Tax Notes

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NOTABLE CASES IN THE PAST YEAR

— The Honourable Donald G.H. Bowman, Q.C., Former Chief Justice of the Tax Court of Canada, Counsel with Dentons Canada LLP

2016 has been something of a vintage year. A number of notable cases have been decided, some of which are interesting or controversial. Some are being appealed. Not everyone will agree with the decisions.

The Queen et al. v. Scheuer et al., 2016 DTC 5011 (FCA)

This was a decision of the Federal Court of Appeal ("FCA") on appeal from a decision of a Federal Court judge who had dismissed an appeal from a prothonotary. The FCA allowed the appeal and set aside the judgment of the Federal Court judge on the basis that the Statement of Claim disclosed no reasonable cause of action.

The taxpayer, Scheuer, and a substantial number of other taxpayers participated in a tax shelter program promoted by the Global Learning Group Inc. ("GLGI"). He paid GLGI a total of $80,000 over three years and received from GLGI charitable donation tax receipts in the total amount of over $510,000. One does not need to be a fiscal virtuoso to recognize that if you participate in a tax reduction scheme in which you receive charitable receipts of 600% of what you contributed, and it looks too good to be true, it probably is. The CRA disallowed the charitable donations. The taxpayers all sued Canada and the CRA on the grounds that the defendants owed a duty of care to the taxpayers and were negligent in allowing the scheme to be marketed and not warning the taxpayer to be careful of so aggressive a scheme. I thought that was what tax lawyers and accountants or promoters were supposed to do. The prothonotary and the Federal Court judge refused to strike out the Statement of Claim. The FCA did not agree with the lower courts. It struck out the Statement of Claim for "failing to assert a cognizable cause of action".

As a matter of common sense, the FCA decision may be supportable. It is certainly one with which the man on the Clapham omnibus would probably agree. As a matter of legal analysis, however, the decision is wholly devoid of such analysis.

TDL Group Co. v. R., 2016 DTC 5075 (FCA)

The next decision is also by the FCA and the reasons were delivered by the same FCA judge (Dawson JA). It has to do with the deductibility of interest on borrowed money. I agree with the Tax Court and disagree with the FCA. This is how the scheme worked: Wendy's Limited Inc. ("Wendy's), the parent of the Wendy's Group of Companies, lent $234 million to a US subsidiary, Delcom, at a rate of interest not to exceed 7%. Delcom lent that amount to the Appellant, TDL Group Co. ("TDL"), at 7.25%. The Appellant used the full amount to purchase additional shares in its subsidiary, Tim's Donut US Limited Inc. ("Tim's US"). Tim's US lent the moneys received for its shares to Wendy's on an interest-free basis.

The Tax Court judge, Justice Pizzitelli, held that the money borrowed from Delcom by TDL was not borrowed to earn income, but to facilitate an interest-free loan to the

Appellant's parent, Wendy's. I agree with Justice Pizzitelli. This was simply a case of money going in a circle (Wendy's — Delcom — TDL — Tim's — Wendy's). In the course of this exercise in incestuous circularity TDL picks up an interest deduction. This scheme is a blatant misuse of subparagraph 20(1)(*c*)(i). I mentioned above the man on the Clapham omnibus. What do you suppose he would have done with this scheme?

Attorney General of Canada and Canada Revenue Agency v. Chambre des notaires du Québec and Barreau du Québec, 2016 DTC 5067 (SCC), 2016 DTC 5068 (CSC); *MNR v. Duncan Thompson*, 2016 DTC 5069 (SCC)

The next two decisions of the Supreme Court of Canada ("SCC") are unanimous and they deal with solicitor-client privilege. The first case is referred to as *Chambre* and the second is *Thompson*.

The *Chambre* case involved a disagreement between the Attorney General of Canada ("AGC") and the Canada Revenue Agency ("CRA") (Appellants) and Chambre du Notaires du Québec and the Barreau du Québec (Respondents). The essence of the disputes between the Appellants and the Respondents is that the AGC and the CRA contend that the exception in the requirement procedure in the *Income Tax Act* (Canada) ("ITA") does not protect a taxpayer or its lawyer from disclosure under the solicitor-client privilege. The Chambre and the Barreau contend that the disclosure of accounting information in the possession of a lawyer may reveal information that is protected by solicitor-client privilege. The Quebec Supreme Court and the Quebec Court of Appeal agreed with the Chambre and Barreau and held that subsection 231.2(1) and section 231.7 are unconstitutional.

The SCC agreed with the Quebec Court of Appeal and the Supreme Court and held the exception in subsection 231.2(1) and section 231.7 to be unconstitutional.

I shall quote only two passages from the SCC judgment:

> [4] The Superior Court and the Court of Appeal ruled in favour of the Chambre and the Barreau. The Court of Appeal found that, pursuant to s. 52 of the *Constitution Act*, 1982, ss. 231.2(1) and 231.7 and the accounting records exception are unconstitutional and of no force or effect with respect to Quebec notaries and lawyers for all information and documents protected by professional secrecy. We are in substantial agreement and would dismiss the appeal.
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> [5] The Court has held in the past that professional secrecy is a principle of fundamental justice within the meaning of s. 7 (*R. v. Lavallee, Rackel & Heintz*, 2002 SCC 61, [2002]3 S.C.R. 209 (S.C.C.), at para. 49). It is also a civil right of supreme importance in the Canadian justice system. Professional secrecy must thus remain as close to absolute as possible, and the courts must adopt stringent standards to protect it.

This decision of the SCC is of extreme importance and should be read by all practising lawyers and notaries in all of Canada, including Quebec.

I should mention only briefly the SCC decision in *Thompson*. The point in this case is whether the exceptions for accounting records in the ITA and the requirement to disclose information are consistent with the requirement to provide information.

The Supreme Court of Canada held that the solicitor-client privilege included accounting records and need not be disclosed.

The SCC states:

> [41] Given our holding in *Chambre des notaires* that the exception contained in the definition of "solicitor-client privilege" in s. 232(1) ITA is constitutionally invalid, the Minister's request that Mr. Thompson be compelled to disclose the documents he has been withholding must be rejected. The information contained in those documents is presumptively privileged, and its disclosure cannot be required unless a court first determines whether solicitor-client privilege actually applies. Because we conclude in *Chambre des notaires* that the ITA's requirement scheme is unconstitutional insofar as it applies to lawyers like Mr. Thompson, it is unnecessary to return the matter to the Federal Court.

All lawyers should read these two decisions.

Kruger Incorporated v. R., 2016 DTC 5079 (FCA)

This is an important decision of the Federal Court of Appeal.

The question is whether losses claimed by the Appellant from dealing in foreign exchange options were deductible.

The issue is succinctly stated by the FCA as follows:

> [3] The primary issue turns on the method according to which the Appellant can compute income from dealing in foreign exchange options pursuant to section 9 of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (the Act). The Tax Court judge agreed with the Minister's contention that in computing income from that source, the profit or losses could only be recognized when realized, thereby rejecting the Appellant's use of mark to market accounting as an acceptable method for computing income under the Act. However, he accepted, in part, the Appellant's alternative argument that its foreign exchange option contracts were inventory, and could on that account give rise to a loss based on their value at year end.

