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**Tax Notes**

Report No.: 663

**Date:** April, 2018

# PLEADING NOT GILTI—DEFERRAL STRATEGIES FOR CANADIAN RESIDENT US CITIZENS

*- –Max Reed*[1]

The new US tax rules will make US citizens in Canada who run a business feel GILTI. GILTI is an acronym for "Global Intangible Low-Taxed Income". GILTI is part of the new US international corporate tax regime. Under the new US corporate tax system, US corporations like Apple are now generally only being taxed on the income of the US company itself, and dividends received from a foreign subsidiary are tax free. The purpose of the GILTI regime is to make sure that companies like Apple do not try to shift profits from the US to foreign subsidiaries in a low-tax country to then be repatriated back to the US tax free. That's a laudable goal as applied to Apple and other large multi-nationals, but as is often the case, US individual taxpayers living abroad are also caught up in these complicated rules.

This article does not purport to describe all of the details of the GILTI regime. That has been done very well in other articles. Instead, I set out a few key details and then outline some planning ideas to try and preserve as much total tax deferral as possible. The central thrust of the article is that for many US citizens in Canada and their advisors, GILTI is so complex and punitive that it may be wise to adopt a plan that sidesteps it entirely rather than trying to navigate the regime. For those with a higher tolerance for complexity, an election under US Internal Revenue Code section 962 may provide some relief.

The article is organized as follows:

- Basics of the GILTI regime
- Option 1—Renounce US citizenship
- Option 2—Convert the Canadian corporation to an unlimited liability company ("ULC")
- Option 3—Subpart F position
- Option 4—Restructure share ownership of the company
- Option 5—A Code section 962 election
- Conclusion

To start out, let's review the basics of the GILTI regime and its implications.

## OVERVIEW OF THE GILTI REGIME

This section summarizes some, but not all, of the important details of the GILTI regime. For a full description, I suggest the article "A New Tax Regime for C.F.C.'s: Who Is G.I.L.T.I.?" by Elizabeth V. Zanet and Stanley C. Ruchelman, who have done an excellent job of outlining the technical mechanics of the GILTI formula.[2]

*a. Who the GILTI regime applies to*

The GILTI regime applies to US taxpayers (including individual US citizens resident in Canada) who are US shareholders in a controlled foreign corporation ("CFC"). A CFC is a foreign corporation where more than 50% of the voting power or value of stock is owned by "US Shareholders". A "US Shareholder" is a US taxpayer who owns 10% or more of the votes or value of the total shares of a foreign corporation. Thus, the GILTI rules apply to a US citizen in Canada who owns 10% of a corporation that is more than 50% owned by US taxpayers who each own at least 10%.

*b. Basics of the GILTI formula*

Overly simplified, profits are GILTI if they exceed a 10% return on depreciable tangible assets owned by the corporation. While the formula is complex, it essentially works as follows:

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GILTI = Net CFC tested income – net deemed tangible return income.
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Net CFC tested income is essentially the profits of the CFC. This includes active business income. Net deemed tangible return income is a complex formula that is discussed briefly below, but a more detailed description can be found in the Zanet and Ruchelman article. Certain types of income are categorically not GILTI. This is addressed next.

*c. There is no high tax exception to the GILTI formula*

Certain types of income are excluded from the GILTI formula:

- Income that is effectively connected to a US trade or business;
- Subpart F income;
- Income that is excluded from foreign base company income[3] by virtue of the high tax exclusion found in Code section 954(b)(4);
- Dividends from a related person; and
- Foreign oil and gas extraction income.

Of these, the most relevant and confusing is the third bullet point. It is important to note that, unlike Subpart F, the statutory language does not provide for a general high tax exclusion that would apply to all income. Instead, the high tax exclusion only applies to income that would otherwise qualify as foreign base company income. Here is the technical logic for that conclusion. Code Section 951A(c)(2)(A) sets out what items are not included in net CFC tested income (the income that is part of the GILTI formula). More specifically, Code section 951A(c)(2)(A)(i)(III) reads:

> … any gross income excluded from the **foreign base company income** (as defined in section 954) and the insurance income (as defined in section 953) of such corporation by reason of section 954(b)(4).

This cannot be read as a general high tax exclusion for GILTI income. Instead, it means that income that would otherwise be foreign base company income or insurance income, but is excluded from foreign base company income by reason of the high tax exclusion in Code section 954(b)(4), is not included in the GILTI formula. Because the active business income of a CFC would not normally fall under the category of foreign base company income, even absent the Code section 954(b)(4) exclusion, it is not excluded from foreign base company income by reason of section 954(b)(4). Therefore, there is no blanket exclusion from the GILTI formula for income that is taxed in Canada at more than 18.9%. That means that, subject to the other exceptions, all income earned by the CFC, unless it would otherwise be foreign base company income subject to a tax rate in Canada of at least 18.9%, is included in the GILTI formula.

