Tax Notes

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Wolters Kluwer

CRA ROUNDTABLE — 2017 CANADIAN TAX FOUNDATION ANNUAL TAX CONFERENCE

— Megan Seto and Paige Donnelly, Dentons Canada LLP

The Canada Revenue Agency (the "CRA") held its annual roundtable question and answer session at the Canadian Tax Foundation's Annual Tax Conference to address various issues affecting taxpayers and their advisors. This year, the CRA was asked to answer questions on tax planning using trusts, section 55, and the *Organisation for Economic Co-Operation and Development's* MLI (defined below). The CRA also answered questions relating to tax shelters, stock option deductions, the Canada–US tax treaty, clearance certificates, and CRA administrative issues.

Questions Relating to Tax Planning Involving Trusts

Questions 1 and 2 involved taxation issues involving trusts.

Question 1 asked the CRA to comment on the following fact scenario:

- The trustees of a Canadian resident discretionary family trust are planning to distribute all or a portion of the trust's property to one or more beneficiaries in advance of the trust's 21st anniversary to avoid a deemed disposition.
- The trust's property does not consist of any properties described in subparagraphs 128.1(4)(*b*)(i) to (iii) of the *Income Tax Act* (Canada) (the "Act"), and the individual beneficiaries are non-residents.
- At least one of the non-resident beneficiaries owns a Canadian company ("Canco") that is also a beneficiary of the trust.
- Instead of distributing the property to the non-resident beneficiaries directly, the trustees propose to distribute the property on a tax-deferred basis to Canco under subsection 107(2).
- As a result of this, the property will be moved out of the trust and therefore not subject to the 21-year deemed disposition rule.
- Further, since the property will be distributed to one or more Canadian resident corporations, subsection 107(5) would not apply and the property would be transferred out of the trust on a tax-deferred basis.

At the roundtable, the CRA confirmed that it would consider applying the general anti-avoidance rule ("GAAR") under section 245 of the Act for this particular scenario. The CRA's basic policy is to tax any accrued gains on a regular basis. The proposed facts would effectively permit the beneficiaries to defer gains indefinitely. This tax result would

be contrary to the result obtained for resident beneficiaries. Finally, the CRA also commented that it would not provide any rulings for this type of scenario.

In Question 2, the CRA addressed a specific question regarding the Department of Finance's ("Finance") new rules restricting the circumstances under which a personal trust could claim the principal residence exemption in taxation years starting in 2017 or later. Specifically, the new rules stipulate that only certain eligible trusts, including life interest trusts, will be eligible to claim the exemption. The terms of the trust must also provide the eligible beneficiary with "a right to the use and enjoyment of the housing unit as a residence throughout the period in the year that the trust owns the property."

The CRA stated that as the specific language found in the previously proposed version of subclause 54(*c.1*)(iii.1)(A)(III) of the Act is no longer found in Bill C-63, the language does not need to be included in the trust deed for a life interest trust.

Section 55 Questions

The CRA answered a number of questions regarding section 55 of the Act.

In Question 3, the CRA was asked to consider a scenario wherein the purpose of a transaction was to crystallize the capital gains exemption by way of preserving the qualifying small business corporation shares. In which case, would subsection 55(2) apply in such a transaction. The CRA stated that subsection 55(2) would apply to a dividend payment if the dividend payment has *any* of the purposes in paragraph 55(2.1)(*b*). The CRA notes that a *result* of the payment is a reduction of the fair market value ("FMV") of the shares. Although the CRA made clear that it would have to consider the facts of each case, the removal of surplus may indicate planning that would fall within paragraph 55(2.1)(*b*). The CRA also highlighted some additional questions that it would consider. For example, was a sale contemplated at the time? Why is there a payment of a dividend to remove surplus assets that are not otherwise covered by safe income? The CRA left advisors to consider these points.

Continuing on the issue of the purpose test, for the second part of Question 3 the CRA clarified that it prefers the purpose test set out in *Ludco Enterprises Ltd et al v. The Queen*, 2001 DTC 5505 (SCC) ("*Ludco*"), to that in *The Queen v. Placer Dome*, 96 DTC 6562 (FCA) ("*Placer Dome*"). The CRA takes the view that the two decisions are not inconsistent. *Ludco* is a decision under paragraph 20(1)(*c*) which does not have both a purpose and a result test. Recent jurisprudence on subsection 55(2), including *Placer Dome,* does not apply the principle established in *Ludco* that the objective manifestation of purpose is critical to ascertain the purpose or intention behind actions under former subsection 55(2) because of the particular language therein that distinguishes between purpose and result. *Placer Dome* stands for the proposition that subsection 55(2) requires a subjective understanding for the purpose test and an objective approach for the result test.

In Question 4, the CRA also confirmed that both a deemed gain under paragraph 55(2)(*c*) and an addition to the Capital Dividend Account ("CDA") occur at the time the dividend was paid.

In Question 5, the CRA answered questions as to the interaction between paragraph 55(5)(*f*) and subsection 55(2.3) with subsection 55(2.1). Paragraph 55(5)(*f*) deems a portion of a dividend to be "safe income", which is income that can reasonably be viewed as contributing to the gain on the payor company's shares. The CRA stated that the purposes outlined in paragraphs 55(2.1)(*a*) and (*b*) apply to the entire dividend paid. However, the purpose outlined in paragraph 55(2.1)(*c*) applies only to the part of the dividend that is in excess of "safe income." This interpretation applies for both cash and stock dividends.

In Question 6, the CRA addressed the issue of circular calculations with respect to Part IV tax. The circularity arises as follows:

- Holdco received a dividend of $400,000 that is subject to Part IV tax because the connected payor corporation has received a dividend refund. The Part IV tax payable by Holdco is $153,333 (38.33% of $400,000).
- Holdco pays a dividend to its shareholders which results in a refund of the Part IV tax. The dividend received by Holdco would therefore be subject to the application of subsection 55(2).
- If the dividend received by Holdco was originally taxed as a capital gain to Holdco, the refundable tax on the capital gain would be $61,333 ($400,000 × 50% × 30.66%).

- Instead of paying the whole amount of $400,000 as a taxable dividend so that it can be established that the Part IV tax of $153,333 is fully refunded for subsection 55(2) to apply, Holdco would only need to pay an amount of $160,000 as a taxable dividend ($61,333 / 38.33%). Therefore, a capital dividend of $200,000 can be paid at the same time as the taxable dividend to the shareholders of Holdco.

- This result can be achieved because of circular calculations where the dividend received is deemed to be reduced by the application of subsection 55(2) after each calculation, resulting in a reduced Part IV tax whereas the amount of the tax refund remains the same at each calculation.

The CRA did not agree that the scheme of subsection 55(2) supports a circular calculation. Furthermore, the CRA takes the position that Part IV tax has priority over subsection 55(2). Subsection 55(2) does not apply to negate the consequences of Part IV. In the example described, the taxpayer would have CDA and excess of the refundable dividend tax on hand ("RDTOH") which may be accessed later. The CRA also noted that Holdco would have to file two returns in this case — the regular return and an amended one immediately following.

Multilateral Instrument

Concerning international measures, the CRA offered guidance to the implementation of actions aimed to reduce base erosion and profit shifting.

When Canada signed the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (the "MLI"), Canada chose the Principal Purpose Test ("PPT") as its method to address treaty abuse. The implementation date is 2019, and the CRA confirmed that it will supervise the implementation and provide rulings.

The CRA confirmed in Question 8 that the GAAR indeed applies to tax treaties and that the CRA has applied, and will continue to apply, GAAR to schemes designed to obtain treaty benefits inappropriately. It is unclear how the courts will interpret the differences in wording between the GAAR and the PPT, but the CRA is of the view that the test in the PPT must be read in relation to Article 6 of the MLI, which reads as follows:

> 1. Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement

The CRA suggested that the GAAR Committee may be a useful model to look to to ensure consistency in the application of the PPT. Additionally, the CRA confirmed that rulings on the PPT would be available once the MLI is implemented. However, the CRA did not comment on the Commentary to the draft OECD Model Tax Convention. The CRA made clear that the examples in the Commentary have yet to be approved.