Paragraph 14 reads in part as follows:

> [14] Mark to market accounting is an accrual method of accounting whereby both the writer and the purchaser value the option at market as at balance sheet date — in this case December 31, 1998 — and recognize any change in the market value as a gain or loss for the period (Reasons, para. 2e; Expert Report of Patricia L. O'Malley, Appeal Book, Vol. 12, p. 2410, paras. 26, 32 and 33). For that purpose, the premium reflects the value of the option at inception, positive in the case of the purchaser and negative for the writer (Appeal Book, Vol. 17, pp. 3393 to 3397).
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> [16] For the purpose of computing income from its foreign exchange option operations for the year in issue, the appellant marked to market the value of each contract to which it was a party at year end and deducted as a loss the difference between their value at inception based on the above computation (idem, para. 14) and their value at year end, as provided by the financial institutions or banks which were the counterparties to these contracts. In addition, the Appellant "deferred and amortized" the premiums paid and received over the term to maturity of the related option (although the notes to the financial statements indicate that only the premium income received on written options was treated this way (Appeal Book, Vol. 2, p. 244), the working papers show that for tax purposes this treatment was applied to all premiums, both received and paid (Appeal Book, Vol. 10, pp. 2032 to 2057)). As a result, the net amount of premiums to December 31, 1998 was included in income for that year, i.e. $18,696,881, and the balance, i.e. $32,883,453, was deferred to 1999 (Reasons, para. 4, footnote 4).
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> [17] By notice of reassessment issued July 15, 2002, the Minister denied the claimed loss, taking the view that the appellant could not use the mark to market method of accounting, but had to record income in conformity with the principle of realization. Consistent with this principle — according to which the premium is taken into account only when the option expires or is transferred — the Minister removed from income the premiums which the appellant had included. The net effect of the reassessment was to add to the declared income of the appellant the amount of $72,407,498 i.e.: the difference between the loss claimed — $91,104,379 — and the amortized portion of the premiums — $18,696,881. The large corporations tax under Part I.3 of the Act was reassessed accordingly.
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> [23] The Tax Court judge therefore conducted his analysis on the basis that mark to market accounting was implemented and went on to consider whether the use of this method was permitted (Reasons, paras. 85 and following). After reviewing the case law, including in particular the decisions of the Supreme Court in *Canadian General Electric Co. v. MN.R.*, [1962] S.C.R. 3 [*Canadian General Electric*]; *Friedberg v. Canada*, [1993] 4 S.C.R. 285 [*Friedberg*]; *Canderel*; and *Friesen v. Canada*, [1995] 3 S.C.R. 103 [Friesen], the Tax Court judge expressed the view that "a general principle of taxation is that neither profits nor losses are recognized under the Act until realized except if the Act provides an exception to the realization principle" (Reasons, para. 104).

The FCA concluded that the best method of determining the value of the options is the mark-to-market method.

Univar Holdco Canada ULC v. R., 2016 DTC 1133 (TCC)

Univar Holdco Canada ULC ("Univar") is a somewhat lengthy decision of V.A. Miller J. of the Tax Court of Canada and an unsuccessful attempt to avoid section 212.1 of the ITA. Here is what happened. CVC Capital Properties ("CVC") (a UK company) acquired Univar NV, a Netherlands public corporation. The assets of Univar NV included shares of a Canadian operating subsidiary, Univar Holdco Canada ULC, the Appellant. It had a surplus in excess of $889,000,000. CVC wanted to strip that surplus out of the Appellant tax free. The obstacle to doing so was section 212.1, which provides that if a non-resident person disposes of shares of a Canadian resident corporation to a Canadian resident corporation with which the vendor does not deal at arm's length, the amount by which the fair market value of the consideration received by the vendor (other than shares of the purchaser corporation) exceeds the paid-up capital of the purchased shares immediately before the disposition is deemed to be a dividend paid by the resident purchaser to the non-resident vendor. Also, in computing the paid-up capital of any class of the purchaser corporation's shares there is to be deducted the excess of the paid-up capital of the purchaser corporation's shares over the consideration referred to in paragraph 212.1(1)(*a*). Subsection 212.1(4), as it read at that time, provides some relief against the anti-avoidance provision of section 212.1 where the purchaser controls the vendor prior to the disposition.

It seems clear, and was found by Justice Miller, the series of transactions was designed to avoid the adverse consequences of section 212.1 and bringing the transactions with the relieving provision of subsection 212.1(4). The Minister assessed Part XIII tax on the basis that the GAAR (section 245) applied. The respective positions of the parties are contained in paragraphs 48 and 56:

> [48] It was the Appellant's position that the GAAR does not apply in the circumstances of this appeal because the object, spirit and purpose of section 212.1 were not frustrated by the transactions at issue. The transactions were arranged to take advantage of the relieving provision contained in subsection 212.1(4) of the *Act*.
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> [56] It was the Respondent's position that the transactions undertaken by Univar NV were designed to avoid the application of subsection 212.1(1) of the *Act* and to take advantage of the relieving provision in subsection 212.1(4). In so doing, the transactions resulted in abusive tax avoidance because they misused section 212.1 in a manner which frustrated its object, spirit and intended purpose: *Canada Trustco (supra)* at paragraph 45.

The TCC dismissed the appeal and took into account the fact that the series of transactions had as its purpose the avoidance of subsection 212.1(1) and the application of subsection 212.1(4). The judgment is carefully written and is consistent with the principles stated in *Canada Trustco*.

Quinco Financial Inc. v. R., 2016 DTC 1175 (TCC)

This is a decision of Justice Randall S. Bocock of the Tax Court of Canada. The issue is whether interest under subsection 161(1) of the ITA starts to run when the assessment is made under subsection 245 (GAAR). The application of section 245 was to deny certain capital losses.

The decision contains a lengthy discussion of section 245 of the ITA and of the leading case of *Copthorne*, which dealt with the application of a penalty when section 245 is applied.

The Tax Court ultimately concluded that interest on tax assessed under GAAR should start to run from the taxpayer's balance-due date up to the date of the GAAR assessment.

Justice Bocock stated:

> [41] In short, the Appellant, in the present case as a taxpayer possibly subject to GAAR, could have filed by deducting the future-impugned capital loss, but applying GAAR for the purposes of calculating tax payable. Upon assessment under GAAR, interest would not accrue. Moreover, thereafter the Appellant could have objected and appealed. The Court would then determine the application of the GAAR, in the first instance and the reasonableness (including timing) of the reasonable tax consequences as determined by the Minister. To suggest such an option is unavailable or dissimilar from such an option with non-GAAR provisions is not correct.
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> [42] Implicit within this conclusion, is this Court's determination of GAAR's clear intent and inference that all taxpayers, who are directly subject to GAAR assessments, that is, non-third parties, are required to consider and apply GAAR. Taxpayers who are directly or may be directly subject to the nullification of a tax benefit need not ask the Minister for permission to apply GAAR (*STB Holdings Ltd.* at paragraph 23).
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> [43] In conclusion, while not simple or uncomplicated, a taxpayer is able to approach, anticipate and account for GAAR as a taxpayer is obligated to do with all other taxing sections of the *Act* to which GAAR, by necessity, must correlate. If the Minister reassesses, nothing precludes a taxpayer's appeal to this Court.

Frankly, I find this reasoning unconvincing, unrealistic, and utopian. It is, however, exactly the result I would have expected. Implicit in the conclusion is the unstated hypothesis that GAAR is a form of punishment for engaging in abusive tax schemes. One cannot engage in ingenious and aggressive tax schemes and then get off without even paying interest.