*d. Net deemed tangible return income*

The second part of the GILTI formula is net deemed tangible return income. Overly simplified, this essentially represents a 10% return on depreciable trade or business assets. This formula is complex and a full discussion of it would take us away from our focus on simpler solutions. It is fully discussed in the Zanet and Ruchelman article cited above.

The salient point is that many Canadian corporations controlled by US individuals will have little in the way of depreciable trade or business assets. For instance, a doctor who is a Canadian-resident US citizen performing services through a Canadian corporation typically will not have much in the way of assets. The corporation's business assets may be limited to computers and some medical equipment, and the profits of the doctor's corporation will be GILTI income to the extent that they exceed 10% of its tax basis in these depreciable tangible assets. From a practical perspective, however, trying to calculate what that amount is on an annual basis will prove complex for many advisors to small- and medium-sized Canadian businesses that have depreciable tangible property owned by US citizens. Many business owners will not want to incur the expense of this exercise. Thus, it may be best to try and avoid the application of the GILTI regime altogether. I will return to this point later.

*e. Effect of GILTI income*

Income that is judged to be GILTI is taxed in the hands of the US taxpayer personally even if it is not distributed. This will effectively deny the deferral of income from personal taxation and dramatically increase the annual US tax cost to the US Shareholder.

*f. Foreign tax credits are limited*

To make matters worse, the GILTI rules place restrictions on how foreign tax credits can be used. Put simply, Code section 904(d)(1)(A) states that GILTI income is includible in a separate foreign tax credit "basket". That means that existing foreign tax credit carryforwards cannot be used to offset the resulting US tax. Without an election under Code section 962 (discussed below), there is no credit for the Canadian corporate taxes paid by the CFC. However, a dividend paid out in the same year as the GILTI inclusion should generate Canadian tax that can be used to offset that inclusion. The reason being, after the application of the GILTI rules, the dividend on which Canadian tax is paid is, for US tax purposes, considered to be previously taxed income under Code section 959.[4] Thus, the dividend itself is not US taxable income (although it is subject to the net investment income tax). The Canadian tax on the dividend can be allocated to the basket that relates to the previously taxed income.[5] In this case, since the inclusion is caused by GILTI, presumably the tax generated by the dividend can be allocated to the new GILTI basket. What that means is that the double tax risk can be negated—albeit only at the cost of a significant tax hit.

*g. Example of GILTI rules in action*

Consider the following simple example to illustrate the above rules. Dr. Jones is a US citizen living in Canada. She uses a Canadian corporation to conduct her medical practice. She earns profits of C$500,000, but only takes a salary from the corporation of C$100,000. Prior to the new US tax law, she was able to defer the remaining C$400,000 from personal tax until she needed the money. However, because she is a doctor working in a hospital her company's tangible assets are limited to a laptop worth $3,000. Under the new GILTI rules, all profits earned by the company ($400,000) in excess of a 10% return on her laptop ($300) would be taxed to her personally in the United States. Because of the separate foreign tax credit limitations, Dr. Jones would not be able to use previously generated foreign tax credits to offset the GILTI inclusion tax. Nor would she be able to take a credit for the Canadian tax that her corporation pays. Next, I look at some planning ideas that Dr. Jones could use to achieve some tax deferral.

## OPTION 1—RENOUNCING US CITIZENSHIP

One way to avoid being GILTI is to renounce US citizenship. The rules on renunciation have largely not changed with US tax reform. The *Tax Cuts and Jobs Act* ("TCJA") does, however, allow more people to renounce US citizenship without incurring additional taxes. In order to renounce without tax exposure, a US citizen's net worth has to be less than US$2 million. It is now possible to make gifts of up to US$11.2 million (up from US$5.6 million under prior law) to reduce a US citizen's net worth to below the US$2 million threshold. Thus, with proper advice, it should be possible for Dr. Jones to renounce her American citizenship without paying any taxes and without any border risk. If the practical and emotional value of the citizenship is less than the tax headaches caused by the GILTI regime, then that may be a wise decision.

## OPTION 2—CONVERT THE CANADIAN CORPORATION TO A ULC

Certain Canadian provinces (British Columbia, Alberta, and Nova Scotia) allow for the creation of unlimited liability companies ("ULCs"). For incorporated professionals in other provinces, the professional regulatory body of the other province may allow for the continuation in that province of a ULC formed in BC while it maintains its characteristics as a ULC. From a corporate law perspective, a regular corporation may be converted to a ULC without the creation of a new entity. Such a conversion would be tax neutral from a Canadian tax perspective because from a Canadian tax perspective the corporation would still be a taxable corporation. After the mandatory repatriation tax of the TCJA,[6] from a US tax perspective there may be minimal tax cost to such a conversion, unless there are assets in the corporation with significant unrealized gains or the corporation has significant goodwill.