Other Topics of Interest

Stock Option Deductions

In technical interpretation 2015-0572381E5, the CRA concluded that the stock option deduction in paragraph 110(1)(*d*) is not available where an employee receives treasury shares of a corporation having a value equal to the in-the-money value of the options upon surrender of the options. However, the technical interpretation did not include a discussion on subsection 110(1.1). In clarifying the details in the technical interpretation, the CRA in technical interpretation 2016-0672931E5 has since clarified that an election can be filed under subsection 110(1.1) such that the deduction in paragraph 110(1)(*d*) is still available.

Tax Shelters

The CRA confirmed that it would not provide advance income tax rulings concerning limited partnership financing arrangements involving the application of the at-risk rules in the context of a tax shelter. This is not an appropriate use for the rulings process. Information Circular IC 70-6R7 states that if it is primarily a factual matter and the facts cannot be determined at the time, the CRA will not provide a ruling.

Treatment of LLC in ULC structures under the Canada–US tax treaty

The CRA previously indicated that Article IV(6) of the Canada–US Tax Treaty (the "Treaty") does not apply to treat a particular amount as being derived by a US resident member of a US LLC where that amount is disregarded under US taxation laws.

The CRA confirmed that dividends paid by a Canadian unlimited liability company to US LLCs would not be eligible for treaty benefits. Article IV(7)(b) is an anti-avoidance provision in the Treaty. The Treaty would apply and override the results described. There is no reduction to the withholding tax rate. The withholding tax rate of 25% would apply.

Election not to be a public corporation

A corporation may elect under subsection 89(1) by filing form T2067 not to be treated as a public corporation. However, certain conditions under subsection 4800(2) of the *Income Tax Regulations* (the "Regulations") must be satisfied. One requirement provides that at the time of the election, for each class of shares, the insiders of the corporation must hold more than 90% of the issued and outstanding shares that were previously listed or designated. In certain circumstances, such as a situation where a private corporation ("Acquisitionco") acquires all of the shares of a publicly-listed target corporation ("Targetco"), the designated stock exchange may take several days to formally delist the purchased shares.

In Question 12 the CRA was asked whether Targetco could make a valid election not to be a public corporation prior to the formal delisting of its shares at a time when Acquisitionco owns 100% of Targetco. The idea is that when Acquisitionco and Targetco vertically amalgamate to form a new corporation ("Amalco"), Amalco would not be considered to be a public corporation. The CRA answered that it is comfortable with an election being made *after* the amalgamation. The CRA also assured that further rulings would be issued on this issue.

Section 116 procedures for tax-deferred disposition on foreign mergers

On September 16, 2016, Finance released draft legislation to provide a mechanism for deferral of recognition of gains and losses from disposition of shares of Canadian resident corporations caused by certain foreign mergers. This deferral would be available provided such shares are "taxable Canadian property" and do not constitute "treaty-protected property".

The following year, on October 25, 2017, Finance released revised legislative proposals which expanded the scope of the tax-deferral mechanism of subsections 87(8.4) and (8.5) to also include joint elections made in connection with dispositions of certain taxable Canadian property, other than treaty-protected property, that are interests in partnerships and interests in trusts. The revisions contain details concerning the joint election mechanism, which were not outlined in the original draft. The proposals of subsections 87(8.4) and (8.5) in Bill C-63 apply to foreign mergers that occur after September 15, 2016.

At the roundtable, the CRA confirmed that it will accept elections for the tax-deferred treatment of dispositions under proposed subsection 87(8.5) of the Act before the enactment of the legislation.

The joint election in proposed paragraph 87(8.4)(*e*) should be in writing and should include whatever pertinent information the taxpayers think is relevant. The CRA will not extend its position to exempt dispositions of shares in respect of which an election is made under proposed paragraph 87(8.4)(*e*) from section 116 notification procedures outlined in Income Tax Folio S4-F7-C1. The section 116 notification is still required. The CRA is prepared to issue section 116 certificates for the dispositions of such shares occurring after September 15, 2016. The notification does not require a valuation of the shares for a section 116 clearance certificate, but some justification to support the adjusted cost base calculation should be included in the election.

CRA Update on the Folio project

The CRA acknowledged that the folio project is taking longer than usual. Since the project started in 2013, 39 of the 265 IT bulletins have been updated. It is their hope that additional folios will be out soon.

Online authorization process

The CRA's online authorization process can be used to authorize representatives to access client accounts. The CRA requires that certain information contained in the request match information it already has on file. However, representatives and clients are facing difficulties verifying the authorized individuals the CRA already has on file, particularly for larger and non-resident corporations where employees regularly leave the company. This causes delays, repossessing requests, and resubmissions of change documentation. The CRA was asked to confirm whether they were aware of the problem.

The CRA confirmed that it is aware of this problem but does not anticipate making any changes to the current verification system. If the proper verification information is not in the system, then the representative will receive a rejection notice.

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

CRA Publishes Interest Rates for Q1 2018

The CRA has published the prescribed annual interest rates applicable from January 1, 2018, to March 31, 2018. These rates apply to amounts owed to the CRA and amounts owed by the CRA to individuals and corporations. Since Q4, no changes to the prescribed rates have occurred, except for the rate on corporate taxpayers' pertinent loans or indebtedness, which increased to 4.98% (from 4.75%).

CRA Publishes Final Policies on Updated Voluntary Disclosure Program

Earlier last year, the CRA published a draft information circular and GST/HST memorandum which outlined proposed changes to the Voluntary Disclosure Program ("VDP"), which were expected to take effect on January 1, 2018. The CRA has released finalized versions of these publications, and the new policies appear to have changed little since they were first introduced last year. Notably, the application date of these policies has been pushed back two months, so the new VDP rules apply to disclosures made on or after March 1, 2018. The updated policies can be found in draft Information Circular IC00-1R6, and draft GST/HST Memorandum 16.5.

CRA Announces 2018 Indexation of Personal Amounts

The CRA has announced the indexed personal amounts for 2018. The indexation increase for 2018 is 1.5%. This increase applies to the personal tax brackets, non-refundable and refundable tax credits, and the lifetime capital gains exemption limit, among others. The complete chart of indexed amounts is available on IntelliConnect.

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.

Shares Issued to a Partnership Less Than 24 Months Before Their Disposition Not Qualified Small Business Corporation Shares

***Gillen v. The Queen*, 2017 DTC 1099 (Tax Court of Canada)**

The *Gillen* decision of the Tax Court of Canada concerned the application of the 24-month holding period rule for qualified small business corporation shares, and in particular, how that rule applies when the small business corporation in question issues new shares to a partnership within the 24-month period preceding the sale of the shares by the partnership. *Gillen* confirms that, in such circumstances, in order for the issued shares to be considered as qualified small business corporation shares, the shares must have been issued to the partnership as part of a transaction or series of transactions in which the partnership disposed of property to the corporation that consisted of assets used in an active business by the members of the partnership. This decision has been appealed to the Federal Court of Appeal, which may ultimately provide further guidance regarding the interpretation of the relevant provisions of the *Income Tax Act* (the "Act").

Gillen involved a gain realized on the sale of shares of a corporation, Devonian Potash Inc. ("Devonian"), by a partnership, GDC Potash Holdings Limited Partnership (the "Limited Partnership"). The individual taxpayer, Don Gillen, had been involved in the oil and gas industry, and in the course of his career became interested in mineral rights related to potash, which is commonly used for fertilizer. As a result, in October 2007 the taxpayer directed a corporation of which he owned shares, Kinderock Resources Ltd. ("Kinderock"), to apply for permits from the Province of Saskatchewan which would allow for the exploration for potash in specific areas, although, as will be discussed below, permits were not actually issued until several months later. Also in October 2007, the taxpayer met with other individuals: an accountant (Bruce Carson) and a hockey agent (Brad Devine), who would work together with the taxpayer in the potash exploration project. A meeting was also held with Jim and Jason Mann (the "Manns"), who were involved in importing fertilizer.