Gerbro Holdings Company v. R., 2016 DTC 1165 (TCC)

This is one of the most important cases to be issued in 2016 by the Tax Court of Canada. It is also one of the most articulately written judgments to be issued by the Tax Court of Canada. The judge is Lucie Lamarre A.C.J. It involves section 94.1 of the ITA.

I shall not comment on the case as it may be appealed. However, I shall summarize it. The Appellant invested in five offshore investment (hedge) funds. The Minister of National Revenue attributed to the Appellant substantial income under section 94.1 of the ITA. I shall not try to deal in detail with the many issues discussed by Lamarre A.C.J. Anyone interested in section 94.1 will want to read the entire judgment. The Tax Court judgment has been appealed to the FCA.

The Appellant, as stated, invested in five offshore investment (hedge) funds. The CRA added substantial amounts to the income of the Appellant under section 94.1 on the basis that it could reasonably be concluded that the taxes on the income, profits, and gains subject to tax were significantly less than the taxes would have been if the income had been earned directly by the taxpayer, and one of the main reasons for the taxpayer for investing in the offshore funds was to pay less tax than would have been applicable if the income were earned directly by the taxpayer.

Paragraphs 11 and 12 of Justice Lamarre's judgment read as follows:

> [11] Although Gerbro's main objective was capital preservation, like most investors, it had as a secondary objective earning a return consistent with prevailing market expectations. This meant that if the markets were achieving good returns, Gerbro also wanted to benefit from the higher than normal returns, subject to the level of volatility being acceptable.
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> [12] Moreover, the money Gerbro invested had to be allocated to investments that (i) were liquid, (ii) provided Gerbro with sufficient cash to pay its yearly operating costs as well as its yearly tax liabilities, and (iii) provided Marjorie Bronfman with enough cash to sustain her lifestyle and to fully carry out her philanthropic endeavours.

Associate Chief Justice Lamarre found against the CRA on the motive test. I should think this factual finding could render an appeal by the Crown difficult, if not impossible.

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.

A PRIMER ON THE NEW PRINCIPAL RESIDENCE RULES

— Cameron Mancell, CFP®, Research Analyst, Wolters Kluwer

On October 3, 2016, the Department of Finance announced new financial measures, including tax measures, which target the Canadian housing and mortgage lending sectors. The tax measures are intended to "improve tax fairness and the integrity of the tax system" and specifically propose to amend the capital gains rules pertaining to the disposition of a principal residence. At this time, these amendments are merely proposed and have yet to be introduced in a bill. This primer will discuss the nature of these proposed tax changes and their implications.

Goodbye to the "One-Plus" Rule for Non-Resident Purchasers

Currently, paragraph 40(2)(*b*) computes the gain on the sale of property which was an individual's principal residence at any time since the acquisition date of the property. The gain otherwise determined is reduced by the proportion of the gain that is:

(i) one plus the number of taxation years ending after the acquisition date for which the property was designated as the taxpayer's principal residence and during which the individual was resident in Canada;

of

(ii) the number of taxation years ending after the acquisition date during which the taxpayer owned the property whether jointly or otherwise.

The general intent of the "one plus" rule is to allow taxpayers to claim the principal residence exemption ("PRE") for both their old and new residences for years in which they move from one to the other. If not for this rule, taxpayers would only be allowed to designate one principal residence for the year in which they moved and could potentially realize a taxable capital gain upon the disposition of one of them.

As stated in paragraph 2.75 of Income Tax Folio S1-F3-C1, *Principal Residence*: "[i]t may be possible for a property in Canada that is owned in a particular tax year by a non-resident of Canada to qualify as the non-resident's principal residence (that is, satisfy all the requirements of the section 54 definition of principal residence for the non-resident) for that year." For example, say a non-resident purchases a property for his daughter to live in while attending university in Canada for four years. Since the daughter ordinarily inhabited the property during those four years, the property could be considered a principal residence of the non-resident person. Since the non-resident person never resided in Canada, he would not be able to claim the PRE with respect to any of those years. However, the current wording of the formula in paragraph 40(2)(*b*) allows him to claim the PRE for a single year due to the "one-plus", regardless of him having never resided in Canada.

Effective for dispositions occurring on or after October 3, 2016, the "one plus" element of the computation under paragraph 40(2)(*b*) is exclusive to taxpayers who were resident in Canada during the year in which they purchased the principal residence. Thus, if a taxpayer was not resident in Canada during the year that he or she acquired the property, the computation will not include a "one plus" year. According to the Department of Finance, the general intent of this measure is to ensure that taxpayers are not eligible for the PRE with respect to a year in which they were not resident in Canada. And this amendment will achieve just that. Taxpayers who were not resident in Canada in the year that they acquired their property will only be allowed to designate the property as their principal residence for years in which they were resident in Canada and meet all of the other necessary criteria.

Taxpayers who acquired a principal residence prior to the announcement can be affected by this change. For example, say a taxpayer purchased her residence for $500,000 in 2013, immigrated to Canada in 2014, and sold the residence in 2017 for $600,000. The residence is excluded from the deemed acquisition upon immigration rules under paragraph 128.1(1)(*c*) since it is considered taxable Canadian property. Therefore, the taxpayer's adjusted cost base would presumably be the historical cost of $500,000. Under the previous rules, assuming she was resident in Canada throughout 2014 to 2017 and the property was her principal residence (meeting all necessary conditions), the entire $100,000 gain would be eliminated by the PRE.

However, under the new rules, the taxpayer will not have access to a "one plus" in computing her gain. Therefore, amount (i) above would equal 4 years and amount (ii) remains at 5 years, so $^4/_5$ of the $100,000 gain would be sheltered by the PRE. The taxpayer will have incurred a $20,000 gain in 2017 which is a $10,000 taxable capital gain resulting from the sale of her principal residence.

No grandfathering provision is provided to taxpayers who acquired their principal residences while not resident in Canada prior to the announcement. That said, with every passing year that taxpayers own the principal residence while resident in Canada, the potential taxable capital gains become proportionately lower. Taxpayers who recently immigrated to Canada and are upgrading their house may be exposed to a more onerous tax burden, particularly when selling a home in the greater Toronto or Vancouver areas, which have seen consistent price gains in recent years.

Stricter Principal Residence Criteria for Trusts

Only individuals and personal trusts are eligible to utilize the PRE. In the case of a personal trust, the conditions under paragraph (*c.1*) of the definition of "principal residence" in section 54 must be met in order for that property to qualify as the trust's principal residence. Sparing you the details of the existing criteria, the draft legislation proposes to expand paragraph (*c.1*) by including further criteria for personal trusts. Applicable to tax years beginning after 2016, in order for property to be considered a principal residence of a personal trust, the trust must be:

(A) an *alter ego* trust, spousal or common-law partner trust, joint spousal or common-law partner trust, or a "protective trust", the beneficiary of which is the individual whose death determines the day of disposition for the trust under subsection 104(4);

(B) a qualified disability trust (as defined under subsection 122(3)) the electing beneficiary of which is resident in Canada and a spouse or common-law partner, former spouse or common-law partner, or a child of the settlor; or

(C) settled by a deceased parent of an orphan under the age of 18 who is resident in Canada.

Moreover, if the trust acquires a property after October 2, 2016, the terms of the trust must provide the beneficiary referred to above with the right to the use and enjoyment of the housing unit as a residence in order for the property to be considered a principal residence of the trust. This additional condition applies to taxation years of the trust beginning after 2016.