The benefits of such a conversion are:

- A ULC is not treated as a corporation for US federal tax purposes. Thus, it is not subject to the GILTI regime. The annual compliance work is thus simpler.
- There would still be some tax deferral possible. Under a ULC, the goal is to make sure that the total Canadian tax (corporate and personal) equals the US personal tax. Otherwise, there is double tax exposure because US tax is paid in year 1 and Canadian tax is paid when the income is taken out of the corporation.
- Under the ULC option, there are no foreign tax credit limitations. You get a full credit for all Canadian corporate tax paid. Further, general basket foreign tax carryforwards can be used to offset the US tax. Finally, all Canadian personal tax generated (whether it be by salary or dividends) can be used as a credit against the US personal tax.

The drawbacks of this option are:

- There may be some US tax cost to the conversion if the corporation has assets with unrealized gain or goodwill.
- ULCs do not offer liability protection (although a ULC might be combined with an LP to combat this).
- ULCs are not widely available.

## OPTION 3—PROFITS ARE NOT GILTI BECAUSE OF THE HIGH TAX EXEMPTION

As noted above, one of the categories of income that is not subject to GILTI is income that would otherwise qualify as foreign base company income and is subject to Canadian corporate tax of at least 18.9%. The second possible planning tool would be to take the position that an item of income is foreign base company income and make sure that it is subject to tax in Canada of at least 18.9%. This could work for income from professional services or rental income[7] that was previously classified as active business income. Let's use income from professional services as an example.

To review, foreign base company income is a broad category that includes foreign personal holding company income. In turn, foreign personal holding company income includes personal service contract income ("PSCI") under Code section 954(c)(1)(H) (essentially, income from personal services). Under prior law, it was generally more favourable to take the position that income from professional services (e.g., medical income earned by Dr. Jones) was not classified as PSCI. With the advent of GILTI, that may have changed. It might be better to take the position that the professional services income is PSCI and opt out of the Canadian corporate small business tax rate. The legal basis for such a position is beyond the scope of this article. This would result in the medical services income (a) being classified as foreign base company income, and (b) being taxed at a Canadian corporate tax rate of higher than 18.9%. That would mean that it is not GILTI income. Assuming all active business income can be classified as foreign base company income, the benefits of this strategy would be:

- There is still some deferral of income from personal tax, although this is reduced since the Canadian corporate rate is increased.
- The dividends should be eligible dividends so the Canadian tax cost of withdrawing the money from the corporation is lower and should fully offset the US personal tax on the dividend.
- No restructuring of the corporation is necessary.
- Liability protection is preserved (compared to the ULC option).
- The compliance is straightforward as no income is subject to the GILTI formula.

The downsides to this approach are:

- Some risk in taking the position that what was previously not Subpart F is now changed.
- Modestly higher total Canadian tax as integration is not perfect.
- Less deferral than if the US citizen simply renounces.

## OPTION 4—RESTRUCTURE THE SHARE OWNERSHIP OF THE CORPORATION

The GILTI rules allocate GILTI inclusions to US shareholders the same way that *pro rata* shares of Subpart F are allocated to different shareholders.[8] This means that if a particular US shareholder has no distribution rights, meaning no rights to a dividend, then there would be no GILTI inclusion.[9] One strategy, then, for a couple where one spouse is a US citizen and one spouse is not would be to have the US-citizen spouse own only voting shares of the corporation. This prevents the corporation from becoming a passive foreign investment company ("PFIC"),[10] but also limits the GILTI inclusion. It also complies with professional regulations under which an incorporated professional normally must own all of the voting shares of the corporation. The US citizen could then be paid a salary or bonus.

The benefits of this strategy would be:

- It would maximize the deferral since there would be no GILTI inclusion;
- The US-citizen spouse would be paid a salary which does not trigger net investment income tax; and
- The newly enhanced US estate tax exemption provides more flexibility in making gifts to a spouse on a tax-free basis.

The downsides of this approach are:

- It may require restructuring the corporation, which is costly and complex; and
- The newly expanded Canadian TOSI rules may make this plan unduly expensive.

## OPTION 5—CODE SECTION 962 ELECTION

Put generally, Code section 962 allows an individual US taxpayer to be subject to US tax as if she was taxable as a US corporation on Subpart F income. The downside to Code section 962 is that when the income is later distributed by way of dividend, a portion of it is also taxable (as opposed to subsequent distributions of Subpart F inclusions which are normally not taxable) to the extent that the distribution exceeds the tax paid with the 962 election in place. Prior to the TCJA, Code section 962 was generally not used as it resulted in a higher overall US tax rate. Undoubtedly, an individual US taxpayer can use Code section 962 to access the new, lower, corporate tax rate for the GILTI inclusions. This is because under Code section 951A(f), GILTI is treated as Subpart F income for a variety of purposes including Code section 962. However, on its own, without the deduction, this is not attractive because: (a) the 21% corporate tax rate may in some cases be higher than the individual tax rate, and (b) even if it is not, there would be subsequent US tax when a distribution is made to the US taxpayer personally.