In November 2007, Mr. Carson proposed a legal structure for the potash project that would allow the taxpayer, Mr. Carson, and Mr. Devine to claim the capital gains exemption without "being saddled with a two-year hold". This structure involved the creation of a new corporation, Devonian, rather than simply using Kinderock, because Kinderock had other assets. It also included the use of family trusts to allow for the participation of family members.

On December 7, 2007, several key agreements were made to implement Mr. Carson's proposed structure. First, trust agreements were entered into to create three family trusts, including the Gillen Family Trust (of which the taxpayer was the trustee and a beneficiary). Second, a partnership agreement was entered into to create the Limited Partnership, of which the three family trusts (including the Gillen Family Trust) were limited partners and Kinderock was the general partner. Third, the Court found as fact that the Limited Partnership acquired the potash applications from Kinderock on December 7, 2007, although it appears that no written agreement documenting this transaction was entered into evidence. Fourth, the Limited Partnership and Devonian entered into a "Subscription and Roll-Over Agreement" under which Devonian agreed to issue Devonian shares to the Limited Partnership upon the issuance of the potash permits (which had not occurred by December 7, 2007). Legal ownership of the permit applications could not be transferred from the Limited Partnership to Devonian on December 7, 2007, because this was not permitted by the relevant Saskatchewan legislation. As such, the Limited Partnership retained bare legal title to such assets but beneficial ownership to the applications and any related potash permits were transferred to Devonian on December 7, 2007.

In February 2008, a numbered company (the "Numbered Company") controlled by the Manns and another person offered to buy the Devonian shares, including any shares which were to be eventually issued to the Limited Partnership. According to the taxpayer's testimony, this offer "came out of the blue". An agreement was made under which the Numbered Company would acquire the Devonian shares after the potash permits were issued. In March 2008, certain potash permits were issued, and on March 31, 2008, Devonian shares were issued to the Limited Partnership in exchange for certain of the potash permits. On April 25, 2008, the Numbered Company acquired the Devonian shares. The Limited Partnership reported a gain on the sale of the Devonian shares of which about $3 million was allocated to the taxpayer as a beneficiary of the Gillen Family Trust. The taxpayer claimed the capital gains exemption on the basis that the Devonian shares were qualified small business corporation shares when they were sold by the Limited Partnership, a position which was contested by the Minister.

The disputed issue concerned the 24-month holding period requirement in the definition of "qualified small business corporation share" in subsection 110.6(1) of the Act. A "qualified small business corporation share" of an individual is a share that, throughout the 24 months immediately preceding its disposition, was not owned by anyone other than the individual or a person or partnership related to the individual. If this rule were read in isolation, it could not apply to "put offside" new shares issued to the individual as the shares would not have been owned by anyone other than the individual. But paragraph 110.6(14)(*f*) of the Act generally deems shares issued to a person or partnership to have been owned immediately before their issuance by a person who was not related to that person or partnership. Accordingly, when shares are issued in the 24 months prior to their disposition, the shares will not generally be qualified small business corporation shares at the time of the disposition. This anti-avoidance rule prevents the circumvention of the holding period rule.

That said, under clause 110.6(14)(*f*)(ii)(A) of the Act, the anti-avoidance rule described above will not apply if the shares were issued as part of a transaction or series of transactions in which the person or partnership disposed of property to the corporation that consisted of all or substantially all of the assets used in an active business carried on by that person or the members of that partnership. This exception to the anti-avoidance rule allows, for example, a sole proprietor or members of a partnership to transfer assets used in an active business to a corporation in exchange for issued shares, then to sell the business by selling the shares of the corporation, and still qualify for the capital gains exemption even if the issued shares were not held for more than 24 months. The particular question in *Gillen* was whether clause 110.6(14)(*f*)(ii)(A) was applicable.

The taxpayer advanced three main arguments in support of his position that the Devonian shares issued to the Limited Partnership were issued as part of a transaction or series of transactions in which the Limited Partnership disposed of property to Devonian that was comprised of all or substantially all of the assets used in an active business carried on by the Limited Partnership or its members. All of these arguments were rejected by the Court.

The first such argument was that, from the time that the first potash permit application was made in October 2007, an active business was being carried on by the taxpayer, together with Mr. Carson, Mr. Devine, and Kinderock, as a general partnership. According to this argument, the Limited Partnership was simply a continuation of the general partnership that existed prior to the formation of the Limited Partnership on December 7, 2007. The Court rejected this argument because the agreement which created the Limited Partnership stated that it was a new partnership and did not refer to any continuation of an existing partnership. In any event, the taxpayer was not a partner of the Limited Partnership; the partners of the Limited Partnership were Kinderock and the three family trusts. Finally, the evidence did not establish that any general partnership had been formed to carry on any business before December 7, 2007.

The second argument advanced by the taxpayer was that the potash permit applications and the permits were acquired by Kinderock on the Limited Partnership's behalf. Under this argument, the Limited Partnership owned the permit applications before December 7, 2007, and used them in an active business prior to their disposition to Devonian on December 7, 2007. The Court also rejected this argument on the ground that the Limited Partnership did not exist when the potash permit applications were made by Kinderock in October 2007. Indeed, the creation of a limited partnership was not even contemplated until it was proposed by Mr. Carson in November 2007. Accordingly, the potash applications could not have been made on the Limited Partnership's behalf.

The third argument advanced by the taxpayer rested on the distinction between legal and beneficial ownership. As noted above, the Devonian shares were not issued to the Limited Partnership until March 31, 2008, after certain potash permits were actually issued. Legal title to the potash applications was not transferred to Devonian on December 7, 2007. The taxpayer contended that, during the period from December 7, 2007, to March 31, 2008, the Limited Partnership retained ownership of the potash applications, which were used in an active business, thus satisfying the test in clause 110.6(14)(*f*)(ii)(A) of the Act. This third argument was also rejected based on the Court's factual finding that beneficial ownership of any rights related to the potash applications or permits was transferred to Devonian on December 7, 2007, and on Supreme Court of Canada authority holding that the beneficial owner of property is the property's "real or true owner". Some uncertainty as to the transfer of rights may have existed until the deal actually closed and the permits were conveyed on March 31, 2008, but under the "relation-back" doctrine applicable to transfers of equitable interests, once the agreement was completed, the trust relationship was solidified retroactively to December 7, 2007. Therefore, the Limited Partnership acquired the relevant potash assets from Kinderock on December 7, 2007, and instantly transferred its beneficial interest in such assets to Devonian. It could not be said that the Limited Partnership used the relevant assets in any active business after that time; clause 110.6(14)(*f*)(ii)(A) was therefore inapplicable. As a result, the Devonian shares were not qualified small business corporation shares when they were sold by the Limited Partnership, and the taxpayer's claim for the capital gains exemption was denied.

— *Theodore Stathakos*

Montminy Redux

***Montminy v. The Queen*, 2017 DTC 5092 (Federal Court of Appeal)**

This case is an appeal of a Tax Court of Canada decision concerning the deduction available under paragraph 110(1)(*d*) of the *Income Tax Act* (the "Act") to reduce by one-half the employment benefit that would otherwise arise on the exercise of options issued under an employment stock option plan. In this case, the employer was a Canadian-controlled private corporation ("CCPC"). The Tax Court perceived that the relevant regulations imposed a two-year holding requirement for CCPC shares received under the employer-granted option and the taxpayer was denied the paragraph 110(1)(*d*) deduction by the Tax Court on the basis of the failure to meet that requirement.

The facts of the case are relatively straight-forward. The employer, Cybectec Inc., was a CCPC that had adopted a stock option plan on May 1, 2001. The stock plan provided that options could be exercised only on an initial public offering or on the sale of all issued shares of Cybectec, failing which they could be exercised on the 10th anniversary of the grant of options. On December 17, 2001, Cybectec granted options, with an exercise price of $0.20 per share, to ten employees who each entered into an agreement with Cybectec with respect to the grant. On January 18, 2002, Cybectec granted options to an eleventh employee, for a total of 1,974,000 options granted to the eleven employees.

