)(7) provides that "such other information as the Secretary may prescribe" may be required on Form 8854. The word "[p]rescribe," according to case law, is not the power to make law but is instead merely the power to carry out the will of Congress.[15]

Regulations prescribed by the Treasury are intended to clarify existing substantive law rather than to make new rules. Treasury has not developed any regulations under Code section 6039G; arguably nothing is prescribed, and thus there are no other legal requirements under Code section 6039G. As such, the IRS' instructions to Form 8854 are not in line with Congressional intent, nor are they in line with the Secretary's prescriptions. This would then indicate that the instructions both go beyond the law and beyond the regulations, and are therefore not binding on the taxpayer.

The fact that the instructions to a particular Form request certain information does not convey a legal requirement. In general, Forms and their instructions are not authoritative in and of themselves. They facilitate tax reporting but do not themselves prescribe tax consequences.[16] As the US Tax Court noted in *Zimmerman v. Commissioner*, "authoritative sources of Federal tax law are in the statutes, regulations, and judicial decisions and not in [. . .] informal [IRS guidance]."[17] Most importantly perhaps, IRS notices and announcements (including instructions) cannot modify existing statute or affect the plain meaning of any given statute.[18] Thus, the instructions to Form 8854 cannot be said to modify the plain meaning of Code section 6039G, which does not set out the requirement to disclose pre-expatriation changes in net worth.

In contrast, consider Code section 6038(a), which sets out the requirements for another form:, Form 5471.[19] The Code section lists a few mandatory items and allows the Secretary to prescribe regulations. Treasury has actually done so in this case, and the list of information required on Form 5471 is lengthy.[20] However, in the context of Code section 6038G and Form 8854, the Treasury has not prescribed regulations, and therefore not prescribed the information requested by the instructions to Form 8854. It is therefore arguable that the "requirement" on Form 8854 to disclose material changes in assets is not legally required.

Third, the anti-avoidance doctrine of economic substance must be analyzed. Under Code section 7701(o), a gift must have economic substance (a change of ownership would likely satisfy that) and a "substantial purpose" (other than US federal tax purposes).[21] The desire to be generous to a spouse is, in many cases, a substantial purpose. After all, a taxpayer is allowed to make gifts, hence the purpose of the gift tax regime. If done in conjunction with Canadian estate planning, this may also provide a substantial purpose outside of US tax.

Finally, the economic substance doctrine may not apply to the transaction at all. Code section 7701(o)(5)(B) reads, "[i]n the case of an individual, paragraph 1 shall apply only to transactions entered into in connection with a trade or business or an activity engaged in for the production of income." It is unlikely that a gift of assets to a spouse meets this threshold. The purpose of the transfers should be documented. A successful application of the economic substance doctrine may result in the IRS ignoring the gift and asserting that the renunciant is a covered expatriate.

In short, one way to avoid CE status is to make gifts to a spouse. Such gifts generally should not attract either Canadian or US tax in many cases. While there are some risks to making pre-expatriation gifts, these risks are largely manageable. Next, consider the immigration risks.

2. Renouncing Without Immigration Consequences

In 1996, Representative Jack Reed drafted and had passed an amendment to the Immigration and Nationality Act ("INA") that made any individual renouncing their citizenship for tax reasons potentially inadmissible into the United States. This piece of legislation, known colloquially as the "Reed Amendment," is found at section 212(a)(10)(E) of the

[14] Department of Treasury, Internal Revenue Service, *Instructions for Form 8854 - Initial and Annual Expatriation Statement*, last issue October 29, 2015 (online https://www.irs.gov/pub/irs-pdf/i8854.pdf).

[15] See *Swallows Holding, Ltd. v. Commissioner*, 126 T.C. 96 at 129 (2006), rev'd 515 F.3d 162, citing *Manhattan Gen. Equip. Co. v. Commissioner*, 297 U.S. 129 at 134-5 (1936).

[16] *Ibid.*

[17] *Zimmerman v. Commissioner*, 71 T.C. 367 (1978) at 371.

[18] See *United States v. Josephberg*, 562 F.3d 478 (2nd Cir. 2009) and *Rezazadeh v. Commissioner* T.C. Memo, 1996-245 which states "Internal Revenue IRS Publications [. . .] are merely guides published by the IRS to aid taxpayers [. . .] Petitioners may not rely on such publications to the extent the information in them conflicts with the law."

[19] IRC §6038(a).

[20] See treasury regulations section 1.6038-2(f).

[21] IRC §7701(o).

INA and reads as follows:

> Any alien who is a former citizen of the United States who officially renounces United States citizenship and who is determined by the Attorney General to have renounced United States Citizenship for the purpose of avoiding taxation by the United States is excludable.[22]

The risk of the Reed Amendment applying to someone who has renounced US citizenship is low. There is no formal process to guide its application and, even if there was, it would be difficult to implement for a variety of administrative reasons. The fact that it has been applied fewer than 5 times in the last 20 years is evidence that this is the case. The technical barriers to its application and the history of its application are discussed in turn below.

First, the statute refers to the purpose of "avoiding taxation" rather than avoiding the onerous tax reporting requirements. Even if a US citizen pays the exit tax, he or she is unlikely to be considered to have "avoided taxation" because all taxes due were paid.

Second, the Reed Amendment lacks regulations to guide its application and so there are no details on how it should be applied.

Third, the Attorney General does not have the authorization to obtain the necessary tax information in order to make the required determination.[23] Section 6103 of the Code prohibits the IRS from disclosing "return information" unless an exception applies.[24] Currently, return information can only be disclosed to federal officers or employees for the administration of non-tax-related federal law only where it is relevant to an investigation of criminal or terrorist activities, or in emergency circumstances.[25] Indeed, such unauthorized disclosure is subject to criminal prosecution under Title 18 of the US Code. Absent a signed waiver of an individual's rights under IRC §6103, the Department of Homeland Security ("DHS") cannot examine an individual renunciant's tax returns.

Fourth, even with the taxpayer's consent, the Reed Amendment cannot function. On November 30, 2015, the DHS issued a report on the implementation of the Reed Amendment.[26] The DHS Report contains a number of insights. The DHS Report notes:

> Even if a renunciant were to waive Treasury confidentiality provisions, such that DHS and DOS might review specifics of an individual's Internal Revenue Service filings, DHS lacks the expertise and resources to review tax filings meaningfully or engage in complicated tax liability analysis, involving both domestic and foreign tax law to determine whether a section 212(a)(10)(E) inadmissibility presumption could be rebutted.[27]

This is assuming a rebuttable presumption exists in the first place. Currently, it does not. The DHS Report also notes that such a presumption is ultimately undesirable and likely either over-inclusive or under-inclusive. In short, the DHS notes that such a presumption would not be proportional to the ends it seeks to achieve.[28]

Fifth, bureaucratic obstacles make the law difficult to enforce even if there were regulations in place. INA section 212(a)(10)(E) outlines that there must be an actual finding of US tax avoidance purposes. This implies an official process undertaken by the Attorney General's office or its delegate.[29] As noted above, the IRS is statutorily barred from sharing the tax return information necessary to make such a determination. The DHS, which has the authority to establish a rebuttable presumption based on that information, has deemed it undesirable to do so.[30] The Department of State, which processes the actual renunciation, has neither the access to the requisite tax information nor the authority to make the determination of "a tax avoidance purpose."