The GILTI rules provide a 50% deduction against the GILTI inclusion for US domestic corporations. It is unclear whether the 50% deduction is available to individual US taxpayers filing a section 962 election. My view is that there is a reasonable case that it is, but that this has risk to it. Here is why. On one hand, the express text of Code section 962 provides for the substitution of the corporate tax rate for the individual tax rate. However, it says nothing about allowing an individual US taxpayer to qualify for corporate *deductions* as well as the corporate tax rate. Further, there is no express reference in Code section 951A or the legislative history to that section that would suggest Congressional intention to allow an individual US taxpayer to qualify for the deduction. These two points suggest at least some risk to taking the view that an individual US taxpayer would qualify for the deduction. On the other hand, the entire point of Code section 962 is to equalize treatment between individual CFC owners and corporate CFC owners. That, and the express reference to Code section 962 in Code section 951A(f), strongly implies that as a policy matter individual US citizens should be eligible for the GILTI deduction under Code section 962. There is a technical argument to support this position,[11] although it is less convincing than the competing technical argument. Thus, my view is that while there is an arguable case that the deduction would apply, this position is not without risk. The advantages of the Code section 962 approach are:

- If individual taxpayers are eligible for the deduction, then short of renouncing, this is likely the best way to preserve deferral.
- With the indirect tax credit (even at an 80% limitation) and the 50% deduction, even income taxed at the small business tax rate in Canada should fully offset the GILTI inclusion.
- When paid out, the dividends should be qualified dividends and thus fully offset by the Canadian tax paid on those same dividends.

The downsides are:

- The compliance work is complex. Put generally, to use the 962 election, a US tax advisor would have to: 1) Calculate the GILTI inclusion using the GILTI formula; 2) Calculate the effects of the 962 election in year 1 (inclusion taxable as a corporation, GILTI deduction, and foreign tax credit limitation); and 3) track the US tax when the income is paid out and make sure it is offset by Canadian tax.
- The foreign tax credit is limited to 80% of the Canadian corporate tax paid. The ULC conversion option has no such limitation.
- There is at least some risk that the IRS could deny the deduction; thus there is some risk of an overall higher tax rate.

### CONCLUSION

There is no doubt that the GILTI inclusion increases the complexity for US citizens who own Canadian businesses. Left unaddressed, the GILTI rules can create substantially more tax even to the point of double tax exposure. This article has outlined, at a conceptual level, some possible strategies for preserving tax deferral. Stated simply, the following conclusions can be reached:

- Renouncing US citizenship is the most effective way of preserving the deferral from personal tax.
- If renunciation is not palatable, then the best strategy will depend on the specific facts.
    - Taxpayers who have relatively low corporate income may prefer the ULC plan.
    - Taxpayers who have a moderate amount of corporate income may prefer the Subpart F plan.
    - Assuming a taxpayer is comfortable with the uncertainty as to the availability of the deduction, the Code section 962 election may deliver the best results.

Whatever option is chosen, taxpayers should plead not GILTI to try and maintain some semblance of personal tax deferral.

## CURRENT ITEMS OF INTEREST

### CRA FORMS AND GUIDES UPDATE

With tax filing season upon us, the CRA has been releasing many updated forms and guides. Tax preparers should be aware of the following noteworthy changes:

- Guide T4003, *Fishing and Farming Income*, has been cancelled, and the content of that guide has been added to Guide T4002, which is now known as *Self-employed Business, Professional, Commission, Farming, and Fishing Income*.
- New Form T217, *Election, or Revocation of an Election, to use the Mark-to-Market Method*, is now available. This form allows taxpayers to make a mark-to-market election in respect of an eligible derivative pursuant to the mark-to-market rules under new section 10.1 of the *Income Tax Act*.
- Unlike many past years, the CRA will not be issuing a new T2 Corporation Income Tax Return for 2017. Therefore, the current version of the form (for 2016 and later years) is applicable for 2017.

### SECOND QUARTER INTEREST RATES

The CRA released the prescribed annual interest rates for Q2 of 2018. The following rates apply with respect to income tax:

- The interest rate charged on overdue taxes, Canada Pension Plan contributions, and employment insurance premiums will be 6% (up from 5% in Q1).
- The interest rate to be paid on corporate taxpayer overpayments will be 2% (up from 1% in Q1).
- The interest rate to be paid on non-corporate taxpayer overpayments will be 4% (up from 3% in Q1).
- The interest rate used to calculate taxable benefits for employees and shareholders from interest-free and low-interest loans will be 2% (up from 1% in Q1).
- The interest rate for corporate taxpayers' pertinent loans or indebtedness will be 5.18% (up from 4.98% in Q1).

## CANADA TO STUDY TAXING TECH GIANTS

According to BNN[12], Federal Minister of Finance Bill Morneau stated that the government will study whether Canada needs a new digital tax regime. These comments were made after the G20 Finance Ministers agreed to a collaborative solution to digital taxation.