In early 2007, Cybectec received an unsolicited offer for the purchase of its assets from Cooper Industrial (Electrical) Inc. In light of Cooper's offer, and because Cybectec's two directors found it unjust that the affected employees should be prevented from exercising their options due to what, in their view, was a technical reason — i.e., the sale of the business took the form of an asset rather than a share deal — Cybectec resolved on January 10, 2007, to allow the exercise of options upon the sale of all or substantially all of its assets. Cybectec wrote to the employees to advise them that, following the asset sale to Cooper, the employees would be permitted to exercise their vested options and immediately resell the shares, consistent with the written agreements evidencing the grant of the options, to 9135-8184 Québec Inc., a corporation related to Cybectec, for $1.2583 per share.

On January 26, 2007, Cybectec sold all of its assets to Cooper, and on January 28, 2007, nine employees exercised their options and immediately sold the corresponding Cybectec shares to 9135-8184 Québec Inc. The shares were acquired for a total of $325,380 and sold for a total of $2,047,128.

The nine Cybectec employees who exercised their options would have realized employment income on the exercise of their options and seven of them claimed the paragraph 110(1)(*d*) deduction to reduce the amount of the associated employment benefit by half. (It should be noted that the similar paragraph 110(1)(*d*.1) deduction which is often associated with employment options granted by CCPC employers would not have been available under the circumstances given the immediate sale of the shares following the exercise of the options.)

In November 2010, the Minister reassessed the employees to disallow the paragraph 110(1)(*d*) deduction on the basis that two statutory requirements for claiming the deduction were not met: first, the optioned shares were not prescribed shares, and second, the fair market value of the shares at the time of grant of the options was higher than the $0.20 per share exercise price under the options. The reassessed employees appealed to the Tax Court.

In the Tax Court, the Minister's reassessment was upheld. Although the Tax Court found that the exercise price under the options was the fair market value of the Cybectec shares at the time of grant, it agreed with the Minister's conclusion that the shares received on the exercise of the options were not prescribed shares.

The Tax Court's (and Minister's) conclusion that the shares were not prescribed shares depended on the interpretation to be placed on subsections 6204(1) and (2) of the *Income Tax Regulations*. At a high level, subsection 6204(1) sets out three basic requirements for a share to be a prescribed share for purposes of the 110(1)(*d*) deduction, and subsection 6204(2) sets out some interpretative rules for evaluating the subsection 6204(1) requirements. Based on the wording in subsection 6204(1) alone, the Cybectec shares issued to the employees would not qualify as prescribed shares because they would fail one of the three requirements: namely, the requirement in paragraph 6204(1)(*b*) that Cybectec cannot reasonably be expected to acquire the issued shares within two years of their issuance. Thus, the principal dispute in the case revolved around the scope of paragraph 6204(2)(*c*), which would allow the employee's right to require Cybectec to acquire the option shares to be ignored for purposes of applying subsection 6204(1) in the circumstances, if certain conditions surrounding the granting of the put right are met.

The Minister conceded that the circumstances under which Cybectec agreed to purchase the employee shares were such that paragraph 6204(2)(*c*) would be engaged. However, the Tax Court accepted the Minister's position that the impact of paragraph 6204(2)(*c*) is restricted to interpreting the requirements in paragraph 6204(1)(*a*) and should not be taken into account when evaluating the requirement in paragraph 6204(1)(*b*) that Cybectec cannot be reasonably required to acquire the employee shares. Although the Tax Court's conclusion appeared to be inconsistent with the language used in subsection 6204(2), the Tax Court was satisfied that its interpretation was consistent with the wording of subsection 6204(1) and (2) taken together and what the Court perceived to be the tax policy underlying the regime in the Act for employment stock options.

On appeal, the Federal Court of Appeal reversed the Tax Court decision based on both a textual and contextual analysis of subsections 6204(1) and (2) of the *Income Tax Regulations*.

The Federal Court of Appeal's textual analysis focused on the Tax Court's examination of the structure of subsections 6204(1) and (2), which led to the lower court conclusion that the subsection 6204(2)(*c*) interpretative rule was directed at modifying the application of certain, specific paragraphs of subsection 6204(1) and not the subsection as a whole. The Federal Court of Appeal rejected the Tax Court's view that there needed to be a logical connection between paragraphs 6204(1)(*b*) and 6204(2)(*c*), stating that such an approach "goes against the language of paragraph 6204(2)(*c*) because it considers the obligation to redeem '[f]or the purposes of subsection [6204](1)', whereas it is specifically provided that this paragraph must apply 'without reference to [an] obligation to redeem'".

The Federal Court of Appeal's contextual analysis revolved around the Tax Court's conclusion that, from a tax policy perspective, the entitlement to the paragraph 110(1)(*d*) deduction appeared to be predicated on the employee being exposed to risk in respect of the shares and, in the Tax Court's view, there was no risk to the employees here without a two-year hold because the employees could avoid risk right up until they exercised the option.

The Federal Court of Appeal observed that employees incur risk while they hold the option. In the Federal Court of Appeal's view, Parliament chose to preclude the abuse of the preferential tax treatment of the benefit from employment stock option plans in two different ways. Paragraph 110(1)(*d*.1) of the Act, which allows the deduction that is normally available in respect of the employment benefit associated with shares under employment options issued by a CCPC, imposes a minimum hold period of two years following the acquisition of the shares in order to ensure that the employee incurs a risk comparable to that of an investor during that period. Paragraph 110(1)(*d*) of the Act employs an alternative approach that requires the shares be prescribed or "plain vanilla common shares" (i.e., without redemption or conversion rights or fixed dividends), to which the Federal Court of Appeal stated:

> The fact that a prescribed share must be "plain vanilla" prevents the improper use of particular share features once they are issued. For example, excluding shares with a right to redeem prevents the repeated grant of options followed by successive redemptions during periods of rapid growth.
>
> The other distinction that is of particular interest in this case relates to the exercise price of the option. Specifically, paragraph 110(1)(d) requires this price to be at least equal to the FMV of the shares under the option at the time of its grant (see subparagraph 110(1)(d)(ii) of the ITA). In this case, this price was 20¢ per share with the result that the option had no intrinsic value at the time of its grant.
>
> This requirement ensures that the growth of the value of the options held by the appellants between the time they were granted and the exercise date — i.e. from 20¢ to $1.2583 — is attributable solely to the growth of Cybectec between those two dates. It follows that in this case the option, which was without value the day of its grant because it was issued at par, fluctuated from that point on until the day of the exercise. Thus, insofar as the options are concerned, the appellants are in the same position as an investor holding this type of property. In both cases, the value of the options fluctuates according to the economic performance of the issuer, and the hope is that at the time of exercise, the shares will have a greater value than they did at the time of their grant.
>
> This is to be contrasted with paragraph 110(1)(d.1) which allows the exercise price of the option to be set below the value of the shares at the time of the grant. Under this scenario, there is no guarantee that the employee will be subject to a risk comparable to that of an investor." [emphasis added]

The fact that paragraph 6204(1)(*b*) imposes a requirement that it cannot be reasonably expected that the issuer will redeem, acquire, or cancel the share within two years of its issuance does not mean that Parliament was seeking to mandate a hold period on prescribed shares. The Federal Court of Appeal instead held that paragraph 6204(1)(*b*) should be interpreted as a provision that was designed to broaden the circumstances in which shares would be disqualified from being prescribed shares by virtue of an informal or unenforceable right to have the issuer acquire or redeem the share beyond the formal or enforceable rights that are identified in paragraph 6204(1)(*a*). There is nothing about that intended purpose of paragraph 6204(1)(*b*), which would imply that a two-year hold period would be an overriding requirement, when interpreting that provision.

— *Lorraine Allard*

Threat of Gross Negligence Penalty in Light of Alleged Unreported Capital Gain Is Not Duress

***Radelet v. The Queen*, 2017 DTC 1097 (Tax Court of Canada)**

The Tax Court of Canada determined in this case that the waiver of a limitation period provided by a taxpayer was enforceable despite the taxpayer's arguments to the contrary.