Therefore, even if a renunciant were to affirmatively state a tax avoidance purpose at their renunciation interview, the Department of State must forward this information onto either the Department of Justice or DHS for the Reed Amendment to be enforced. Absent that, coordination would be required between the IRS, Department of State, and either the Department of Justice or DHS, as well as the sharing of information that the IRS is in fact prohibited from disclosing. This kind of inter-agency cooperation, aside from being (at the current time) legally impossible, is difficult,

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[22] 8 United States Code ["U.S.C" or "U.S. Code"] §1182(a)(10)(E).

[23] Charles M. Bruce, Lewis Saret, Stéphane Lagonico, and Steve Trow, "The Exit Tax – A Perfectly Bad Idea," *Tax Notes International* 867, March 13, 2006 at 869 ["A Perfectly Bad Idea"].

[24] IRC §6103.

[25] *Ibid.*

[26] DHS Report, *supra* note 2 at 3.

[27] *Ibid.*

[28] *Ibid.*

[29] Very generally, this process has been delegated to any immigration officer, as they have the authority to take and consider evidence concerning the privilege of any person to enter the United States, or concerning any matter which is material or relevant to the enforcement of the Immigration and Nationality Act see - INA §103(a)(4) and 8 CFR 287.5(a)(2).

[30] DHS Report, *supra* note 2.

costly, and ultimately unlikely to be particularly effective as a function of attempting to coordinate up to four separate bureaucracies. The cost of this, combined with the fact that the Reed Amendment is not actually a revenue-raiser, seems out of proportion compared to the desired effect of this legislation, especially where an individual renunciant has no exit tax liability in the first place (as is often the case).

Here is a scenario to illustrate these difficulties. Assume Mr. Doe goes to the US consulate in Vancouver to renounce his citizenship because he is worried about having to pay US tax on the sale of his house that has increased in value substantially. Assume he does not mention tax issues as a motivation during the interview. It would be almost impossible for the consular officer to determine that he has renounced US citizenship for tax reasons. There is no investigative process which follows or which is part of the renunciation process. The consular officer cannot have access to Mr. Doe's tax returns. The consular officer cannot invoke the Reed Amendment on his own. He has to get the Attorney General's office or its delegate to do so. Even if Mr. Doe unwisely confesses to a tax-motivated expatriation during his interview, it would still be difficult to legally invoke the Reed Amendment. First, there is no official process set out for the consular officer to follow. Second, the consular officer has no unilateral authority. Third, the unwieldy inter-agency collaboration described above must be followed.

Perhaps understanding the difficulties in enforcement, Senator Reed originally attempted to strengthen the Reed Amendment — unsuccessfully. In Senate Report 113-98 on the subject of the Department of Homeland Security Appropriations Act, Senator Reed included language specifically to create regulations enforcing INA 212(a)(10)(E).[31] This was not included in the bill eventually passed,[32] which indicates an unwillingness on behalf of both the legislature and the executive insofar as enforcement of the Reed Amendment is concerned. Of course, future legislative changes are impossible to predict. It should be noted that, even if a determination of a tax avoidance motive is made for an individual and that individual is initially deemed inadmissible, they may nonetheless be granted a waiver to enter the US on a temporary basis.[33]

The difficulty of applying the Reed Amendment is evidenced by the few times it has been applied. There have only been two documented invocations of the Reed Amendment to actually deny entry to an individual between 2002 and 2015.[34] The two times the Reed Amendment was actually applied were both cases where the individuals had admitted specifically to expatriating to avoid taxation.[35] Recall that there were over 11,000 renunciations from 2012 to 2015 alone. Though the incidence of renunciation between 2002 and 2012 was nowhere near as frequent as between 2012 and 2015, the scarce application of the Reed Amendment is certainly indicative of an unwillingness to enforce on behalf of the government.

There are several caveats of which to be aware. While there are few documented cases of the Reed Amendment being enforced and no regulations for its enforcement, there is still some risk at the border. A foreign passport may identify a US birthplace, which is a telltale sign of US citizenship. Because a US passport is required under US law for a US citizen to enter the United States,[36] a border agent might then inquire as to a former US citizen's passport. This would open that individual to a line of questioning about their renunciation. This discussion is best avoided by having an answer ready that does not mention tax considerations.

With some care, it should be possible for an individual to renounce US citizenship without worry about tax or immigration risks. A prospective renunciant would want to:

- Make sure that he or she is fully caught up on US tax returns for the past 5 years;
- Unless they qualify for one of the exceptions, ensure that their average annual US tax liability is less than US$161,000 over the past 5 years and that his or her net worth is under US$2 million; and
- Make sure to avoid mentioning anything related to tax to authorities during the entire renunciation process.

In short, it should be possible to divorce Uncle Sam with no tax or immigration consequences, but it may take some time and planning.

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[31] S. 2534 sec. 546.

[32] H.R. 83.

[33] 8 U.S.C § 1182(d)(3)(A).

[34] DHS Report, *supra* note 2 at 3.

[35] DHS Report, *supra* note 2 at 2.

[36] INA § 215(b).

PROVINCIAL LIMITATION PERIODS AND WAIVERS

— Josh Kumar, Associate, Dentons Canada LLP, Toronto

The Ontario Superior Court of Justice recently released a decision on limitation periods and waivers for provincial tax purposes in *Aubrey Dan Family Trust v. Minister of Finance*, 2016 ONSC 3801. This case raised novel issues relating to limitation periods and waivers in the provincial context.

The Aubrey Dan Family Trust ("ADFT") brought a motion for summary judgment to allow its appeal and vacate its reassessment for the 2007 taxation year under the *Income Tax Act*, RSO 1990, c. I. 2 ("Ontario Act"). The motion was brought on the basis that the reassessment was made outside of the limitation period and the waiver signed by the trustee was invalid.