## NEW NOTICE OF WAYS AND MEANS MOTION

On March 22, 2018, the Department of Finance published a Notice of Ways and Means Motion, which proposes to implement certain tax measures, including proposals relating to passive income, income sprinkling, cannabis taxation, carbon pricing, and other Budget 2018 measures. Explanatory notes and a bill are expected shortly.

## IRS ENDING OFFSHORE VOLUNTARY DISCLOSURE PROGRAM

The IRS has announced that it will close its Offshore Voluntary Disclosure Program ("OVDP") on September 28, 2018. The program has been in effect since 2012, but the number of disclosures has been decreasing over the years to as low as 600 disclosures in 2017. A news release from the IRS highlighted the program's achievements, and the reasons behind its end:

> Since the OVDP's initial launch in 2009, more than 56,000 taxpayers have used one of the programs to comply voluntarily. All told, those taxpayers paid a total of $11.1 billion in back taxes, interest and penalties. The planned end of the current OVDP also reflects advances in third-party reporting and increased awareness of U.S. taxpayers of their offshore tax and reporting obligations.

## NOVA SCOTIA BUDGET

Nova Scotia's Finance and Treasury Board Minister, Karen Casey, presented the province's 2018–2019 Budget, *Stronger Services and Supports*, on March 20, 2018. The Budget projects a surplus of $29.4 million for 2018-2019, with a balanced budget over each of the next four fiscal years. The tax highlights from the Budget include:

- enhancing the basic personal amount, spousal amount, and eligible dependant amount each by $3,000 (subject to income-tested phase-out);
- enhancing the age amount by nearly $1,500 (subject to income-tested phase-out);
- removing the $10,000 cap for the medical expense tax credit with respect to dependent relatives;
- introducing a new innovation equity tax credit in 2019; and
- doubling the poverty-reduction credit from $250 to $500 per year.

## ALBERTA BUDGET

Alberta Budget 2018 was tabled March 22, 2018, by Minister of Finance Joe Ceci. The Minister announced that the government will operate at a deficit of $8.8 billion in 2018–2019. Though there were only a few tax measures announced, highlights from the Budget include:

- introducing the refundable Interactive Digital Media Tax Credit, which is worth 25% of eligible labour costs incurred after April 1, 2018;
- extending the Alberta Investor Tax Credit until 2021–2022; and
- extending the Capital Investment Tax Credit until 2021–2022.

### MANITOBA BUDGET

Finance Minister Cameron Friesen presented Manitoba's 2018-2019 Budget on March 12, 2018. The Budget estimates a deficit of $521 million for 2018-2019, announced the new provincial carbon tax, and presented several other tax changes. Notable tax changes from the budget include:

- Manitoba's basic personal amount will increase from $9,382 to $10,392 for the 2019 taxation year, with a further increase to $11,402 in 2020;
- the computation and administration of the Primary Caregiver Tax Credit will be simplified;
- the labour-sponsored funds tax credit will be eliminated for shares acquired after 2018;
- the small business deduction limit will increase from $450,000 to $500,000, effective January 1, 2019;
- the introduction of a new tax credit for the creation of licensed child care spaces in a workplace, which will provide a $10,000 credit (over 5 years) for each space created;
- the minimum investment for the small business venture capital tax credit is lowered from $20,000 to $10,000, effective March 12, 2018;
- the credit union tax deduction will be phased out over 5 years, beginning January 1, 2019; and
- the rental housing construction tax credit will be eliminated as of January 1, 2019.

The budget also confirmed the government's previous commitment to reduce the sales tax rate from 8% to 7% by 2020.

## 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.

### HBP RELIEVING PROVISION UNINTENTIONALLY CREATES HARDSHIP

***Chitalia v. The Queen*, 2017 DTC 1141 (Tax Court of Canada)**

In the *Chitalia* case, the Tax Court of Canada confirmed the correctness of the Minister's reassessment to treat the taxpayer's withdrawal of funds from his Registered Retirement Savings Plan ("RRSP") to be an ineligible amount under the Home Buyers Plan ("HBP") and, therefore, not an "excluded withdrawal" that could avoid being included in the taxpayer's income for the year of withdrawal under subsection 146(8) of the *Income Tax Act* (Canada) (the "Act"). What is interesting—or, from this taxpayer's perspective, unfortunate—about the case is the fact that the taxpayer appears to have been tripped up by a deeming provision in the HBP rules that was likely intended to provide relief to HBP participants in a different factual context.

The HBP rules (found in section 146.01 of the Act) allow first-time home buyers to withdraw up to $25,000 from their RRSPs towards the cost of purchasing their homes and restore those funds to their RRSPs over a 15-year period. For RRSP withdrawals to qualify under the HBP, there are various timing restrictions that straddle the date on which the taxpayer acquires the home.

One restriction pertains to how early the taxpayer can withdraw the funds from the RRSP: the home must be acquired before October 1 of the year that follows the year in which the funds were withdrawn,

effectively creating a maximum 21-month window between withdrawal of the funds and acquisition of the home. Presumably, the long period between the withdrawal of funds and the acquisition of the home was to accommodate new construction homes and taxpayers who would use the HBP amount to fund the up-front deposit required by the selling developer well in advance of when the new home would be completed.