Personal trusts meeting the above conditions may continue to claim the PRE (provided the general conditions are met) with respect to a property held in 2017 and later years. These new conditions also do not apply in determining whether a trust can designate a property as its principal residence with respect to tax years beginning before 2017 and thus is not relevant to trusts that dispose of principal residences in 2016.

Transitional Rule for Trusts

If a trust does not meet the post-2016 conditions, a proposed transitional rule deems the trust to have notionally disposed of the principal residence (with no immediate tax consequences). Where a trust owns a property at the end of 2016, it does not meet the new conditions in its first taxation year beginning after 2016, and the trust disposes of the property after 2016, the trust's gain from disposing of the property is computed as the sum of two parts:

> (1) The gain computed under paragraph 40(2)(*b*) under the assumption that the trust disposed of the property on December 31, 2016, for proceeds of disposition equal to its fair market value ("FMV") at that time.
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> (2) The gain in respect of the actual disposition calculated under paragraph 40(2)(*b*) without the "one plus" year addition and under the assumption that the trust acquired the property on January 1, 2017, at a cost equal to the proceeds of disposition as determined for the first computation.

Also, the sum of these two gains is reduced by the amount (if any) by which the FMV referred to above exceeded the actual proceeds of disposition. So where the proceeds of disposition are less than the amount of the notional disposition on December 31, 2016, the reduction generally accounts for any selling costs or a subsequent decrease in the property's value after the notional disposition. This transitional rule allows a trust to claim the PRE with respect to years before 2017 in which it owned a principal residence where it is no longer eligible to claim the exemption for years beginning after 2016 due to the stricter criteria. Affected trusts will likely need to obtain a valuation of the property as of December 31, 2016, in order to claim the PRE with respect to prior years.

New Tax Compliance Rules

The proposed legislation also proposes to expand the CRA's ability to assess taxpayers outside the normal reassessment period, which for individuals and trusts is three years after the earliest of the date that the original notice of assessment was sent and the date that a notification that no tax payable was sent. Proposed paragraph 152(4)(*b.3*) will allow the CRA to assess a taxpayer for a further year outside of the normal reassessment period where he or she failed to report the disposition of real or immovable property on his or her return for that year. However, if the taxpayer subsequently amends the return to report the disposition, the CRA may only reassess the taxpayer within the three years following the date that the amendment was filed.

Paragraph (*c*) of the definition of a principal residence in section 54 has always required that individuals (other than personal trusts) designate their property as their principal residence in a prescribed form. However, it has long been the CRA's administrative position that where an individual taxpayer (other than a trust) disposes of his or her principal residence and no gain is taxable since the property was his or her principal residence during every year of ownership, the taxpayer is not required to report any information on his or her tax return. Otherwise, individuals are required to complete CRA Form T2091 (or T1255 in the case of deceased individuals).

On the same day that the Department of Finance announced the new tax changes, the CRA announced new filing requirements with respect to claiming the PRE. Effective for dispositions occurring on or after January 1, 2016, the CRA now requires that individual taxpayers report the sale of a principal residence on Schedule 3 for the tax year in which the property was sold if the property was designated as the taxpayer's principal residence for every year of ownership. Schedule 3 will require taxpayers to provide the year of acquisition, the proceeds of disposition, and a description of the property. This new rule applies to actual and deemed dispositions.

Taxpayers cannot utilize the PRE if they fail to report the disposition on Schedule 3. If a taxpayer does not report the disposition, he or she can request that the CRA amend the tax return for the year of disposition so that he or she can claim the exemption. Unfortunately, the CRA may enforce the penalty for late filed, amended, or revoked elections under subsection 220(3.5) since a designation of a principal residence is deemed to be an election. This penalty is the lesser of $8,000 and $100 for each complete month between the original due date and the date the request is made. The CRA has stated that they will only assess any late filing penalties in the most excessive cases.

Given the prospect of being denied the PRE or facing a significant penalty, it is paramount that taxpayers include all pertinent information on Schedule 3 of their T1 tax return for the year that they disposed of their property and wish to designate it as their principal residence for every year of ownership. Fortunately, the CRA aims to ensure that taxpayers and tax professionals are informed of the new reporting requirement.

If the disposed property was not the taxpayer's principal residence for every year of ownership (e.g., where a cottage will be designated for one or more of those years), the taxpayer must continue to report the disposition on Form T2091 and any gain computed on the form must be included on Schedule 3.

CURRENT ITEMS OF INTEREST

Senate Finance Committee Proposes Major Amendment to Bill C-2

The Standing Senate Committee on National Finance presented its report following a thorough review of Bill C-2. In its current form, the bill proposes to lower the 2nd personal tax rate to 20.5% and to create a new highest tax rate of 33%, among other changes. If the proposals are enacted, the personal federal tax brackets for 2016 are as follows:

first $45,282 of income	15%
income exceeding $45,282 up to $90,563	20.5%
income exceeding $90,563 up to $140,388	26%
income exceeding $140,388 up to $200,000	29%
income exceeding $200,000	33%

The Committee voted to amend the bill, which would result in two fundamental changes to the personal tax brackets. First, the second tax bracket ($45,282 to $90,563) will effectively be divided into two separate brackets. One, applicable to income exceeding $45,282 up to $52,999, would be 16.5%. The other, applicable to income exceeding $52,999 up to $90,563, would be 20.5%. To this end, taxpayers with income less than $90,563 will see further tax savings than what is otherwise proposed by Bill C-2.

The second change complicates matters. The third tax bracket (income exceeding $90,563 up to $140,388) is amended so it would be computed as the lesser of:

(i) the maximum tax payable computed under lower brackets ($15,766.22) plus 1/2 of the amount by which income exceeds $90,563; and

(ii) the maximum tax payable under the 15% tax bracket ($6,792.30) plus 22% of income exceeding $45,282 up to $90,563, plus 26% of the amount by which income exceeds $90,563.

As a taxpayer's income exceeds $90,563, his or her tax benefits from the tax cut are phased out at a 50% rate and are completely eliminated when taxable income is $94,679. Once income exceeds this level, taxpayers must pay 22% on all taxable income exceeding $45,282 — this effectively means that solely lower-income earners (lower than $90,563) will potentially have access to the "middle-class tax cuts."

The Senate news release provided a brief explanation of the rationale behind the proposed changes:

> The committee's amendment would ensure Canadians who earn between $45,000 and $90,000 a year benefit most. It would also be revenue neutral — i.e. it would not cost the government money to implement — by maintaining the income tax rate for Canadians who earn more than $90,000 a year.

Now the Senate must vote on Bill C-2 in its amended form. The Senate is already debating whether the amendments constitute an increase in tax revenues and thus would be out of order and invalid. So it remains to be seen if the Senate will vote in favour of the amended bill and whether amending the bill is even permitted. Further, the House of Commons may simply reject these significant changes to the bill.

CBA and CPA Joint Committee on Taxation Comments on Technical Proposals

On November 15, 2016, the CBA and CPA Joint Committee on Taxation sent a submission to the Department of Finance regarding a series of draft technical amendments that were released on September 16, 2016. Proposed amendments on which the Committee commented include:

- foreign mergers (rollover);
- upstream loan rules;
- foreign tax credit generator rules;
- stub period FAPI rules;
- foreign affiliate dumping rules;
- derivative forward agreements; and
- Regulation 6204 prescribed shares (for stock option deduction).