The important dates and facts for the motion are as follows:

- On December 31, 2007, ADFT filed its 2007 trust return as a resident of Alberta with the Canada Revenue Agency ("CRA").
- On July 30, 2008, ADFT was assessed as filed by the CRA via Notice of Assessment.
- On July 6, 2011, a CRA auditor wrote to ADFT's trustee and lawyers explaining that she proposed to reassess the trust on the basis that it was resident in Ontario; however, the limitation period was set to expire on July 30, 2011. As such, if they desired to make further representations, a waiver was required.
- The CRA auditor asked that a T2029–*Waiver in Respect to the Normal Reassessment Period* ("Waiver") be signed by each trustee. This form is prescribed under the federal *Income Tax Act* (the "Federal Act").
- On July 19 and 20, 2011, the trustees sent the CRA auditor signed Waivers in respect of ADFT's 2007 taxation year.
- The CRA auditor accepted these Waivers and permitted an extension to provide further submissions, but ultimately concluded that ADFT was an Ontario resident for the 2007 taxation year and proceeded to assess under the Ontario Act.
- On February 22, 2012, the CRA issued a Notice of Reassessment to ADFT in relation to the 2007 taxation year (the "Reassessment").
- ADFT filed a Notice of Appeal in response to the reassessment.

For both the Federal Act and Ontario Act, the sending of an original Notice of Assessment starts the running of the normal three-year reassessment limitation period. The Respondent's position in this case was that ADFT's Federal and Alberta limitation periods began running upon the issuance of the July 30, 2008, Notice of Assessment. Since no Ontario tax was assessed at that time, the Ontario limitation period only began running when the February 22, 2012, reassessment was issued.

The Court dismissed the Respondent's position on the basis that it ran counter to the law and public policy,

> [17] . . . If the original notice does not constitute notification of no tax payable in all provincial or territorial jurisdictions, then a taxpayer receiving such a notice, could be assessed for income taxes in any other province or territory indefinitely. This could happen many years beyond a taxpayer's record keeping period or beyond the expiry of the normal reassessment period for the province or territory that first assessed the taxpayer.

The second issue was whether the Waivers signed by the trustees were in a prescribed form, as required by subparagraph 152(4)(*a*)(ii) of the Ontario Act. Interestingly, Ontario does not have a prescribed waiver form and apparently relied on the federal form. The Ontario Act contained a deeming provision related to prescribed forms in subsection 48(15),

> Every form *purporting* to be a form prescribed or authorized by the Provincial Minister shall be deemed to be a form prescribed by order of the Provincial Minister under this Act unless *called into question* by the Provincial Minister or by some person acting for the Provincial Minister or Her Majesty [emphasis added in original].[1]

ADFT argued that since Ontario had not issued a prescribed form as required by the legislation, the Waiver submitted by the trustees was not valid. Without a waiver, the reassessment was issued outside of the limitation period and therefore must be vacated.

The Court disagreed and found that the waiver signed by the trustee was a prescribed form within the meaning of the Ontario Act,

[1] Which is similar to subsection 244(16) of the Federal Act.

> [37] The Ontario Act fully adopts the federal regime in respect of waivers, including the prescribed T2029 form, and any doubt is resolved by the interpretative provisions in section 1 and by subsection 48(15) of the Ontario Act.

Therefore, the motion was dismissed as the limitation period was extended by the Waivers. Since the CRA administers the tax regime federally and for every province except Quebec, the Court's findings support efficient tax administration and policy across the country.

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.

CURRENT ITEMS OF INTEREST

Department of Finance Releases Draft Income Tax Legislation

On September 16, 2016, the Department of Finance announced draft technical legislative and regulatory proposals. These proposals are intended to improve the accuracy and consistency of existing tax rules. The proposed technical amendments include:

- extending types of reverse takeover transactions that are subject to the acquisition of control rules;
- improving consistency of rules applicable to SR&ED expenditures;
- introducing rules to allocate taxable income of credit unions among provinces/territories in the same manner as is done for banks;
- providing relief in certain circumstances from the upstream loan rules;
- introducing an election to defer disposition of taxable Canadian property on a foreign merger;
- providing relief from shareholder benefit rules in respect of foreign reorganizations; and
- making technical changes to the Sales of Linked Notes measure from Budget 2016.

These are just a few of the numerous tax rules subject to proposed amendments. See the table of contents of the Explanatory Notes for a full list of proposed changes.

The proposals are available on IntelliConnect. Print copies (Special Report 094H) are available for $21.95 by calling 1-800-268-4522 or emailing cservice@wolterskluwer.com.

Employment Insurance Rate to Decrease for 2017

On September 14, 2016, the Actuarial Report on the Employment Insurance Premium Rate was released. The Canada Employment Insurance Commission, which is in charge of setting EI premium rates, established the premium rate and maximum contribution for 2017.

The EI Operating Account has returned to a cumulative balance of $0.9 billion, and thus the EI Commission will reduce the EI premium rate for 2017. The EI premium rate applicable to employees will be 1.63% of earnings for 2017 (down from 1.88% for 2013 to 2016). The maximum annual insurable earnings amount increased to $51,300 for 2017 (up from $50,800 in 2016). As a result, Canadian employees will see a reduction of their annual EI deductions of up to $118.85 in 2017 (compared to 2016). Since employers are required to pay 1.4 times what an employee must pay, employers will see their annual EI premiums per employee decrease by up to $166.39 in 2017 (compared to 2016).

The premium rate for employees in Quebec will decrease to 1.27% in 2017 (down from 1.52% in 2016). As a result, employees and employers will see a decrease in their annual EI premiums of up to $120.65 and $168.91, respectively, in 2017 (compared to 2016).

The Small Business Job Credit provided a reduced EI premium rate to businesses that paid employer EI premiums of $15,000 or less in 2015 or 2016. This program will no longer be available after 2016.

CRA Announces Prescribed Interest Rates for Fourth Quarter

Effective from October 1, 2016, to December 31, 2016, the prescribed annual interest rates applicable to amounts owed to the CRA and amounts that the CRA owes to individuals and corporations are mostly unchanged. The only change is to the rate applicable to corporate taxpayers' pertinent loans or indebtedness, which was 4.50% in the third quarter. The rates relating to income tax for this period are as follows:

Rates applicable to overdue taxes, Canada Pension Plan contributions, and employment insurance premiums	5%
Rate applicable to corporate taxpayer overpayments	1%
Rate paid on non-corporate taxpayer overpayments	3%
Rate used to calculate taxable benefits from interest-free and low-interest loans to shareholders and employees	1%
Rate for corporate taxpayers' pertinent loans or indebtedness	4.49%

CRA Provides Tax Evasion Update

The CRA published a news release on September 7, 2016, which highlighted its current initiatives that are intended to combat offshore tax evasion. The release provided several interesting facts:

- the CRA is conducting audits on over 750 taxpayers and criminally investigating 20 cases of tax evasion, all relating to offshore tax havens;
- 3,000 electronic funds transfers (totalling $860 million) to the Isle of Man were reviewed, and as a result, 60 audits are in progress; and
- as of July 31, 2016, the Offshore Tax Informant Program has received 868 calls and 361 letters, which have resulted in over 180 taxpayers being currently under audit.