A second restriction is the one that was at issue in this case and pertains to how late the taxpayer can withdraw the funds from the RRSP: the funds cannot be withdrawn more than 30 days after the taxpayer (or spouse) has acquired the new home.

The taxpayer in the *Chitalia* case entered into an agreement of purchase and sale for a condominium unit in September 2011 in a building that had not been completed. The agreement contemplated a November 3, 2011, interim closing date, at which time the taxpayer would be given vacant occupancy of his unit, and a January 20, 2012, final closing, at which time the ownership of the unit would pass to the taxpayer and the balance of the purchase price would be paid to the developer.

The transaction unfolded in accordance with the timing contemplated in the agreement of purchase and sale. Eight days prior to the final closing, the taxpayer withdrew $5,529 from his RRSP and completed the CRA's prescribed form for withdrawing amounts pursuant to the HBP. The CRA's prescribed form contained a clear notation that withdrawn amounts would not be eligible for the HBP if withdrawn more than 30 days after the taxpayer acquired the home. The taxpayer concluded that he was not disqualified by this requirement because he was making his RRSP withdrawal prior to the date on which he was taking ownership of his condominium unit.

What the taxpayer did not know (and the CRA's prescribed form did not disclose) is that the HBP regime has a seemingly important deeming rule in paragraph 146.01(2)(b) which provides that, in the case of the purchase of a condominium unit, the taxpayer is deemed to have acquired it on the date on which the taxpayer was entitled to immediate vacant possession. This deeming rule was presumably intended to have a relieving effect for condominium-purchasing taxpayers for purposes of the first timing restriction described above, as it would allow purchasers who used the RRSP withdrawal to fund their purchase deposits for new construction condominium units to participate in the HBP provided that they at least received vacant possession of their units before October 1 of the year following the year of the withdrawal, eliminating the risk of having their RRSP withdrawals disqualified from the HBP due to the developer's delays in registering the condominium and transferring title of the units to the purchasers. However, when the deeming rule was applied to this taxpayer's circumstances, it produced the result that his RRSP withdrawal was made 70 days after the November 3, 2011, date on which the taxpayer was deemed to have acquired his condominium unit.

In the Tax Court, the taxpayer was self-represented and he conceded that his withdrawal was not an eligible withdrawal under the HBP rules and, therefore, not an "excluded withdrawal" for purposes of the RRSP rules. But he then argued that he should not be required to include the amount in income as he was misled by the CRA prescribed form as to when he could withdraw the funds from his RRSP in order for the funds to be a qualifying withdrawal under the HBP.

The Tax Court (*per* Paris J) agreed with the taxpayer that the CRA's prescribed form was misleading because it failed to refer to the deemed acquisition date for condominium units. The Court also noted that a taxpayer reading the withdrawal form would have no way of knowing about the special rule relating to the deemed acquisition date, which differs from both the legal and intuitive date of ownership. However, the Tax Court also stated as follows:

> Unfortunately for Mr. Chitalia, the Court cannot give effect to a form drafted by the Canada Revenue Agency (the "CRA") if that form conflicts with the provisions of the Act. The wording of the Act must prevail.

This principle is confirmed by the Federal Court of Appeal in *Klassen* (2007 DTC 5612 (FCA)), where the Court stated that no relief could be granted by the Court on the basis that the taxpayer had received erroneous advice from the CRA. The Court stated that the wording of the relevant portions of subsections 146.01(1) and (2) of the Act are clear and unambiguous and thus dismissed the taxpayer's appeal.

The Tax Court was not without sympathy towards the taxpayer and, given the inequity of the result in this case, urged the taxpayer to consider applying for a remission order under the *Financial Administration Act*.

If it is true that the deeming rule in paragraph 146.01(2)(b) was included in the HBP rules to provide relief to taxpayers who had used their RRSP withdrawals towards deposits for new construction condominium units, it is difficult to understand why its application was not restricted to the determination of how far the withdrawal was made in advance of acquiring a condominium unit. In the case of most new condominium buildings, the interim closing date represents the beginning of a phase when the relationship between the purchaser and selling developer transitions temporarily into one of tenant and landlord until the final closing. It is not customary for funds to move from the purchaser to the seller on that date towards the purchase price of the condominium unit and, therefore, somewhat absurd that an HBP deadline for withdrawing funds from an RRSP would in any way be tied to the interim closing date. For first-time home buyers who want to use the HBP but did not need to draw on their RRSPs to fund their purchase deposits, the true date on which an HBP-eligible RRSP withdrawal would be useful is the final closing which, per the current real estate market trends, can be anywhere from two months to two years after the interim closing. The paragraph 146.01(2)(b) deeming rule dictates that, in these circumstances, the required funds must be withdrawn from the RRSP months before the money is actually needed as part of the purchase price of the condominium unit and, if any income is earned on the withdrawn funds during the period prior to actual purchase, the earnings would be taxable income outside of the taxpayer's RRSP. Presumably, the application of paragraph 146.01(2)(*b*) to circumstances like the one in this case is an unintended result and could be easily corrected through a legislative amendment.