Mr. Radelet, the taxpayer, disposed of a commercial property in British Columbia in 2008. The Minister asserted that Mr. Radelet did not report the disposition and reassessed him, including in his income a taxable capital gain of $222,776. The Minister also disallowed a $400,000 business loss claimed in 2008 by Mr. Radelet. Mr. Radelet represented himself in the appeal. The Court divided the appeal into two parts due to Mr. Radelet's health difficulties, which required frequent breaks in the appeal proceedings: Part I concerned the validity and enforceability of the waiver provided by Mr. Radelet, and Part II concerned whether the reassessment was correct. In this decision, the Court addressed only Part I.

In 2011 and 2012, Mr. Radelet had spent the winter in Mexico to recuperate from various health difficulties. On November 15, 2011, the CRA sent Mr. Radelet a proposal to reassess. The proposal included disallowing the claimed business loss, including the taxable capital gain in income, and assessing gross negligence penalties. Mr. Radelet requested extra time to respond to the CRA's questions and was granted an extension to January 24, 2012. In January, he requested a further extension, until April 15, 2012, due to difficulties in retrieving documents while he was in Mexico. The CRA auditor agreed to the extension provided that Mr. Radelet filed a waiver to extend the normal three-year reassessment period. Mr. Radelet was advised by the CRA that if he did not sign the waiver, the proposed reassessment as outlined in the November 15th proposal letter would be levied. Mr. Radelet submitted the waiver on

January 31, 2012, and the CRA granted the extension. Shortly after submitting the waiver, Mr. Radelet sent a handwritten note to the CRA auditor to thank her for her patience and assistance.

After Mr. Radelet provided information regarding his cost base, capital cost allowance claims, and certain other information, the CRA issued a reassessment including the taxable capital gain in income and disallowing the loss claimed, but not imposing a gross negligence penalty. In Part I of his appeal to the Court, Mr. Radelet challenged the reassessment on the basis that it was statute-barred due to: (i) the waiver being invalid, and (ii) the reassessment being issued after the normal reassessment period.

In challenging the waiver's validity, Mr. Radelet raised three arguments:

(1) that he was coerced into signing the waiver under threat of the gross negligence penalty;

(2) that due to his health difficulties, he lacked the mental capacity to understand the waiver; and

(3) that he did not understand that the waiver extended the period for reassessment beyond the normal date.

The Court noted that a waiver can be set aside on the basis of coercion or undue influence if the CRA tried to mislead, threaten, or unduly pressure a taxpayer in obtaining the waiver (*Nguyen*, 2005 DTC 1673 (TCC)). The Court noted also that a waiver is unenforceable on the basis of coercion if it was more likely than not that the taxpayer did not freely consent or was unduly pressured to provide the waiver (*Nguyen*).

The Court found that Mr. Radelet was not unduly pressured, misled, or influenced. Mr. Radelet's communications with the CRA were cordial, as evidenced, for example, by his thank-you note, and it was not unreasonable for the CRA to include the gross negligence penalty in the proposed reassessment based on the CRA's position that Mr. Radelet failed to declare the disposition of valuable real property in his 2008 tax return.

The Court held that Mr. Radelet did not rebut the presumption that he had the mental capacity to contract, including to execute the waiver. Mr. Radelet did not present relevant information regarding how his health difficulties impacted his mental capacity. He executed the waiver form independently, and communicated clearly and professionally.

Despite the plain wording of the waiver, Mr. Radelet asserted that he did not understand that the effect of the waiver was to extend the reassessment period. Courts interpret waivers according to the intention of both parties, as expressed in the relevant documents and surrounding circumstances and from the perspective of an objective reasonable bystander. The Court held that an objective reasonable bystander would consider Mr. Radelet to have understood the waiver and its effect, since he independently filled out the form with relevant information, was granted a second extension on the condition that he file the waiver, and could have consulted his lawyer before completing the waiver.

The Court held that the waiver was enforceable, and ordered that Part II of the appeal should proceed. At the time that this case comment was written, the hearing for Part II had not yet been scheduled. While the Court demonstrated sympathy towards Mr. Radelet by bifurcating his claim, it was not willing to accept Mr. Radelet's unsubstantiated submissions as to why the waiver was invalid.

— *Alyssa Novoselac, Articling Student*

Defendant Law Firm Named in Class Action Lawsuit for Providing Tax Opinion to Fraudulent Investment Entity Awarded Over $300,000 in Costs

***Schneider v. McMillan LLP et al*, 2017 DTC 5099 (Saskatchewan Court of the Queen's Bench)**

In this decision, the Saskatchewan Court of the Queen's Bench considered whether to grant McMillan LLP, as the successful defendant in a class action lawsuit, costs on a substantial indemnity basis. The defendant law firm sought to recover $629,837 in costs, representing approximately 40% of its total defence costs. This amount included double costs for certain items under Tariff Column 3 of Schedule I "B" to *The Queen's Bench Rules* on the basis that the items were incurred after the defendant law firm had served on the plaintiff a formal offer to settle. The defendant law firm sought to apply an additional discretionary cost multiplier under the *Class Actions Act* (Saskatchewan).

In the decision giving rise to this cost proceeding (2017 DTC 5002 (SKQB)), the Court had considered whether the defendant law firm owed a duty of care to the investor plaintiffs when it issued an opinion to and for the benefit of a fraudulent investment entity (Royal Crown Gold Reserve Inc.) concerning the entitlement of investors to deduct Canadian Development Expenses. The Court concluded that the defendant law firm did not owe a duty of care to the investor plaintiffs, and, in any event, the defendant law firm had neither acted negligently when they provided the opinion in respect of the Canadian Development Expenses nor caused the losses incurred by the investor plaintiffs by providing the opinion.

The claim was certified as a class action in 2012, at a time when Saskatchewan was a "no costs" jurisdiction for class actions, with the only exception to the prohibition on costs being judicial orders in respect of vexatious, frivolous, or abusive conduct by a party. On May 14, 2015, during the course of the class action proceeding, the *Class Actions Act* (Saskatchewan) was amended to make Saskatchewan a "costs" jurisdiction by restoring judicial discretion to award costs in class action proceedings. On June 25, 2015, the defendant law firm served on the plaintiff a formal offer to settle, which was not accepted.

As amended in 2015, section 40 of the *Class Actions Act* entitles the Saskatchewan Court of the Queen's Bench (or the Court of Appeal) to award costs that it considers appropriate with respect to any application, action, or appeal pursuant to the *Class Actions Act*. Subsection 40(2) lists certain enumerated factors that the Court may take heed of in exercising that discretion, namely, whether or not:

- the public interest is engaged;
- the action involves a novel point of law;
- the action is a test case;
- the case concerns access to justice for members of the public using class action proceedings;
- or any other factor that the Court considers appropriate.

The Court found that the case was not one which met the criteria of being a matter of public interest litigation, given that its outcome was of significance only to class members and had no specific significance to the public at large. Instead, the Court stated that the action was undertaken for the potential financial benefit of the plaintiff class members rather than for some public benefit.

The Court further concluded that the case did not involve a novel point of law. In the Court's view, the case giving rise to the costs proceeding had simply been an application of the test in *Anns v. Merton London Borough Council* ([1978] All ER 492 (HL)) to a particular fact situation in order to determine if the defendant law firm owed a duty of care to the plaintiff investors, and, if so, whether the defendant law firm had acted negligently in respect of that duty of care.

As the action was not one litigated to resolve an issue applicable to pending or anticipated litigation, the Court also concluded that it was not a test case within the meaning of paragraph 40(2)(*d*) of the *Class Actions Act*. Paragraph 40(2)(*d*) requires the Court to consider whether the action engaged access to justice matters for the public using a class action proceeding. The Court considered the *Kerr v. Danier Leather Inc.* case (2007 SCC 44) for the proposition that not all class action cases engage access to justice matters.

As an example of a proceeding engaging an access to justice issue, the Court described a situation in which widespread damage was done to the public with a financial impact that could not justify plaintiffs each initiating separate proceedings. The Court considered the limited class of affected individuals (some 400 investors), the lack of due diligence taken on their part, and the speculative nature of the investments before stating that investors should be expected to factor into their investment decisions the potential for having to pursue judicial remedies and to bear the costs of such proceedings.