Drought Regions for 2016 — Livestock Farmers Eligible for Tax Deferral

Every year, various regions throughout Canada are designated as prescribed drought or flooding regions for that year. Farmers in those regions are eligible to defer the tax on the proceeds from selling their breeding livestock until the following year if certain conditions are met. A preliminary list of the prescribed drought regions was released, which includes regions in Alberta, Ontario, and Quebec. This list can be found on the Agriculture and Agri-Food Canada website.

CRA Publishes List of Investment Funds That Are Registered Investments

Every year, the CRA publishes a list of funds (see http://intelliconnect.ca/public/CCH-News-2016-11-188480_fittracker.pdf) that are registered investments as of December 31 of the preceding year. Therefore, this particular version lists all registered investments (as defined in subsection 204.4(1)) as of December 31, 2015.

Prescribed Amounts Released by the CRA

Last week, the CRA released two prescribed amounts:

(1) The prescribed interest rate for leasing rules for December 2016 is 2.68%.

(2) The maximum pensionable earnings for 2017 (the amount of earnings that are subject to CPP contributions) will be $55,300 (up from $54,900 in 2016). The basic exemption will remain at $3,500. As a result, the maximum employee (and employer) annual CPP contribution in 2017 will be $2,564.

Finance Committee Releases Report on Tax Avoidance

This spring, the House of Commons Standing Committee on Finance adopted a motion to call the Minister of National Revenue ("MNR"), senior Canada Revenue Agency ("CRA") officials, the Department of Justice, and officials from KPMG to appear before the committee. The purpose of the hearings was to explore the CRA's role in combatting tax evasion and tax avoidance. After weeks of hearings, the committee released a report on October 26, 2016. The committee and the CRA each recommended 14 actions with respect to combatting tax avoidance and tax evasion in Canada. The recommendations are summarized below:

The Committee's Recommendations

(1) The MNR conduct a review of the advance tax ruling process and identify opportunities to improve efficiency and timeliness, and lower costs.

(2) The MNR require Canadian tax advisors to register all their tax products with the CRA.

(3) The CRA conduct a review of its voluntary disclosure program. This should include a review of the guidelines applied in determining whether to settle or pursue litigation.

(4) The MNR strengthen protections to informants under the Informant Leads Program and Offshore Tax Informant Program. Further, the MNR should ensure these programs provide adequate incentives for informants and all credible information obtained through them is investigated.

(5) The MNR report the audit progress related to the Panama Papers to the House of Commons.

(6) The CRA enhance its technical, human resource, and other capabilities with regard to domestic and international aggressive tax planning.

(7) The CRA calculate and report Canada's federal tax gap on an ongoing basis.

(8) The federal government accelerate its review of the *Income Tax Act* and hastily implement initiatives intended to simplify the federal income tax system.

(9) The federal government improve coordination between the CRA and the Department of Justice in handling cases of tax evasion.

(10) The MNR establish a reporting program for the CRA that would provide statistical information about tax avoidance/evasion enforcement to the public (e.g., number of investigations leading to settlements or convictions).

(11) The federal government review the 92 tax treaties and 22 tax information exchange agreements to ensure that they do not facilitate non-compliance with tax laws, particularly with respect to secrecy in certain tax jurisdictions.

(12) The MNR address offshore non-compliance through greater collaboration with other jurisdictions through enhanced joint audits with treaty partners.

(13) The CRA take a lead role in ensuring global implementation of the Base Erosion and Profit Shifting ("BEPS") actions recommended by the Organisation for Economic Co-operation and Development ("OECD").

(14) The CRA conduct a complete review of its code of conduct for employees.

The CRA's Recommendations

Many of the CRA's recommendations are similar or identical to those of the committee. That said, several of the CRA's recommendations are noteworthy too:

- Independent studies be conducted with respect to:
  - the voluntary disclosure program;
  - the consistency of the CRA's rules for levying penalties;
  - the relationship between CRA auditors and accounting firms; and
  - the CRA's investigations into tax avoidance or evasion.
- The CRA expand its efforts to prosecute tax experts who create aggressive tax planning schemes.
- The federal government amend the voluntary disclosure program to account for penalties that no longer exist.
- "The CRA stop the systematic negotiation of reduced penalties for tax evaders under the pretext of reducing costs to the justice system, depriving Canada of jurisprudence and creating a regime in which law enforcement becomes the subject of bargaining."
- The federal government re-examine paragraph 5907(11) of the *Income Tax Regulations* which "allows Canadian companies to transfer assets into tax havens before repatriating them without paying taxes, in cases where the country in question negotiated a [tax information exchange agreement] with Canada."
- The federal government clarify professional secrecy status for accounting firms.

This is a cavalcade of potential changes to the operation and oversight of the Canadian tax system. The recommendations that we find most interesting are the simplification of the Canadian *Income Tax Act*, the review of every tax treaty, and encouraging the CRA to pursue tax evasion cases in the courts rather than settling with reduced penalties.

European Commission Proposes Single Market Tax System

On October 25, 2016, the European Commission reintroduced proposed corporate tax reforms, which would affect companies doing business in the European Union ("EU"). These proposals were first released in 2011, but were not agreed upon by all member states. The package consists of three central proposals, which will be submitted to the European Parliament:

(1) the common consolidate corporate tax base ("CCCTB");

(2) improved mechanisms to resolve double taxation disputes; and

(3) measures to tackle tax loopholes in non-EU nations.

The most notable proposal is the CCCTB, which is a harmonized system that determines companies' taxable profits earned in the EU. It will consist of a single set of tax rules, so a company will calculate its tax base for the entire EU, rather than on a country-by-country basis. The stated benefits of the CCCTB include lower tax compliance costs, the removal of "loopholes and mismatches", and "reduc[ing] harmful tax competition". It will apply to multinational groups with global revenues exceeding €750 million per year. Thus, if enacted, a new set of tax rules will apply to all large companies doing business in the EU.

According to the Commission's news release, there are currently 900 double taxation disputes outstanding in the EU with an estimated value of €10.5 billion. The Commission proposes changes to the dispute resolution processes that are currently in place.

The third proposal is a set of measures targeting hybrid mismatches between the tax systems of EU member states and non-EU countries. Hybrid mismatches effectively allow specific forms of income or legal entities to be exempt from tax in both jurisdictions. Proposals which target hybrid mismatches within the EU have already been introduced. These new proposals will target mismatches with non-EU countries.

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.

Reliance on Business Partner Insufficient Shield Against Liability as Director for Failure by Corporation To Withhold and Remit Source Deductions

***Helgesen v. The Queen*, 2016 DTC 1087 (Tax Court of Canada)**

Helgesen is an informative case that sheds light on when a passive investor/director will be held liable *qua* director for a corporation's failure to withhold and remit source deductions of income tax, CPP, and EI. In this regard, *Helgesen* provides insight as to the circumstances in which a director is likely to succeed in resisting assessments on the basis of the due diligence defense in the *Income Tax Act* (the "Act"), which also applies in respect of required remittances of CPP and EI.

The taxpayer was an experienced businessman who acted as a passive investor in, and one of two directors of, 1072519 Alberta Ltd. The corporation's core business involved operating a franchise of O.K. Tire Stores Inc. The day-to-day operations of the corporation were overseen by Mr. Pyle, the other shareholder and director. However, the taxpayer engaged in the typical duties and responsibilities of a director and, on numerous instances, paid and guaranteed the corporation's debts.