CBA and CPA Joint Committee's Comments Regarding Draft Legislation

The Joint Committee on Taxation of the Canadian Bar Association and the Chartered Professional Accountants of Canada ("the committee") made a submission to the Department of Finance regarding the recent draft legislative proposals that were released on July 29, 2016. The committee provided comments on two specific Budget 2016 proposals: multiplication of the small business deduction and life insurance policies.

The first Budget measure is intended to target certain structures that can multiply the small business deduction limit. The committee highlighted numerous aspects of the amendments that were problematic with respect to compliance by taxpayers and administration by the CRA. The committee also pointed out several elements of the proposed legislation that may contain technical issues. The submission examines the details of certain proposed amendments in order to address what aspects of them may prove to be problematic.

Second, the submission raised a concern with respect to an aspect of the life insurance amendments. Although most of the amendments would apply as of Budget day, a few proposed changes with respect to non-arm's length transfers of policies would apply retroactively. The committee opined that the effect of the amendments should only apply to transfers occurring on or after Budget day in order to "not affect tax attributes arising on to prior legitimate transactions."

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.

Personal Services Business: Employee Vs. Independent Contractor

***Ivan Cassell Limited v. The Queen*, 2016 DTC 1048 (Tax Court of Canada)**

The *Ivan Cassell* case is instructive in that it both (a) confirms that there is no single, conclusive test for distinguishing between an employee and independent contractor for the purposes of identifying a "personal services business" pursuant to subsection 125(7) of the *Income Tax Act* (the "Act"); and (b) identifies a list of factors that should be considered, collectively, to guide such a determination.

The case involves an appeal by the taxpayer, Ivan Cassell Limited, of the reassessment of its 2008, 2009, and 2010 taxation years. The taxpayer was incorporated by Ivan Cassell in 1983 to operate a home comfort centre for Imperial Oil. Cassell subsequently worked for six years as a supervisor for Ultramar, where he oversaw all of Ultramar's independent retail agents located in parts of Newfoundland and Labrador. In 1990, Cassell left Ultramar, at which time the taxpayer purchased from Ultramar a retail oil and gas business located outside of the major urban centres of Newfoundland. Cassell worked to grow the taxpayer's business by acquiring several gas stations in the areas that the major oil companies were leaving. The retail oil and gas business was carried on under the name Western Petroleum.

In 2005, Western Petroleum Newfoundland Limited ("WPNL") was incorporated and the Western Petroleum business transferred to it. The shares of WPNL were owned, indirectly, by the Cassell Family Trust together with others, some of whom dealt at arm's length with the taxpayer and some of whom did not. Cassell was the president and a director of WPNL.

In his role as president of the taxpayer, Cassell performed management services for WPNL. The services were performed pursuant to an oral agreement between the taxpayer and WPNL, which was reduced to writing sometime after 2010, but which was backdated to 2005.

In addition to providing services to WPNL, the taxpayer owned six commercial properties which it rented to arm's length parties that operated gas bars. The taxpayer maintained that it also provided management and consulting services through Cassell's role as president of WPNL to a company called West Coast Excavating Limited.

In respect of the income earned by the taxpayer from WPNL, which was several hundred thousand dollars in each of the years in issue, the taxpayer claimed the small business deduction. The claim was rejected by the Minister in notices of reassessment issued on the basis that the taxpayer's business of providing services to WPNL was a "personal services business", as defined in subsection 125(7) of the Act.

As Cassell clearly provided services to and was a specified shareholder of the taxpayer, the sole issue based upon the personal service business requirements was whether Cassell would reasonably be regarded as an officer or employee of WPNL but for the taxpayer's existence.

In determining whether the taxpayer was carrying on a personal services business, Owen J. referred extensively to jurisprudence setting out the considerations relevant to this determination. In respect of the policy rationale for the inclusion of the personal services business provisions in the Act, Owen J. quoted from the decision of the Federal Court of Appeal in *Dynamic Industries Ltd*. (2005 DTC 5293 (FCA)) wherein it was stated:

> The provisions of the *Income Tax Act* relating to personal services businesses were enacted to deny certain tax advantages that may be obtained by providing services through a corporation, rather than personally. These provisions are directed primarily at the situation exemplified by *Sazio v. Minister of National Revenue* [. . .] The rejection of the business purpose test appeared to make it easier for a person to provide services through a Sazio-type arrangement, rather than personally, thus obtaining the related tax advantages. The government still believed that such a result was not reasonable. The enactment of the definition of "personal services business" [. . .] was intended to deny, in part, the tax advantages of such arrangements [. . .]

As noted by Owen J, "the base test in the jurisprudence asks whether the individual is performing the services in issue as a person in business on his own account". In making this determination, consideration needs to be had to: the factors of control; ownership of tools and equipment; and opportunity for profit and risk of loss. In respect of the control test, which has historically been regarded as an important determinant as to whether the personal services business provisions apply, Owen J. referred to jurisprudence providing that reliance on the control test alone can be misleading particularly where, as in this matter, "one is addressing circumstances involving services provided by a professional or by an owner or high-level manager of the business receiving the services".

In dismissing the role of common intention in the application of the personal services business definition, Owen J. stated:

> I will first consider the role of common intention in the application of the PSB definition. [. . .T]he importance of common intention or mutual understanding is rooted in the principle that parties are entitled to organize their affairs and relationships as they deem fit. Importantly, however, common intention or mutual understanding can only be relevant to the analysis if the parties to the arrangement under scrutiny have an agreement (written or oral) with one another. Here, the relevant agreement is between ICL and WPNL. In circumstances such as these, there can be no mutual understanding or common intent to consider in assessing whether Mr. Cassell would reasonably be regarded as an employee of WPNL but for the existence of ICL. The hypothetical circumstance imposed by the PSB definition in order to achieve its anti-avoidance objective simply precludes any such analysis.

Owen J. noted that the jurisprudence clearly provided that there is no single conclusive test to determine the distinction between an employee and an independent contractor. Nonetheless, issues of control, ownership of tools and

equipment, and opportunity for profit or risk of loss are factors to be considered. Analyzing these factors in the case at bar, the Court held that Cassell's role in providing services to WPNL was to grow WPNL's business. This conclusion was supported by the fact that there was no written agreement between the taxpayer and WPNL, no HST was charged on fees paid by WPNL, and the taxpayer did not advertise its services. In other words, "[i]f the existence of [the taxpayer] were ignored, there [was] no evidence of business-like activity to support the conclusion that Mr. Cassell would reasonably be regarded as providing the services as a person in business on his own account."