The Court further stated that even if access to justice concerns weighed in favour of the plaintiffs, the presence of one or more factors enumerated in subsection 40(2) would not prevent the Court from awarding costs to a successful defendant to a legal proceeding, noting that defendants too have access to justice rights.

As Saskatchewan had changed from being a no costs jurisdiction to a costs jurisdiction during the course of the class action proceeding, the Court noted that it was within the Court's exercise of its discretion under paragraph 40(2)(*e*) to take heed of the change as a factor to be weighed in the fixing of costs.

The Court considered the structure of the costs rules in Part 11 of *The Queen's Bench Rules* before determining how the existing jurisprudence on costs should be applied in light of the legislative changes in section 40 of the *Class Actions Act*. The defendant law firm had argued that, pursuant to rule 4-31, it should be awarded double costs for all steps of the proceeding that occurred after it had made a valid offer to settle within the meaning of Part 4, Division V of *The Queen's Bench Rules*. The Court noted that subrule 4-31(3) does not lead to a presumptive entitlement to double costs where the Court has been asked to make a costs ruling under rule 11-1, which allows the Court to increase costs based upon a multiplier against costs assessed under a column of the Tariff. Subrule 11-1(4) lists a number of factors the Court may consider when exercising its discretion under rule 11-1, including a written offer to settle as well as any other matter it considers to be relevant.

In respect of its offer to settle, the defendant law firm argued that when the offer was tabled, the plaintiff should have been aware that the case was going to turn on settled legal principles (the *Anns* test), and that it would be difficult for the plaintiff to sustain its factual assumptions about the retainer between the defendant law firm and Royal Crown Gold Reserve Inc.

The plaintiff countered by arguing that it had received four rulings in respect of its action supporting its view that there was no guarantee of a successful defence by the defendant law firm (on a motion to strike, the certification proceeding, an appeal of the certification decision, and an attempt by the defendant law firm to decertify the claim).

Citing the Saskatchewan Court of the Queen's Bench decision in *Houweling Nurseries* (2011 SKQB 181), the defendant law firm had requested a 0.5x multiplier be added to a Column 3 Tariff calculation of costs. In the present fixing of costs, the Court rejected the defendant law firm's request for the additional 0.5x multiplier and provided a number of reasons why *Houweling Nurseries* should not be applied. These reasons included the fact that, in the Court's view, the then-Tariff and cost entitlement in *Houweling Nurseries* was out of date with the current economic realities of litigation and that the changes to the cost rules had been intended to only partially indemnify a successful party's costs of a proceeding.

The Court weighed the factors and, after considering the appropriateness of amounts tabled for recovery in respect of expert witnesses, concluded that the defendant law firm should be entitled to a cost award of $309,324.00. The Court weighed the adverse impact to the plaintiff of the change to the cost rules that had occurred with retroactive effect during the course of the action. The Court stated that this adverse impact to the plaintiff was enough to offset the additional cost multiplier to which the defendant law firm might otherwise have been entitled based on the length and complexity of the litigation and the offer of settlement made by the defendant law firm.

In addition to the Court's determination that negligence proceedings against tax lawyers did not, at least in this case, qualify as matters of public interest, of note to tax practitioners may be the reasoning of the Court in response to submissions by the defendant law firm that it deserved a larger cost award as, in its view, it should never have been put to the burden of defending an unmeritorious claim. The Court stated that, at least in the present case, the simple fact that the plaintiff's claim was found lacking should not be enough to entitle the defendant law firm to costs on a substantial indemnity basis. The Court's reasoning was based in part on the logic that the practice of tax law (as well as other complex, specialized, and correspondingly remunerative areas of law) carries with it the risk of being embroiled in a negligence proceeding and that tax practitioners should factor that risk into the business decision of what price to charge for services rendered.

— *Justin Shoemaker*

RECENT CASES

Penalty assessed for failure to file T1134 upheld on appeal

The corporate taxpayer, which held 28% of the issued and outstanding shares of a Bermudian company, failed to file its required T2 corporate income tax returns for the 2006 through 2011 taxation years. Owing to that failure to file, the Minister issued an arbitrary assessment for the 2006 taxation year. The taxpayer then filed returns for all of the outstanding years in order to claim accrued losses. With the consent of the taxpayer, the Minister reassessed on the basis of those returns, and also imposed penalties for the taxpayer's failure to file T1134 returns. The taxpayer appealed from the imposition of those penalties.

The appeal was dismissed. The Tax Court of Canada held that the two issues for determination were whether the Minister was statute-barred from levying the disputed penalties and whether the taxpayer fell within the requisite definitions and thresholds obligating it to file the T1134 returns. On the first issue, the Court concluded that the evidence provided had established, on a balance of probabilities, that the appellant had misrepresented its income in a return, by failing to disclose income in all of the penalty years. That misrepresentation was sufficient at law to provide the Minister with the authority to open the statute-barred year and to levy the penalty in respect of all penalty years. The Court then considered whether the requisite value thresholds which would create an obligation to file a T1134 had been met and concluded that they had. The Court reviewed the definition of a "dormant" or "inactive" foreign affiliate (which would be exempt from the filing requirement) and held that, based on the appellant's cost amount of the Bermuda property, such property did not so qualify. In reaching that conclusion, the Court reviewed the evidence relating to the various share valuations provided for that affiliate and held that such evidence prepared at the relevant times was to be preferred to similar evidence assembled several years later. That contemporaneous evidence established to the Court's satisfaction that the value or cost of the property during the penalty years was well above the required minimum set out in the legislation which was necessary to trigger the T1134 filing requirement. The Court held as well that the evidence clearly showed that the assumptions of the Minister respecting the ownership of the Bermuda company had not been displaced and were "most probably correct". The Court concluded that the appellant was a reporting entity holding specified foreign property in a foreign affiliate for each of the penalty years, and that the cost amount of such foreign property exceeded the statutory threshold. The appellant was therefore required to file T1134 returns for each of the years in question, and the Minister properly assessed penalties for the appellant's failure to do so.

RAR Consultants v. The Queen

2017 DTC 1134

Taxpayer providing insufficient evidence to establish entitlement to bad debt deduction

The taxpayer, who had a dental practice, failed to file his 2002 through 2006 tax returns on a timely basis. The Canada Revenue Agency issued arbitrary assessments, and began collection actions in late 2005. Those collection actions included garnishment of the taxpayer's business bank account as well as amounts payable to the taxpayer by dental insurers. To avoid the effects of the garnishment orders, the taxpayer asked insured patients to file insurance claims themselves and then to remit amounts received from insurers to him. However, the taxpayer fell behind in billing and collection of amounts owed to him, and his home and business premises were lost to foreclosure. A Notice of Loss Determination was issued by the Minister in respect of the taxpayer's 2008 taxation year, and the taxpayer appealed from that Loss Determination on the basis that he was entitled to a deduction for bad debts for that year, in the amount of $126,214. That amount was calculated as the difference between the amount he reported on his tax returns for the 2005 to 2008 taxation years as income for work billed and the amount he was able to collect for that work.

The appeal was dismissed. The Tax Court held that in order to succeed in a claim for deducting a bad debt, the taxpayer is required to show that a debt exists, that the debt in issue was included in income for the year the deduction is claimed or a previous year, and that the debt became a bad debt in the taxation year in which it is claimed. The jurisprudence provides that a debt becomes a bad debt when the taxpayer determines that the debt is uncollectible and has, in making that determination, acted reasonably and in a pragmatic, business-like manner,

applying the proper factors. Accordingly, the onus was on the appellant to establish, on the balance of probabilities, that there was a debt owing to him, that it was included in the computation of his income for the 2008 taxation year or a previous year, and that it had become bad in the year it was claimed. The Court concluded, following a review of the evidence provided by the appellant and his spouse, that he had not met that onus. In the Court's view the evidence, which consisted only of the testimony of the appellant and his spouse, was far from convincing. The Court noted that no accounting records of the dental practice were placed into evidence. Such evidence as was provided did not allow for the identification of specific debtors or the amount that each debtor owed and such information was, in the Court's view, essential to proving the existence of the debts. As well, it was not possible for the appellant to have made a determination that a debt or debts had become uncollectible without knowing who his debtors were or the amount that they owed to him. There was no way of assessing the accuracy of amounts claimed in the absence of business records from the appellant's practice, and the Court concluded that the appellant had not shown, on a balance of probabilities, that he was owed the amount claimed or that such debts became bad during the 2008 taxation year.