From January 2008 onwards, the corporation failed to withhold and remit to the CRA payroll deductions for income taxes, CPP, and EI, and to pay to the CRA GST collected. The corporation was assessed in respect of this failure, including for related interest and penalties. In February 2008, the CRA advised the taxpayer that the corporation owed approximately $110,000 in respect of such unremitted amounts and warned him that he could be held personally liable for these amounts. However, the CRA agreed that it would not hold the taxpayer personally liable for the failure to remit prior to February 2008.

After being advised by the CRA of the corporation's failure to make payroll remittances, the taxpayer spoke to Mr. Pyle about the need to be diligent in making such remittances and stopped by the business every two or three months to monitor how things were going. The taxpayer also provided approximately $55,000 to the corporation in January 2010 to enable it, the taxpayer testified, to make remittances to the CRA, although the corporation failed to make use of the money for this purpose.

In October 2011, the corporation was assessed for not withholding and remitting payroll deductions of $184,000. The Minister also assessed the taxpayer pursuant to the directors' liability provisions of section 227.1 of the Act, and the corresponding directors' liability provisions for CPP and EI. The taxpayer appealed the director's liability assessment to the Tax Court on the basis that he met the due diligence threshold, permitting him to avoid personal liability as a director.

In considering the due diligence defense, Ouimet J. for the Tax Court referred to *Buckingham* (2011 DTC 5078), which set out a detailed analysis of the due diligence provisions in subsection 227.1(3) of the Act.

In *Buckingham*, the Federal Court of Appeal noted that, in order to succeed under subsection 227.1(3), a director must prove that he or she exercised a requisite degree of care, diligence, and skill to prevent the failure to remit the required amounts. In this regard, the Act states that the degree of care that must be exercised is what "a reasonably prudent person would have exercised in comparable circumstances." *Buckingham* affirmed that the Act's reference to the actions of a "reasonably" prudent person indicated an objective test, as was set out by the Supreme Court of Canada in *People's Department Stores Ltd.* (2004 SCC 68).

Relying upon *Buckingham,* Ouimet J. stated:

> [. . .] a person who is appointed as a director must carry out the duties of that function on an active basis. The director must establish that he turned his attention to the required remittances with a view to preventing a failure by the Corporation to remit these amounts. A director will not be allowed to defend a claim for malfeasance in the discharge of his or her duties by relying on his or her own inaction.

Applying this objective test in *Helgesen*, Ouimet J. held that the taxpayer failed to act in the manner that a reasonably prudent individual would have in similar circumstances. The taxpayer did not investigate in sufficient depth whether remittance payments were being made to the CRA, continuing to rely on the assurances of Mr. Pyle that the remittances were up to date despite his knowledge of the corporation's poor financial performance. Moreover, the Court noted that:

> The Appellant had signing authority for the Corporation's bank account and he could have investigated the matter and acted to ensure that the debt to the CRA was being paid off by making payments himself and by

> monitoring the situation with regard to future required payments [. . .] The Appellant continued to allow Mr. Pyle [. . .] to make day-to-day decisions for the Corporation. He chose not to review any of the Corporation's documents other than the occasional year-end document. The Appellant testified that he would hire someone to do this on his behalf; however, it never happened.

Ouimet J. noted that the taxpayer continued to rely on Mr. Pyle despite receiving additional notices from the CRA in July and August 2008 that source deductions were still owed, and that the CRA was considering assessing him personally. Given that the taxpayer waited until January 2011 to notify the CRA that he had been misled by Mr. Pyle about the status of the remittances, the Court held that the taxpayer could not then assert the malfeasance of Mr. Pyle as a defense for his failure to discharge his duties. Consequently, Ouimet J. dismissed the appeal, awarding costs to the Minister.

The *Helgesen* case, although it has been appealed to the Federal Court of Appeal, provides a useful illustration of the degree of care, diligence, and skill that that may be required by a director to meet the due diligence standards contemplated in respect of the failure by a corporation to withhold and remit source deductions.

— *Krupa Kotecha, Articling Student*

Unsuccessful Appeal from a Loss Determination; Taxpayer Fails To Demolish Minister's Assumptions

***Atlantic Thermal Star Limited v. The Queen*, 2016 DTC 1097 (Tax Court of Canada)**

This matter involves the somewhat uncommon situation of a taxpayer appealing from a loss determination made by the Minister.

The taxpayer was a corporation in the heating and cooling products business. In determining its income from that business, the taxpayer claimed a bad debt expense in its 2008 taxation year and a cumulative eligible capital deduction in its 2010 taxation year.

The deductions of the bad debt expense and the cumulative eligible capital amount were disallowed by the Minister in assessments for the 2008 and 2010 taxation years. As the taxpayer was in a loss position in each of those years, it had requested that the Minister determine the amount of its losses, as per the requirements of subsection 152(1.1) of the *Income Tax Act* (the "Act"). However, pursuant to the loss determination, the Minister determined the taxpayer's losses on the basis that both the bad debt expense and the cumulative eligible capital deduction had been properly disallowed. Accordingly, the taxpayer appealed to the Tax Court.

Although the amounts in issue were not substantial, and the taxpayer apparently would not have had a resulting tax liability regardless of the outcome of the appeal, the taxpayer advised the Tax Court that it was appealing on a question of principle rather than need. Apparently, as part of that question of principle, the taxpayer sought costs "for the delays occasioned by the CRA in completing its audit, the incompetency of CRA auditors, the difficult process of dealing with the CRA, the stress and deterioration of Mr. Backman's health caused by this whole process, and for the CRA failing to respect the rights guaranteed to the Appellant by the Taxpayer Bill of Rights."

Notwithstanding the question of principle, however, the taxpayer's principal shareholder — Michael Backman — did not testify; rather, the sole witness for the taxpayer was its bookkeeper/accountant, Doug Rudolph, who had been neither the bookkeeper nor the accountant for the taxpayer during the years in issue. Mr. Rudolph also acted for the taxpayer in bringing the appeal.

In respect of the bad debt expense, Mr. Rudolph filed an exhibit which he maintained demonstrated that the taxpayer had included the amount in question in the 2008 taxation year or a prior taxation year. Mr. Rudolph testified that Mr. Backman made the determination that the debt became a bad debt in the 2008 taxation year, and thereby acted as a reasonable person and in good faith. The Minister maintained that its assumptions of fact — that the amount had not been included in 2008 or a prior year and was not a debt that became a bad debt in 2008 — had not been "demolished" by the taxpayer, as Mr. Backman had not testified and Mr. Rudolph was not involved with the affairs of the taxpayer during the taxation years in issue.

In respect of the cumulative eligible capital deduction, it was noted that the taxpayer had acquired the business in 2006 from Mr. Backman, who had previously carried on the business as a sole proprietorship and, prior to that, had carried on the business in partnership with another person. The transfer to the corporation had been undertaken pursuant to section 85 of the Act. As part of that transaction, the goodwill was transferred at $103,197, for which the corporation issued a promissory note to Mr. Backman. In respect of the goodwill, however, the Minister took the position that it had no value at the time of the transfer, such that there was no cumulative eligible capital to support the deduction claimed by the taxpayer.

Mr. Rudolph filed (with consent) some materials purporting to show that Deloitte & Touche had valued the goodwill at a little over $100,000 on January 1, 2005, at the time that Mr. Backman bought out his partner's interest. The taxpayer took the position that the Minister was statute-barred in challenging the value of the goodwill since it was

established in 2005 and that, in any event, the amount was correctly determined by Deloitte & Touche, an arm's length party. The Minister responded that the value was nil and further, since the taxpayer claimed a deduction in 2010, that the Minister's challenge was not statute-barred.