Moreover, the taxpayer's earning of rent was determined to be subordinate to the profitability of WPNL's business, as demonstrated by Cassell's failure to pursue any action regarding defaults in instances in which such action would have negatively affected the profitability of WPNL's business. Owen J. reasoned that an individual in business on his own account would not have such a focus. In addition, the services provided to West Coast Excavating Limited had not been provided in a business-like manner.

The Court further was of the view that the compensation received by the taxpayer, being a fixed monthly amount and an additional performance bonus, was consistent with an employment-like arrangement rather than with independent contractor status. Additionally, the Court noted that the compensation structure ensured that the taxpayer was not exposed to a risk of loss. The fact that Cassell had weekly meetings at WPNL, had the use of a company car, and had access to a makeshift desk at the office also supported that, but for the existence of the taxpayer, Cassell would have been a senior employee of WPNL.

Consequently, the Court determined that:

> The business that is the focus and raison d'etre of Mr. Cassell's activities is the business of WPNL. If [the taxpayer] did not exist, the only business to which the services relate would be that of WPNL and Mr. Cassell would reasonably be considered an employee of that business.

As a result, the taxpayer's business of providing management services to WPNL during its 2008, 2009, and 2010 taxation years was a "personal services business". The appeal was therefore dismissed with costs to the Minister.

As the decision has been appealed to the Federal Court of Appeal, it will be interesting to see how that court deals with the matter having regard to the more extensive activities undertaken by the taxpayer than is typically the case in a matter giving rise to personal services business issues.

Krupa Kotecha, Student-at-Law

Tax Court Employs Expansive Interpretation of Cost Award Rules in Affirming and Apportioning Liability for Costs in Tax Shelter Case

***Mariano v. The Queen*, 2016 DTC 1146 (Tax Court of Canada)**

The *Mariano* case provides useful guidance as to the Court's rationale for attributing and apportioning liability for costs in "lead" cases.

The case concerns a very substantial costs award ruling made in respect of an unsuccessful appeal of the Minister's assessments in a tax shelter arrangement. The underlying matter involved a charitable donation program in which participants were issued charitable receipts far exceeding the amounts paid by them. At the conclusion of a 25-day trial on the merits, the Tax Court held in favour of the Minister on all counts. In this regard, Pizzitelli J. of the Tax Court held at trial that the taxpayers lacked the required donative intent for their donations to qualify for tax credits pursuant to subsection 118(1) of the *Income Tax Act*. Pizzitelli J. held that the charitable donation scheme was a sham with the value of the gifts entirely inflated.

The Minister claimed costs, including disbursements, of about $500,000. This amount included fees for an expert witness of more than $440,000. In considering the taxpayers' challenge of the cost awards, Pizzitelli J. determined that — with a minor exception regarding certain of the expert's fees — the costs claimed were reasonable in the circumstances.

Pizzitelli J. determined that the parties liable for the costs of the appeal were not only the taxpayers advancing the appeal but also the taxpayers who had appealed to the Court and agreed to be bound by the decision (the "bound taxpayers"), and the promoter of the charitable program. The Court declined to fix liability for costs upon any of the thousands of other participants in the program who were similarly assessed. In arriving at this conclusion, the Court addressed the various arguments made by the taxpayers, including that: (1) only the program promoter should be liable for costs; (2) the appeals were "test cases", such that each party should bear its own costs; (3) costs should be allocated amongst the thousands of taxpayers who were similarly assessed; and (4) the fees and disbursements claimed did not reflect the reasonable expectation of the taxpayers as to their potential liability for costs.

Pizzitelli J. began his analysis by suggesting that the factors enumerated in paragraphs 147(3)(*a*) to (*i*.1) of the *Tax Court of Canada Rules (General Procedure)* (the "Rules") would have justified a cost award higher than the Tariff costs claimed in respect of legal fees of just over $40,000, had the Crown sought increased costs.

With respect to the taxpayers' arguments that the promoter alone should be liable for costs, Pizzitelli J. stated that subsection 147(1) of the Rules conferred upon the Court broad discretion to determine who would be liable to pay the costs of the parties involved in any proceeding and how costs would be allocated. In this regard, Pizzetelli J. indicated that the plain wording of the provision makes it clear that non-parties to a proceeding may have costs awarded against them. Further to the point as to whether the promoter alone should be held liable to pay costs, the Court noted that although "the Promoter may bear the direct responsibility for the sham it has perpetrated on the Appellants and the Canadian public at large", the taxpayers and bound taxpayers did "blindly or willingly jump on the Program train in expectation of receiving a net cash advantage from their donation." Accordingly, the Court held that it was appropriate to hold all three groups liable for costs.

With respect to the fact that the matter was a "lead" case, the taxpayers had submitted that because the appeal could be used to dispose of thousands of cases, no one taxpayer should be forced to pay costs any greater than his or her *pro rata* share of the costs, and that to hold otherwise would have a punitive effect on the taxpayers in the lead case. In rejecting this argument, the Court cited *Otteson* (2015 DTC 1028) for the proposition that, in instances in which an appeal has a precedential value, the successful party is entitled to an award even beyond the Tariff. Pizzitelli J. also reasoned that the fact the Minister had thousands of cases at the objection stage that were not confirmed did not constitute special circumstances which justified a departure from the usual rule that costs should follow the event. Further to this point, the Court noted:

> Simply put, someone has to go first and a taxpayer who files an appeal must obviously do so with a view to getting his or her case heard in a reasonable period of time. I agree with the Respondent's reasoning that if the Minister were required to confirm all objections at the same time or all before proceeding to trial, aside from administrative feasibility, the Minister would be put in the absurd position of practically never being entitled to costs.

In further responding to the taxpayers' arguments that the 16,000 taxpayers affected by the decision in the lead appeals should share in the liability for costs, the Court noted that there is no basis in law for allocating costs to taxpayers simply because they are at the objection stage, nor to taxpayers at the appeals stage who did not agree to be bound by the decision in the "lead case". Although Pizzetelli J. determined that the Court has jurisdiction to award costs against persons who are not parties to a proceeding, he stated as follows:

> [. . .] fundamental [. . .] is the principle that persons who have no ability to influence the conduct of an appeal cannot be liable for costs. This I submit is the common sense corollary to the common law rules that a Court has the inherent jurisdiction, if not the statutory one, to hold non-parties liable for costs in certain circumstances, such as funding or maintaining a lawsuit or conducting the action from the sidelines [. . .] There is simply no evidence to suggest any taxpayer at the objection stage or those even at the appeals stage who did not agree to be bound, had any participation, influence, control or other role in the appeals in question.