—*Jaspreet Kaur*

## SPLITTING CAPITAL GAINS BETWEEN SPOUSES VIOLATES THE GAAR

***Gervais v. The Queen*, 2018 DTC 5006 (Federal Court of Appeal)**

The *Gervais* case provides an interesting example of how transferring assets between spouses before an arm's length transaction in order to take advantage of one spouse's lifetime capital gains exemption runs counter to the object, spirit, and purpose of the rollover and attribution rules for spouses under subsections 73(1) and 74.2(1) of the *Income Tax Act* (Canada) (the "Act"), triggering application of the GAAR.

The taxpayer owned 2,087,778 preferred shares of a corporation that he had agreed to sell to an arm's length corporation for $1 per share. If the taxpayer had sold the shares directly to the arm's length corporation, he would have realized a $1 million taxable capital gain.

Prior to the arm's length sale, the taxpayer transferred all of his shares to his wife through two transactions. First, the taxpayer sold half of his shares to his wife at the fair market value of $1 per share and opted to exclude the rollover provided for in subsection 73(1) of the Act so that he realized a taxable capital gain of $500,000. Second, the taxpayer gifted his remaining shares to his wife and allowed the 73(1) rollover. Thus, the taxpayer was deemed to have disposed of the gifted shares at his adjusted cost base, and the wife was deemed to have acquired them at that same adjusted cost base.

The wife then sold all of the shares to the arm's length corporation for $1 per share. Because the shares gifted to the wife had a different cost than the shares purchased by her, the total adjusted cost base of the wife's shares was deemed to be equal to their average cost pursuant to subsection 47(1) of the Act. As a result, the wife realized a $500,000 taxable capital gain, only half of which was attributed to the taxpayer pursuant to subsections 74.2(1) and 74.5(1) of the Act. The wife was then able to deduct her unused $250,000 lifetime capital gains exemption under subsection 110.6(2.1) of the Act, offsetting the $250,000 taxable capital gain.

The result of the transactions was that the taxpayer had a $750,000 taxable capital gain but his wife had no tax liability in respect of her $250,000 taxable capital gain. Thus, the taxpayer reduced the taxable capital gain he otherwise would have been subject to if he had sold the shares directly to the arm's length corporation by $250,000.

The Minister assessed the taxpayer under the GAAR and attributed the entire taxable capital gain realized by the wife to the taxpayer, increasing the taxpayer's taxable capital gain to $1 million.

On the appeal before the Tax Court of Canada (2017 DTC 1082), Jorré J upheld the Minister's assessment on the basis that the three conditions for application of the GAAR were met:

(i) the taxpayer had obtained a tax benefit by interposing his wife into the arm's length transaction to reduce his taxable capital gain by $250,000;
(ii) there was an avoidance transaction because the transactions formed a series of transactions designed to reduce the taxpayer's taxable capital gain and one of the steps in the series (the sale of shares to the wife) was necessary only to obtain a tax benefit for the taxpayer; and
(iii) the avoidance transaction was abusive because it led to a result that subsections 73(1) and 74.2(1) aim to prevent by avoiding the attribution of part of the wife's taxable capital gain to the taxpayer.

In reasons for judgment given by Noël CJ, a unanimous Federal Court of Appeal upheld Jorré J's decision and dismissed the taxpayer's appeal.

First, the Court dealt with the taxpayer's assertion that Jorré J had erred because it was the wife that had derived the benefit rather than the taxpayer, as the wife was able to claim the lifetime capital gains exemption to eliminate her taxable capital gain. The Court noted that Jorré J had found that the taxpayer obtained a tax benefit because he avoided paying tax on a portion of the capital gain that would have been his had he sold the shares directly to the arm's length corporation, and the Court concluded that the taxpayer had failed to explain why this finding was incorrect.

Second, the taxpayer argued, as he had before the Tax Court, that the series of transactions was undertaken primarily for the *bona fide* purpose of rewarding his wife for her contributions to the business and not for tax reasons. The Court agreed with Jorré J, following the principle set out in *Copthorne Holdings Ltd.* (2012 DTC 5007 (SCC)), that if one step in a series of transactions is carried out primarily to obtain a tax benefit, the series is an avoidance transaction. The Court found there was no credible reason why the taxpayer took the step of selling half of his shares to his wife other than to obtain a tax benefit.