In dealing with the taxpayer's positions, Lafleur J. cited the Supreme Court of Canada's decision in *Hickman Motors Ltd*. (97 DTC 5363) in concluding that:

> [. . .] the initial onus [on] the taxpayer consists in demolishing the assumptions relied upon by the Minister to issue the assessment by making out a *prima facie* case that said assumptions are inaccurate. Then, the burden of proof shifts on the Minister, who must prove the assumptions relied upon.

In respect of the shifting of the burden of proof to the Minister, Lafleur J. noted that:

> It is [. . .] very important to keep in mind that the shifting of the burden of proof to the Minister cannot be lightly, capriciously or casually done, since the taxpayer typically has the information within his reach and under his control. Absent exceptional circumstances where facts are peculiarly within the Minister's knowledge, the onus on an assessment of tax owing should be the result of demolishing the Minister's assumptions[.]

Lafleur J. cited the Tax Court's judgment in *Canada Trust Co*. ([1985] TCJ No. 3) in concluding that "the burden of proof applicable to an assessment under the [Act] also applies to a notice of determination of losses".

With those principles in mind, the Tax Court concluded that the taxpayer had not discharged its burden of proof to show that it was entitled to a deduction for bad debt expenses. In this regard, Lafleur J. stated as follows:

> Mr. Backman, who is the director and principal shareholder of the Appellant, did not testify and was not present at the hearing. Furthermore, Mr. Rudolph was not the bookkeeper-accountant of the Appellant during the taxation year in issue. In addition, according to Mr. Rudolph, it was Mr. Backman who decided which debts had become bad debts and thereby always acted in good faith and as a reasonable person.
>
> No evidence was presented to me at the hearing pertaining to the method followed by Mr. Backman as to the determination of a bad debt. The Appellant presented insufficient evidence [. . .]. All I was told by Mr. Rudolph is that Mr. Backman, in making that determination, acted in good faith and as a reasonable person.
>
> Because of this lack of evidence, it is clear that the Appellant did not discharge its initial burden of proof to make out a *prima facie* case showing the inaccuracy of the assumption made by the Minister in that respect.

Regarding the deduction for cumulative eligible capital, the Tax Court relied upon the "New St. James principle" in rejecting the taxpayer's claim that the Minister's challenge was statute-barred since the value was determined on January 1, 2005. Lafleur J. quoted Bowman C.J. (as he then was) in *Coastal Construction & Excavation Ltd*. (97 DTC 26), stating in respect of this principle that:

> The Minister is obliged to assess in accordance with the law. If he assesses a prior year incorrectly and that year becomes statute-barred this will prevent his reassessing tax for that year, but it does not prevent his correcting the error in a year that is not statute-barred, even though it involves adjusting carry-forward balances from previous years, whether they be loss carry-forwards or balances of investment tax credits.

Accordingly, in concluding that the 2010 taxation year was not statute-barred, Lafleur J. stated that:

> In my view, the New St. James principle makes it clear that in the case at bar, the Minister has the power to challenge the computation of the cumulative eligible capital balance of the Appellant for the 2010 taxation year based on the value of the goodwill at the time of transfer of the goodwill by Mr. Backman to the Appellant on September 30, 2006; that challenge is not statute-barred.

In respect of the value of the goodwill, Lafleur J. stated that:

> [. . .] the Minister has made an assumption of fact: the value of the goodwill transferred from Mr. Backman to the Appellant as of September 30, 2006 was nil. Accordingly, if the Appellant has made out a *prima facie* case that the value of the goodwill as of September 30, 2006 was equal to an amount other than a nil amount as assumed by the Minister, then the burden of proof will shift to the Minister, who must then prove said assumption.

However, the Court noted that the evidence presented was as to the value of the goodwill on January 1, 2005, which, even if accepted, would not establish the value of the goodwill some 21 months later, on September 30, 2006, at the time of the transfer to the taxpayer. Lafleur J. noted that even if it were accepted that a *prima facie* case had been made out that the value was other than nil on September 30, 2006, the evidence of the Crown proved, on a balance of probabilities, that the fair market value of the goodwill as of September 30, 2006, was nil.

In respect of the taxpayer's claim for costs, the Tax Court accepted that in exceptional circumstances conduct which occurs prior to a proceeding may be taken into account if that conduct unduly and unnecessarily prolongs the proceeding. However, in rejecting the taxpayer's claim, Lafleur J. noted that:

> I do not see any factors in this appeal that would convince me to exercise my discretion so as to award costs to the Appellant. [. . .] I can see no exceptional circumstances in the conduct of CRA officials prior to the filing of the Notice of Appeal. No evidence was provided by the Appellant as to any disbursements incurred, the state of Mr. Backman's health or any exceptional stress that was occasioned by the conduct of the CRA. This may be in part because Mr. Backman did not appear at the hearing.

Accordingly, the taxpayer lost on both the substantive issues and on the issue of costs. Clearly, the Tax Court was not impressed with the failure of Mr. Backman to appear at the hearing and testify. The decision illustrates how important it is on an appeal to call the appropriate witnesses and to pay careful attention to the evidence presented.

— *Yaroslavna Nosikova, Articling Student*

FCA Determines that a Remission of Tax Payable Does Not Give Rise to an Overpayment of Tax

***Imperial Oil Resources Ltd. v. Canada (Attorney General)*, 2016 DTC 5057 (Federal Court of Appeal)**

At issue in the present appeal were two applications for judicial review that arose out of the operation of the *Syncrude Remission Order*. The two applications had been decided together by the Federal Court in *Imperial Oil Resources Limited v. Canada (Attorney General)* (2014 DTC 5113). In their respective judicial review applications, both Imperial Oil Resources Limited ("Resources Limited") and Imperial Oil Resources Ventures Limited ("Ventures Limited") raised the following question: does a remission of tax debt under the *Financial Administration Act* give rise to an "overpayment" within the meaning of paragraph 164(7)(*b*) of the *Income Tax Act* (the "Act") such that refund interest arises under subsection 164(3)?

In addition to the refund question, the Ventures Limited appeal gave rise to the following threshold issue: under subsection 18.1(2) of the *Federal Courts Act*, was Ventures Limited out of time when, on December 23, 2010, it applied for judicial review of the Minister's refusal to pay refund interest on a tax remission for the 1996 taxation year? On June 10, 2003, the Minister had issued a reassessment containing a revised determination of Ventures Limited's remission entitlement for its 1996 taxation year. Ventures Limited objected to the determination, but argued that the first time it received a judicially reviewable decision on the interest issue was on December 13, 2010, when a CRA official orally communicated that there would be no refund interest on the 1996 remission.

This appeal was made in the broader context of litigation concerning the *Syncrude Remission Order*, a statutory instrument intended to counterbalance increased royalties on the Syncrude Project with tax relief at the federal level.

At the Federal Court, the proceedings giving rise to the present appeal were heard concurrently with another judicial review application which disputed the Minister's computation of the remission amount under the Syncrude Remission Order. The decision in that case was released in a companion judgment. That decision was reported as *Imperial Oil Resources Limited v. Canada (Attorney General)* (2009 DTC 5193).

The judicial review applications were test litigation for over 40 other files that were being held in abeyance by the courts.