Pizzitelli J. rejected the taxpayers' assertions that the quantum of the costs should be reduced significantly to reflect the reasonable expectations of the taxpayers as to their liability for costs in the event that their lead cases were dismissed. The Court pointed to the deficiency in these arguments by noting that the taxpayers did not address why they considered the Minister's claims totalling $491,000 (and specifically the expert witness fees of $422,000 to which the taxpayers primarily objected) to be unreasonable. In fact, the Court concluded that such costs were entirely within a reasonable range of costs, given the fact that the taxpayers expected to, and did, utilize expert witnesses with a view to seeking to substantiate their own claims with respect to the values of their in-kind donations. Moreover, it was the taxpayers' positions and actions, including their use of expert witnesses, which necessitated the Minister's need for an expert witness. Given that the taxpayers were represented at different times by three sets of experienced tax litigation counsel and that the pleadings were long and detailed, Pizzitelli J. found it "incredulous" that the taxpayers would not have been apprised of the risks that the litigation would be expensive and time consuming.

As a result, the Court concluded that the taxpayers, the bound taxpayers, and the program promoter were to be held liable for the entirety of the costs requested by the Minister (apart from certain minor portions of the expert's fees which the Court rejected). In order to allocate liability for costs in a manner that was "compensatory and contributory, not punitive and extravagant", the Court held that the liabilities of the taxpayers and the bound taxpayers were to be capped at their respective proportion of the total charitable tax credits claimed in respect of the schemes. The promoter, on the other hand, was jointly and severally liable for the full amounts in issue.

The *Mariano* case is instructive regarding how a court may deal with costs in a tax shelter arrangement in which a single taxpayer proceeds to court in circumstances in which other taxpayers' cases are held back. The Court's rejection of the taxpayers' arguments and the inclusion of the program promoter (a non-party to the appeal) as among those

liable for the payment of the cost award signifies an expansive approach to interpreting the provisions in the Rules regarding costs.

In respect of the caps provided by the Court on the liability of the taxpayers and the bound taxpayers, but not the promoter, it is interesting to speculate how the Court might have dealt with liability had there not been a third-party such as the promoter that the Court considered should be liable for the full costs generally.

Krupa Kotecha, Student-at-Law

Tax Court Determined That the Capital Gains Deduction Was Available to One Seller but not the Other Pursuant to the Anti-Surplus Stripping Provisions of Section 84.1 of the Act

***Poulin v. The Queen*, 2016 DTC 1155 (Tax Court of Canada)**

In this case, the Tax Court of Canada considered the application of the section 84.1 anti-surplus stripping rules to two taxpayers, each of whom had sold frozen preferred shares in the course of a corporate reorganization. Given that both individuals had sold their shareholdings in the course of the same reorganization, the appeals were heard on common evidence. In each appeal, the pivotal issue was whether or not each appellant had dealt with the corporate purchaser of the frozen preferred shares on a non-arm's length basis as contemplated by paragraph 251(1)(*c*) of the *Income Tax Act* (the "Act"). If so, the provisions of section 84.1 would apply, giving rise to deemed dividends, rather than capital gains, on the share sales.

The taxpayers, Mr. Ghislain Poulin and Mr. Herman Turgeon, were the principal shareholders of *Les Constructions de l'Amiante Inc*., a construction company in which the two individuals had worked since the 1980s.

In 2005, at the time of a conflict between Mr. Poulin and Mr. Turgeon regarding the management and operation of the business, the two men undertook a reorganization of the corporation's share capital for the purposes of introducing a third shareholder, Mr. Bernard Bilodeau.

As part of a freeze transaction, the common shares held by Mr. Poulin and Mr. Turgeon were exchanged for two new classes of shares. Through the reorganization, both Mr. Poulin and Mr. Turgeon received a tranche of 5,756 Class B shares having a redemption value of $450,004 — the amount needed by each of Mr. Poulin and Mr. Turgeon to claim the capital gains deduction under subsection 110.6(2.1) of the Act. The additional value of the former common shares was represented by Class C shares that were received, as well as the Class B shares, for the former common shares. On this basis, Mr. Poulin and Mr. Turgeon each received a tranche of 11,193 Class C shares having a redemption value of $874,996. To complete the reorganization, Mr. Poulin, Mr. Turgeon, and Mr. Bilodeau each subscribed for 10,000 voting common shares for $100 each.

Despite the introduction of a third shareholder, the conflicts between Mr. Poulin and Mr. Turgeon continued unresolved and, in 2006, Mr. Poulin announced his intention to gradually leave Amiante. The parties embarked on negotiations to facilitate Mr. Poulin's departure, but a dispute broke out between Mr. Poulin and Mr. Bilodeau before the parties could conclude an agreement to reorganize the company in order to buy out Mr. Poulin's interest. As a result of the dispute, Mr. Bilodeau resigned from Amiante and received a buyback of his interest in the company.

In order to effect the reorganization, Mr. Turgeon sought out a new shareholder in Mr. David Hélie, an Amiante employee, and on September 20, 2007, the parties signed an agreement outlining a plan to reorganize Amiante to buy out Mr. Poulin and accept Mr. Hélie as a new shareholder.

The parties carried out the 2007 reorganization by having each of the three shareholders form a corporation. In this regard, Mr. Poulin formed Gestion Poulin, Mr. Turgeon formed Gestion Turgeon, and Mr. Hélie formed Gestion Hélie.

Mr. Poulin's Sale of 450,004 Preferred Shares to Gestion Turgeon

Through a two-step exchange process, Mr. Poulin converted his 450,004 Class B shares into 450,004 Class F preferred shares, which he transferred to Gestion Turgeon for $450,004, most of which was payable over time, with the unpaid balance bearing interest at 5%.

The share purchase agreement between the parties obliged Amiante to pay its shareholders 80% of its annual profits. The agreement further stipulated that each year, for the following five years, Gestion Turgeon would pay to Mr. Turgeon, in respect of the unpaid purchase price, the higher of $81,000.80 or 90% of the sums received by Gestion Turgeon.

Less than a week after signing the share purchase agreement, Gestion Poulin sold 10.5% of Amiante's common shares, which it presumably had acquired from Mr. Poulin, to Gestion Hélie for $1.90.

Through an addendum to the Amiante shareholder agreement, Mr. Poulin was obliged to dispose of all of his remaining shares in Amiante no later than the date of his planned departure from the company, which occurred in early 2012.

As required under the terms of the share purchase agreement, Amiante bought back the Class F shares which Mr. Poulin had sold to Gestion Turgeon, allowing Gestion Turgeon to repay the outstanding sums owed to Mr. Poulin under the promissory note.

Mr. Poulin reported the proceeds of disposition from the 450,004 Class F preferred shares in Amiante as a taxable capital gain eligible for the capital gains deduction.