Hokhold v. The Queen

2017 DTC 1135

Claim of Minister of National Revenue having priority over holdback amount

An application was brought seeking direction with respect to conflicting demands for a holdback amount payable by the applicant to a bankrupt company. The Minister of National Revenue had claimed priority with respect to approximately two-thirds of such amount, under the "enhanced requirement to pay" provision in section 224 and the "deemed trust" provision in section 227 of the federal *Income Tax Act*. The validity of the Minister's claim was disputed by various lienholders, who also claimed priority with respect to the holdback amount.

The Minister's claim for the holdback amount had priority. The Master in Chambers held that the jurisprudence supported the priority of the Minister over the lienholders where the available funds were insufficient to satisfy all claims. In making that decision, the Master in Chambers held that the bankrupt company had completed its contract with the applicant and that it was therefore owed the holdback amount in issue, at common law. The Minister's attachment of that receivable, to the extent of the Minister's claim, was therefore valid. An order was issued directing the applicant to pay the lien holdback amount into Court and providing that an amount equal to the Minister's claim be released to the Minister. The remaining funds were available to satisfy the claims of the lienholders.

Canadian Natural Resources v. Thermal Energy et al.

2017 DTC 5129

Appellants bound by terms of Settlement Agreement reached with Minister

Each of the appellants was involved in film production activities and was part of a larger group which included four master limited partnerships ("MLPs"), and, within each of those master limited partnerships, several production services limited partnerships ("PLPs"). The MLPs were associated with one another by virtue of common promoters. Following an audit of the 2000 and 2001 taxation years, the Minister raised concerns regarding certain deductions claimed, and, in particular, whether such expenses met the reasonableness standard. Negotiations took place, following which a Settlement Agreement was entered into and signed by a representative of the Canada Revenue Agency and a representative of the four MLPs and their related PLPs. That Settlement Agreement set out the specific terms of reassessments to be issued. When those reassessments were issued, however, two of the MLPs and their associated PLPs appealed, disputing the Minister's interpretation of the Settlement Agreement and arguing that it was unenforceable against them. Their appeal to the Tax Court was dismissed, and they appealed further to the Federal Court of Appeal.

The appeal was dismissed. The appellate Court held that the central issue was the interpretation of the Settlement Agreement and that such question was reviewable on a standard of palpable and overriding error. The Court held that the Tax Court judge had not erred in finding that the Settlement Agreement applied to the appellants. The Tax Court judge had concluded as well that the wording of the Settlement Agreement meant that the same ratio of disallowed expenses would apply to each of the partnerships, including the appellants. The Federal Court of Appeal concluded that, based on the wording of the Agreement and the evidence before the Tax Court, there were no grounds warranting the Court's intervention with respect to the Tax Court judge's interpretation of the wording of the Settlement Agreement, its enforceability, and its application.

University Hill Holdings et al. v. The Queen

2017 DTC 5131

Appeal from denial of Guaranteed Income Supplement dismissed

The taxpayer was denied receipt of a Guaranteed Income Supplement ("GIS") for the 2014–15 benefit year on the basis that his income for the base year of 2013 exceeded the statutory eligibility threshold. During 2013, the taxpayer had received an amount as a lump sum from a retirement savings plan ("RSP"). In computing the taxpayer's income for the year, the Minister had concluded that such amount did not constitute "pension income", which would be excluded from the income calculation for GIS purposes. The taxpayer appealed from that decision.

The appeal was dismissed. The Court noted that the taxpayer had been a member of a registered pension plan who had transferred funds from that plan to a locked-in retirement fund. Some years later, a smaller amount was transferred to the unlocked RSP from which the withdrawal was subsequently made. The question for determination was the proper characterization of the nature of the withdrawn amount and whether it was required to be included in income for purposes of determining GIS eligibility. The Court held that the documentation relating to the account from which the withdrawal was made was unambiguous in stating that account to be an RSP account, and that the generated T4 RSP clearly identified the investment, withdrawal, and payment as an RSP withdrawal, as opposed to pension income as an annuity payment. In the Court's view, the fact that the "heritage" of the RSP was originally intended to be an annuity under the former registered pension plan, but was converted by the taxpayer, did not alter that characterization. As well, there was no jurisprudence to support the appellant's argument. The Court concluded that the amount was a lump sum withdrawn from an RSP, not a converted periodic annuity paid monthly over a statutorily mandated annuity term. The Court noted that the purpose behind the differentiation of treatment for pension annuity income and RSP withdrawal was neither readily identifiable nor necessarily fair, but that it was clear. Periodic annuity payments in the form of pension income need not be included for GIS income purposes, but RSP withdrawals must be. Accordingly, the Minister's determination of income for the base year of 2013 to include the RSP payment was correct, and the resulting decision to deny GIS benefits stood.

McArthur v. Minister of Employment

2017 DTC 1128

Filing of federal T2029 held to be valid waiver of provincial limitation period

The taxpayer, which had appealed from a reassessment of its provincial income tax, brought a motion seeking summary judgment on that appeal. Its motion was based on an argument that the reassessment had been issued after the expiry of the applicable provincial limitation period, and that its filing of a T2029, the federal limitation waiver form, did not operate to waive the provincial limitation period. Its motion was dismissed, with the motions judge finding that while the relevant limitation period had passed, a valid waiver of that limitation period had been filed by the taxpayer. The taxpayer appealed from that decision to the Ontario Court of Appeal.

The appeal was dismissed. The appellate Court held that the combined operation of section 10 of the Ontario statute (which adopts certain provisions of the federal *Income Tax Act*) and subsection 152(4) of the federal *Income Tax Act* permits reassessment of Ontario tax outside the normal reassessment period where the taxpayer has filed with the Minister a waiver in prescribed form. Subsection 48(15) of the Ontario *Income Tax Act* provides that "every form purporting to be a form prescribed . . . by the Provincial Minister shall be deemed to be a form prescribed by order of the Provincial Minister under . . . [the Ontario] Act unless called in question by the Provincial Minister or by some person acting for the Provincial Minister or Her Majesty." The motions judge had noted that, given the existence of a long-standing collection agreement between the Ontario government and the Federal government, by operation of subsection 1(1) of the Ontario Act, "Provincial Minister" in subsection 48(15) of the Ontario Act means the Minister of National Revenue for Canada. The appellate Court agreed, finding that on a proper reading of subsection 48(15), waiver Form T2029 "shall be deemed to be a form prescribed by order of the [Minister of National Revenue] under this Act." In the appellate Court's view, the clear meaning of that provision was that the form purporting to be "prescribed or authorized by the [Minister of National Revenue] shall be deemed to be . . . prescribed by order of the [Minister of National Revenue]" under the Ontario *Income Tax Act*. The Court of Appeal concluded as well that there was no evidence that the relevant form had been "called into question by the Provincial Minister or by some person acting for the Provincial Minister or Her Majesty." The appeal was therefore dismissed, with costs to the respondent.

Dan Family Trust v. Ontario (Finance)

2017 DTC 5128

Minister's refusal to waive RRSP overcontribution penalty reasonable

The taxpayer had made contributions to his RRSP for the 2003 and 2004 taxation years. Such contributions were made on the basis of third-party advice, and the taxpayer was unaware that he had no RRSP contribution room for those years. The taxpayer ultimately withdrew the overcontributions and reported the amount of those withdrawals as income on his return for 2010. He also sought to claim a deduction for the previously undeducted portion of the overcontributions. The Minister denied the deduction and the taxpayer appealed to the Tax Court. The Tax Court allowed his appeal with respect to the 2004 taxation year but dismissed the appeal for 2003, as the taxpayer had missed the deadline for the withdrawal of the 2003 overcontribution. The Minister also assessed penalties under section 204.1 of the *Income Tax Act* in respect of the excess RRSP contributions made by the taxpayer in 2003 and 2004. The taxpayer sought but was denied administrative relief from such penalties for the 2003 to 2010 taxation years. The denial of relief was based on the Minister's view that the taxpayer had failed to demonstrate "reasonable error" and had not shown that "reasonable steps were taken to eliminate the excess" by eliminating that excess "as quickly as possible". The taxpayer applied for judicial review of that denial.