The *Syncrude Remission Order* was enacted by an order in council on May 6, 1976, and came on the heels of legislative changes to the federal Act that included provincial royalty charges in the income of oil and gas producers effective in May 1974.

Paragraph 12(1)(*o*) required a taxpayer to include in income amounts receivable by the provincial Crown as a royalty in relation to a Canadian resource property. Paragraph 18(1)(*m*) prohibited the deduction of such resource royalties that were payable to the provincial Crown.

Prior to the enactment of paragraphs 12(1)(*o*) and 18(1)(*m*), oil and gas royalties charged by the provinces were deductible by oil and gas producers at the federal level. As the provinces increased their oil and gas royalty rates, the deductibility of these expenses at the federal level resulted in an erosion of the federal tax base.

Both provisions have since been repealed but represent a chapter in the complicated history of the federal government's ever-changing approach to the deduction of Crown royalty charges in the oil and gas industry.

Under the terms of the *Syncrude Remission Order*, the appellants, as well as other participants in the Syncrude Project, were entitled to receive relief from federal tax in the form of a yearly remission by the Minister under the *Financial Administration Act*. In effect, as a result of the order, until the end of 2003 the participants were entitled to remission of any Part I tax payable as a result of the application of paragraphs 12(1)(*o*) and 18(1)(*m*) of the Act.

In the appeal proceeding, both Resources Limited and Ventures Limited argued that the remission orders which they had been receiving under the *Syncrude Remission Order* should have been treated as giving rise to an "overpayment" of tax against which the Minister was obliged to pay refund interest under subsection 164(3) of the Act.

The two Imperial Oil entities emphasized the fact that the administrative systems of the Minister of National Revenue had treated the remission amounts as overpayments of tax and had applied the remission amounts as a payment

against each of their respective tax liabilities.

The Federal Court of Appeal noted that the *Financial Administration Act* authorizes two modes by which the government was entitled to make a remission order: by foregoing the collection of a portion of a taxpayer's debt pursuant to paragraphs 23(4)(*a*) through (*d*), or, if the debt had already been paid by the taxpayer, by repaying the remission amount, pursuant to paragraph 23(4)(*e*).

The Federal Court of Appeal concluded that there were only two ways a remission amount could be credited against the appellants' tax liabilities as required by subsection 164(1) of the Act in order to qualify as a refund: either by reducing taxes assessed, which would run contrary to *Perley* (91 DTC 5176), or by the *Syncrude Remission Order* having modified the Act by eliminating the application of paragraphs 12(1)(*o*) and 18(1)(*m*), which would run contrary to the decision in *Imperial Oil* (2009 DTC 5193).

In light of the foregoing, the Federal Court of Appeal held that the lower court had not erred when it concluded that the remission orders under the *Financial Administration Act* did not give rise to an overpayment of tax that was subject to refund interest.

Despite having concluded that the appellants were not entitled to refund interest, the Federal Court of Appeal nonetheless went on to comment on the timeliness of the judicial review application brought by Ventures Limited.

Subsection 18.1(2) of the *Federal Courts Act* establishes a time limit of 30 days within which an applicant must file for judicial review of an administrative decision.

However, Ventures Limited argued that it could not commence its judicial review application until it had exhausted all avenues of appeal, in this case being the objection it had filed against the assessment issued on June 10, 2003, in respect of the taxpayer's 1996 tax year.

On this point, Ventures Limited submitted that it would undermine the exclusive jurisdiction of the Tax Court of Canada to hear tax appeals if taxpayers were allowed to use the judicial review process to appeal directly to Federal Court within 30 days of receiving a reassessment rather than using the appeals process in the Act.

In relation to this limitation period issue, the Federal Court of Appeal rejected the appellant's argument that the tax appeals process formed part of the statutory regime that had to be exhausted before Ventures Limited could apply for judicial review. The Federal Court of Appeal stated that the objection procedure and subsequent right to bring an appeal before the Tax Court applied only to assessed amounts, which, pursuant to subsection 152(1) of the Act, are only taxes, interest, and penalties.

Citing *McMillen Holdings Ltd*. (87 DTC 585), the Federal Court of Appeal noted that the amount of a refund resulting from an overpayment, including interest payable thereon by the Minister, is not subject to the objection procedure. Though the Minister is entitled to assess taxes, interest, and penalties under subsection 152(1), the Federal Court of Appeal stated that the "interest" referred to in subsection 152(1) is interest claimed by the Minister, not interest payable by the Minister. As a result, the appellant could not wait for its objection to be resolved before resorting to a judicial remedy outside the Act and, therefore, the limitation period for judicial review began to run on June 10, 2003, when the Minister issued its notice of reassessment for the appellant's 1996 tax year.

Neither appellant has sought leave to appeal the decision of the Federal Court of Appeal.

— *Justin Shoemaker*

RECENT CASES

Assessment varied to allow taxpayer to deduct additional business expenses

The taxpayer participated in a pyramid scheme and received a profit from her participation. The Minister reassessed the taxpayer to include unreported business income from that scheme during the 2007, 2008, and 2009 taxation years, and the taxpayer appealed from those reassessments.

The appeal was allowed in part. The Court held that the primary issues for determination on the appeal were the nature of the scheme entered into by the taxpayer and how the amounts earned under that scheme should be taxed. The Court held that the appellant had agreed to join what she believed was a sales organization that would pay her commissions for recruiting new salespeople. She did so and received such payments, which the Court concluded were business income in her hands. The Court then considered how such income was to be calculated, and determined that the Minister was correct in determining the appellant's income by totalling the amounts deposited to the appellant's account with the company. In addition, the Minister had correctly calculated the amount of such income. The Minister had erred, however, in disallowing business expenses claimed by the appellant. In the Court's view, the appellant had demolished the Minister's assumption that the participants in the scheme had bought goods and services from the company for personal use. Rather, the amounts spent by the appellant were laid out to earn the revenue she received

as a sales director, and were properly deductible. The Court concluded that the appeal should be allowed, and the matter referred back to the Minister for reconsideration and reassessment on the basis that the appellant was entitled to deduct additional business expenses in 2007 and 2008.

Mazo v. The Queen

2016 DTC 1184

Application for judicial review allowed where applicant's right to procedural fairness breached

The taxpayer had made a request of the Minister of National Revenue for relief from interest which had been charged following the denial, on reassessment, of the taxpayer's claim for charitable donation tax credits. The request for relief was based on financial hardship, error and delay on the part of the Canada Revenue Agency, and extraordinary circumstances. The taxpayer's request was denied, and the taxpayer sought judicial review of that denial.

The application was allowed. The Court reviewed the history of negotiations between the Canada Revenue Agency and the taxpayer, and noted that the Agency had made settlement offers in the course of those negotiations. While the settlement offers made did not suggest any interest relief, they were both, in the Court's view, made on a "without prejudice" basis. However, the decision appealed from stated several times that the applicant's refusal to accept the CRA's offers to settle was a factor in the rejection of his request for interest relief. The Court held that since the settlement offers were made on a "without prejudice" basis, the applicant was entitled to have his request for interest relief considered without regard to the outcome of the settlement discussions. In the Court's view, the Minister's repeated reliance on the applicant's refusal to settle constituted a breach of the applicant's right to procedural fairness. The Court ordered, therefore, that the applicant's request for interest relief be reconsidered, without regard to his refusal to accept the CRA's offers of settlement.

Morrison v. MNR

2016 DTC 5112

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