Mr. Turgeon's Sale of 388,861 Preferred Shares to Gestion Hélie

After converting his Class B shares into Class D preferred shares, Mr. Turgeon sold 388,861 Class D preferred shares to Gestion Hélie for $388,861, with the entire amount payable over time, with no fixed time for payment, and bearing interest at 4%. The share purchase agreement between the parties obliged Amiante to pay its shareholders 80% of its annual profits and further required that 90% of such sums received by Gestion Hélie were to be paid to Mr. Turgeon in respect of the unpaid purchase price. Significantly, the transaction was structured such that Mr. Turgeon financed the purchase by Gestion Hélie and so that there was no risk to Mr. Hélie.

Mr. Turgeon reported the proceeds of disposition from the 388,861 Class D preferred shares in Amiante as a taxable capital gain eligible for the capital gains deduction.

Amiante bought back $259,982 of the Class D preferred shares held by Gestion Hélie thereby allowing Gestion Hélie to pay down a portion of the amount owed to Mr. Turgeon.

In January 2014, notwithstanding that there was a balance still owing on the purchase price payable to Mr. Turgeon, Gestion Hélie transferred its remaining Class D preferred shares to a holding company controlled by Mr. Turgeon. At the time of the Tax Court hearing, Gestion Hélie still owed a balance on the purchase price. Neither Mr. Hélie nor Mr. Turgeon could recall whether or not Gestion Hélie had received any consideration for the transfer of preferred shares to Mr. Turgeon's holding company.

The CRA reassessed each of Mr. Poulin and Mr. Turgeon under paragraph 84.1(1)(*b*) of the Act, and disallowed the capital gains deduction for each taxpayer's respective sale of his preference shares. According to the CRA, each of Mr. Poulin and Gestion Turgeon, on the one hand, and Mr. Turgeon and Gestion Hélie, on the other hand, had acted in concert, without separate interests. Therefore, according to the CRA, Mr. Poulin and Mr. Turgeon each were in a non-arm's length relationship with Gestion Turgeon and Gestion Hélie, respectively, as contemplated by paragraph 251(1)(*c*) of the Act.

Before the Tax Court, the Crown alleged that the purchase price paid by Gestion Turgeon and Gestion Hélie for the transfer of the Amiante shares was paid entirely with funds from share buybacks by Amiante. In the Crown's view, both Gestion Turgeon and Gestion Hélie were simply conduits acting to convert what would otherwise have been dividend income into a capital gain in the hands of Mr. Poulin and Mr. Turgeon. According to the Crown, the transactions did not reflect ordinary business relations and, further, it made no commercial sense for either purchaser to incur interest expenses in acquiring preferred shares, the value of which was frozen.

Despite the appellants having structured the sale of their preferred shares in a similar manner, the Tax Court reached differing conclusions on the application of section 84.1 to each of the transactions.

In its decision, the Tax Court narrowed the issue to the factual matter of whether the parties dealt at arm's length as contemplated by paragraph 251(1)(*c*). Pursuant to paragraph 84.1(1)(*b*), if the Tax Court accepted that Mr. Poulin and Gestion Turgeon were in a non-arm's length relationship, the sale price of the 450,004 Class F preferred shares would give rise to dividend income, and be ineligible for the capital gains deduction.

A comparable outcome would occur as regards the sale price of the 388,861 Class D preferred shares sold by Mr. Turgeon to Gestion Hélie if Mr. Turgeon and Gestion Hélie were found not to have dealt at arm's length.

In order to determine if a *de facto* non-arm's length relationship existed, the Tax Court turned to *obiter dictum* from the case of *McLarty* (2008 DTC 6354 (SCC)), which summarizes criteria for identifying a factual non-arm's length relationship. In particular, the Tax Court considered what it meant for parties to a transaction to act "in concert without separate interests".

Relying on *McLarty* and *RMM Canada Enterprises Inc.* (97 DTC 302 (TCC)), the Tax Court concluded that the contextual nature of the paragraph 251(1)(*c*) inquiry requires examining a relationship by considering the facts and circumstances more broadly rather than simply looking at the relationship at the moment of the purchase and sale.

Taking into account the broad context of the transactions, the Tax Court concluded that Mr. Poulin and Gestion Turgeon dealt at arm's length, and that each was acting with separate interests. It was in the interests of Gestion Turgeon and Mr. Turgeon that one of the feuding shareholders leave the business, and in the interests of Mr. Poulin to sell on the best possible terms. Though neither factor was determinative, the Tax Court took note of the arduous negotiations between the parties and of the use of independent professionals to structure Mr. Poulin's departure.

Referring to *Brouillette* (2005 DTC 1004 (TCC)) and *McNichol* (97 DTC 111 (TCC)), the Tax Court treated Mr. Poulin's bargaining for a sale structure that achieved tax efficiencies through the use of the capital gains deduction as analogous to bargaining for the best possible price for his shares. The Tax Court found also that Mr. Turgeon and Gestion Turgeon were bargaining to achieve their own benefits from the transaction with Mr. Poulin — namely, acquiring control of Amiante.

The Tax Court reached a different finding as regards the relationship between Mr. Turgeon and Gestion Hélie.

The Tax Court took note of Mr. Turgeon's inability to explain in his testimony why certain transactions and tax operations were effected and did not find it credible that Mr. Turgeon had no specific knowledge of the capital gains deduction, as he alleged.

The Tax Court noted further that the share purchase agreement between Mr. Turgeon and Gestion Hélie eliminated any risk to Mr. Hélie and offered no benefit to Gestion Hélie in purchasing the fixed value preferred shares, particularly given that the shares carried only non-cumulative dividends, that no such dividends were apparently paid, and that the unpaid purchase price was interest-bearing. The Tax Court took further note of the fact that some of the shares were eventually transferred by Gestion Hélie back to an entity controlled by Mr. Turgeon, possibly for no consideration, and without cancellation of the remaining balance on the unpaid purchase price. Nine years after the transaction, at the time of the Tax Court appeal, the unpaid purchase price was still outstanding.

As a result of these features of the transaction, the Tax Court upheld the reassessment of Mr. Turgeon. The Tax Court concluded that Gestion Hélie had no role independent from that of Mr. Turgeon, and that its involvement was only to allow Mr. Turgeon to strip Amiante of its surplus on a tax-free basis through the capital gains deduction, in contravention of paragraph 84.1(1)(*b*) of the Act.

Given the potentially broad scope of the *de facto* non-arm's length provisions, this decision is of interest to planners as it provides an example of the manner in which contextual factors can cause similar transactions to receive different treatment for purposes of paragraph 251(1)(*c*) of the Act.

Mr. Turgeon has filed an appeal of the Tax Court's decision.