The application was dismissed. The application for judicial review alleged that the Minister had made errors of law, had made erroneous findings of fact, and had rendered an unreasonable decision, and that such decision was made in a procedurally unfair manner. The Federal Court, while sympathetic to the taxpayer's circumstances, held that persons who participate in a deferred income plan such as an RRSP are expected to demonstrate a certain level of knowledge related to that investment, and that the reasonable taxpayer must exhibit the qualities of due diligence. As well, the jurisprudence indicates that the Court has consistently refused to acknowledge any concept of waiver of taxes, penalties, or interest based on the conduct of third parties and that there is no such doctrine as a "reasonable mistake of law". The Court reviewed the factual circumstances and the history of events leading to the Minister's decision, and concluded that such decision could not be characterized as unreasonable, or as containing an error in law or being based on erroneous findings of fact. In addition, the decision was not, in the Court's view, made in a procedurally unfair manner. The Court was therefore required to dismiss the taxpayer's application. Given the significant and exceptional financial losses sustained to the retirement finances of the taxpayer and his spouse, the Court held that an order for costs was inappropriate.

Connolly v. MNR

2017 DTC 5127

Minister's decision to deny transfer of tax credits not meeting reasonableness standard

The corporate taxpayer had failed to file required corporate income tax returns for the 2006 to 2010 taxation years on a timely basis. The Minister issued arbitrary assessments which resulted in the taxpayer owing a total of $97,728 and, through a combination of payments made by the taxpayer and garnishment of third party amounts, the Minister was able to collect a total of $100,142, which was applied to the assessments. In 2011, the taxpayer filed the outstanding returns and the assessment of those returns resulted in a substantial credit balance for the taxpayer. However, as the returns had not been filed within three years of the applicable tax year-ends, the Minister could not issue refunds of that credit balance. The taxpayer requested that the Minister exercise the discretion provided by section 221.2(2) of the *Income Tax Act* to re-appropriate that credit balance and apply it to the taxpayer's harmonized sales tax ("HST") account, which was in arrears. The Minister refused that request and the taxpayer applied for judicial review of the Minister's decision.

The application was allowed. The parties were agreed that a decision on whether to allow the re-appropriation of statute-barred credits was within the Minister's discretionary authority, and the Federal Court held that such decision was reviewable on a standard of reasonableness. The Court held as well that the Minister, in exercising such discretionary authority, was required to consider the relevant circumstances surrounding the application. The Court reviewed the documentation leading to the Minister's decision and concluded that such decision was based entirely, or nearly so, on consideration of the taxpayer's history of delinquency in its tax filings and whether there were extraordinary circumstances which explained or excused such delinquency. The Court held that while it could not characterize such factors as irrelevant, they were not the only considerations which should have been taken into account. In the Court's view, and as held in the jurisprudence, it was necessary for the Minister to have also considered the importance of having tax debts paid. Specifically, the Court held that it was consistent with the overall purpose of the *Income Tax Act* that section 221.2(2) be interpreted such that the retirement of outstanding tax debts was an important factor to be taken into account in the exercise of the Minister's discretion. The submissions made by the taxpayer had identified not only the financial hardship that would be sustained by the taxpayer if the re-appropriation request was refused, but also the resulting possibility that the HST liability would not be paid. In the Court's view, the record did not demonstrate that the Minister had taken into account the fact that granting the request would result in the outstanding HST tax debt being retired, and the fact that the taxpayer's financial circumstances were such that it was possible that such HST arrears would not otherwise be paid. In the Court's view, the Minister's failure to consider all the relevant circumstances led, particularly in light of the jurisprudence, to the conclusion that the decision failed to meet the reasonableness standard. The application was therefore allowed and the matter returned to the Minister for redetermination.

Pomeroy's v. AG of Canada

2017 DTC 5126

Defendant found not guilty of fraud and tax evasion

The individual defendant carried on business through his companies between 2006 and 2008. He was charged, personally or as a director of those companies, with failing to remit employee source deductions and HST amounts, failing to declare income for personal income tax purposes, and fraud. It was alleged by the Crown that the individual defendant had re-purposed such funds to his own uses. The defendant acknowledged the failure to remit employee source deductions and HST, but argued that he had no fraudulent or criminal intent and that the failure to remit was due to financial hardship resulting in a lack of funds.

The defendant was acquitted on all counts in the Information. The Court held that its assessment of the charges came down to the question of whether the Crown had proven the elements of fraud and tax evasion beyond a reasonable doubt. The Court reviewed the history of the companies which had been incorporated by the defendant, including the history of their financial difficulties. It concluded, based on the evidence, that there were valid reasons for the Canada Revenue Agency to be suspicious of the taxpayer and to question his truthfulness in relation to the payment of source deductions and HST remittances. However, the Court concluded that the Crown's case did not succeed. Indeed, in order to find guilt, the Court needed to be satisfied that the defendant's evidence about his intentions did not raise a reasonable doubt, but the Court was unable to identify any evidence that showed the defendant's statements to be untrue and, in some instances, there was support for his testimony in the evidence. A finding of guilt required a very high standard of proof and the Court was not satisfied, on the whole of the evidence, that such standard had been met. The Court then considered the charges related to personal income tax and reached a similar conclusion. While the defendant had failed to file as required, the Court was not satisfied on the evidence that the Crown had proven beyond a reasonable doubt that the taxpayer's non-filing was done for the purpose of evading the payment of his taxes. Overall, the Court concluded that the evidence came close to establishing the probability that the defendant was actively engaged in trying to dodge the legal requirements to pay source deductions and HST. However, a finding of probability was well below the standard required for proof beyond a reasonable doubt. The Court's examination of the whole of the evidence, including the defendant's testimony, led it to conclude that there were reasonable inferences to be drawn from it other than the defendant's guilt for fraud and tax evasion. Accordingly, the defendant was acquitted on all counts.

R. v. Spears

2017 DTC 5123

Appeal dismissed where amount paid by taxpayer not deemed to be interest

A predecessor corporation to the appellant taxpayer sought to acquire a corporation known as Encor, but at that time Encor was liable to a third party for the payment of $225 million under a pre-existing loan arrangement. As a condition of the acquisition transaction, Encor paid the predecessor corporation the amount of $17.5 million, in exchange for which that corporation agreed to assume Encor's obligations under the pre-existing loan. The appellant taxpayer sought to deduct as interest the amount of $1,043,700, which was determined by applying a simple interest rate to the $17.5 million that its predecessor corporation received from Encor. That deduction was denied by the Minister on assessment, and the taxpayer appealed.

The appeal was dismissed. The Tax Court of Canada held that the issues for determination were whether the amount claimed by the appellant was deemed to be interest under subsection 16(1) of the *Income Tax Act*, and, if so, whether such interest amount was deductible under section 20(1)(*c*) of the Act. In making that determination, the Court was required to consider whether it was possible, under section 16(1)(*a*), for an amount to be classified as deemed interest for the debtor and capital for the creditor. The Court reviewed the wording and history of section 16(1)(*a*), as well as the relevant jurisprudence, before concluding that the asymmetrical application of that provision argued for by the appellant was antithetical to its intent and purpose, and that there was no indication that Parliament intended that symmetry in the application of the provision to be deviated from. In the Court's view, subsection 16(1) was an anti-avoidance provision that was intended to apply where an agreement does not explicitly identify an amount as being interest and that amount can reasonably be regarded, in the circumstances, to be interest for both parties. The Court concluded that the appellant's approach placed too much weight on its construction of the alleged economic substance of the agreement, and that the broad interpretation of scope of the application of subsection 16(1) proposed by the appellant was not consistent with a textual, contextual, and purposive interpretation of that provision. For those reasons, the appeal was dismissed.

Plains Midstream v. The Queen

2017 DTC 1125

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