Justin Shoemaker

RECENT CASES

Minister's decision to levy over-contribution tax reasonable

The taxpayer late-filed his income tax returns for the 2003 through 2010 taxation years. During the 2007 through 2010 taxation years, the taxpayer made a series of contributions to his registered retirement savings plan ("RRSP") and to a spousal RRSP. The amount of contributions made was based on contribution room information provided on Notices of Assessment issued by the Canada Revenue Agency. That information was not, however, current, owing the taxpayer's practice of late-filing, and the taxpayer was consequently in an over-contribution position. The Minister assessed an over-contribution tax and the taxpayer's request that such decision be cancelled was denied. The taxpayer then applied for judicial review of the Minister's decision.

The application was dismissed. The Federal Court held that the Minister's decision was subject to judicial review on a standard of reasonableness, and that the only issue for determination was whether the Minister's delegate acted unreasonably in failing to exercise her discretion to grant relief from the over-contribution tax imposed. The *Income Tax Act* provides that the Minister can provide such relief where a taxpayer establishes both that the over-contribution was the result of a reasonable error. The Court reviewed the circumstances in which the taxpayer's over-contribution arose

and concluded that he had not met the onus of establishing that such over-contribution was the result of a reasonable error. The taxpayer argued that he had acted in reliance on information provided to him by the CRA in his Notice of Assessment, that he was entitled to do so, and that he bore no responsibility for the accuracy of contribution room notices generated by the CRA. The Court held, however, that the position taken by the taxpayer was untenable. It concluded that it was reasonable for the CRA to issue such information based on what the taxpayer had chosen to report at the time the Notice of Assessment was issued. Having failed to keep the CRA up-to-date with his contributions, the taxpayer could not expect the CRA to provide accurate contribution room advice. The Court concluded that the Minister's delegate acted reasonably in concluding that the taxpayer's over-contributions, however unintentional, were not consequences of "reasonable error" as defined in section 204.1 of the *Income Tax Act*. The decision made was justified, transparent, and intelligible, and fell within the range of possible acceptable outcomes which were defensible in respect of the facts and the law. The application for judicial review was dismissed.

Levenson v. AG (Canada)

2016 DTC 5091

Canada cannot assess charges against US corporation relating to softwood lumber duty refunds

The appellant, a US corporation, provided reload, repackaging, and remanufacturing services for softwood lumber products ("SLP"), produced and sold by Canadian lumber producers. The products were imported to the United States where the services were rendered and then delivered to customers. The appellant was considered an "importer of record" and under two USA orders between 2002-2006 paid duty deposits to the USA on its SLPs. Canada and the USA were involved in a major trade dispute involving Canadian SLPs concerning the legality of anti-dumping and countervailing duties applied to Canadian SLPs. From 2002-2006, the USA collected $5.4 billion in duties, mostly from Canadian lumber producers but also from US corporations such as the appellant. This dispute was resolved in 2006 with the passage of the *Softwood Lumber Products Export Charge Act, 2006* ("SLPECA") under which the USA retroactively revoked its US orders and refunded all duties previously paid and Canada was to pay $1 billion to specified US parties. The Minister of National Revenue levied an 18.06% charge totalling $927,700 on the refunds paid to the appellant. It sent two letters to the taxpayer in 2008 seeking payment and threatening penalties if payment was not made. The appellant did not pay the levy and appealed the assessment.

The appeal was allowed. The appellant argued that the MNR had no jurisdiction to assess it under the SLPECA. The letters sent by the MNR were an attempt to exercise enforcement jurisdiction against a foreign state. That can only be done if the foreign state consents, which the USA did not do. Had Canada wanted to enforce the SLPECA extra-territorially it could have done so through tax treaties or negotiations. The application of the softwood legislation to the appellant cannot be justified on the grounds of international territoriality law as there was no real and substantial link between Canada and the activities giving rise to Canada's claim for taxes. The respondent argued that there was a real and substantial link as there was an alignment of interest between Canada and the US in having the lumber dispute resolved and there was a monetary benefit received by the appellant due to Canada's efforts. Such factors were not enough for a real and substantial link especially given the facts that the appellant had no assets or operations in Canada, all services were done in the USA, and all duties were paid to the USA. There were express instances in the softwood legislation that evinced Parliament's intent to have the legislation extend beyond Canada's borders but no such intention was manifest in the taxing provisions. There was no intent on the part of Parliament to have the taxing provisions of the softwood legislation to apply to parties outside Canada.

Oroville Reman & Reload Inc. v. The Queen

2016 DTC 1147

Bonuses received by status Indian from corporation owned by her and her spouse did not qualify for exemption from tax

The taxpayer was a status Indian living off-reserve but entitled to a tax exemption under section 87 of the *Indian Act* in respect of personal property situated on a reserve. Reel Steel was a construction company owned and operated by the taxpayer and her spouse. The taxpayer worked in Reel Steel's office situated on a reserve (the "Reserve") and was paid a salary and bonuses by Reel Steel (the "Bonuses"). In assessing the taxpayer for 2004, 2005, and 2006, the Minister: (a) exempted from tax (under section 87 of the *Indian Act*) the salary received by her from Reel Steel but refused to grant her that exemption with respect to the Bonuses; and (b) included in her income for 2004, 2005, and 2006, as subsection 15(1) shareholder's benefits, certain amounts. The taxpayer appealed to the Tax Court of Canada, and the shareholder benefits issue was resolved by the parties at the hearing.

The taxpayer's appeal was allowed in part. The issue was whether the Bonuses were sufficiently connected to the Reserve so as to be situated on the Reserve for purposes of the section 87 exemption. To succeed, therefore, the taxpayer had to show significant substantive connection between the Bonuses and the Reserve. These Bonuses were equal to the balance of the estimated annual income of Reel Steel, but exceeded a reasonable remuneration for the taxpayer in the circumstances of this case, since the salary received by her for the work done by her for Reel Steel was adequate or more than adequate to compensate her. The Bonuses, moreover, were paid to the taxpayer to avoid income tax at Reel Steel's corporate and shareholder levels, but were not intended to reasonably compensate her for the actual employment duties which she performed. Granting the Bonuses a tax exemption under section 87 in this case, therefore, would have amounted to abusing the purpose of that section, which is to insulate the property interests of Indians in their reserve lands from the intrusions of society, to ensure that they are not dispossessed of their entitlements (see *Kelly v. The Queen*, 2013 DTC 5129 (FCA)). In addition, a connecting factor analysis applying to the Bonuses led to the conclusions that the taxpayer's employment was not a strong connecting factor to the Reserve, nor were the residence of Reel Steel, the residence of the taxpayer, nor the location where she was paid. As a result of the foregoing findings, the Bonuses did not qualify for exemption from tax under section 87. However, the Minister's argument that moving Reel Steel's offices to the Reserve was abusive was without merit. That move was made to take advantage of the section 87 exemption, and Reel Steel's offices were substantial. The taxpayer's appeal was allowed in part, but only to reflect the settlement reached by the parties concerning the shareholder's benefits issue.

Bell v. The Queen

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TAX NOTES

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