Finally, the taxpayer argued that the transactions could not be considered abusive because none of the provisions relied on to obtain the tax benefit was used to achieve a result contrary to those provisions. The Court rejected this argument. It agreed with Jorré J's reliance on *Lipson* (2009 DTC 5015 (SCC)) in finding that the object and purpose of the rollover and attribution scheme in the Act is to prevent spouses from benefitting from their non-arm's length relationship to reduce the tax payable on capital gains. After setting out the implications of the transactions, the Court concluded that the combination of gifting and selling the shares to the wife resulted in an attribution to the taxpayer of only half of the capital gain that would otherwise have been attributed to him if subsection 47(1) had not applied. The Court stated:

> That result, although it flows from the text of the relevant provisions, is contrary to the object, spirit and purpose of subsections 73(1) and 74.2(1), the purpose of which is to ensure that a gain (or loss) deferred by reason of a rollover between spouses or common-law partners be attributed back to the transferor. Maintaining the transferor's ACB as provided for in subsection 73(1) and then attributing the gain (or loss) to the transferor, under subsection 74.2(1), evidences this objective… It follows that the splitting of that gain, by reason of the astute use that was made of subsection 47(1), frustrates the rationale underlying these provisions or their reason for being.

The *Gervais* case reinforces the Supreme Court of Canada's decision in *Lipson* and provides a cautionary tale for spouses seeking to circumvent the attribution rules in the Act in order to split capital gains. Courts have made it clear that strategically using provisions of the Act to benefit from spouses' non-arm's length relationships to reduce capital gains tax may run afoul of the GAAR, even when specific anti-avoidance rules do not apply.

—*James Parker*

## CORPORATE DIRECTOR NOT NORMALLY A "LEGAL REPRESENTATIVE" OF THE CORPORATION UNDER SECTION 159 OF THE ACT

***Groscki v. The Queen*, 2018 DTC 1001 (Tax Court of Canada)**

*Groscki* is a case concerning the meaning of the term "legal representative", and when a director of a corporation may be considered to be a legal representative for the purposes of the *Income Tax Act* (Canada) (the "Act"). This issue is of particular interest where a director is distributing a taxpayer's assets and may,

as a result, be at risk of being assessed under section 159 of the Act. The Court held that, in order to be considered a legal representative when distributing a corporation's property, the director must do so in the exercise of additional powers beyond directorship that allow the director to legally and factually dissolve and liquidate the corporation.

In *Groscki*, the director who was assessed under section 159 was, in addition to being a director of the taxpayer (EMI Macao), the sole directing mind and indirect shareholder of EMI Macao. EMI Macao was a British Virgin Islands company that operated a business in Macao. EMI Macao's business involved buying products in China for resale to individuals in Canada who would, in turn, donate the products to charities in Canada for amounts equal to retail prices far exceeding the original purchase price paid by EMI Macao to the Chinese manufacturers. Such donors would then claim charitable donation tax credits based on those higher amounts. In December 2003, the Government of Canada announced changes to the Act that effectively prohibited the acquisition of products at low wholesale prices followed by the donation of those products to charities at amounts equal to a high retail value. As a result, EMI Macao was left with valueless, stranded inventory. Further, in December 2004, the special administrative region of Macao revoked EMI Macao's authorization to conduct its activities in Macao, effective July 21, 2004.

The Minister conducted an audit of EMI Macao (and other entities involved in the charitable donation program) and assessed the director on the basis that he was the legal representative in possession and control of the property of EMI Macao, which had a tax liability. For the purposes of the Tax Court hearing, the Minister conceded that the tax liability of EMI Macao relevant to the section 159 assessment was no more than approximately $375,000.

Section 159 of the Act imposes liability on a "legal representative" (as defined in subsection 248(1)) to pay a taxpayer's taxes payable in two sets of circumstances: one before distribution of the taxpayer's property by the legal representative, and one after. Subsection 159(1) applies before the legal representative distributes the taxpayer's property. Pursuant to subsection 159(1), and generally speaking, where a person is a legal representative of a taxpayer at any time, the legal representative is liable to pay each amount payable under the Act by the taxpayer at or before that time and that remains unpaid, to the extent that the legal representative is ***at that time*** in possession or control of property that belongs or belonged to the taxpayer.

Subsection 159(3) applies after the legal representative distributes the taxpayer's property and its application is contingent on the legal representative's failure to comply with subsection 159(2). Pursuant to subsection 159(2), a legal representative (other than a trustee in bankruptcy) is required, before distributing the taxpayer's property, to obtain a clearance certificate from the Minister certifying that all amounts (1) for which the taxpayer is or can reasonably be expected to become liable under the Act at or before the time the distribution is made; and (2) for the payment of which the legal representative is or can reasonably be expected to become liable in that capacity, have been paid or security for the same has been provided to the Minister. Generally speaking, pursuant to subsection 159(3), if the legal representative fails to obtain this clearance certificate and distributes property of the taxpayer, then the legal representative is personally liable for the payment of the amounts for which he or she was required to obtain the clearance certificate, to the extent of the value of the distributed property.

The interesting feature of the *Groscki* decision is its discussion of the meaning of "legal representative", a term that has received little judicial consideration in the context of directors who are alleged to be legal representatives. It is a term most commonly associated with executors of estates of deceased taxpayers. The definition of "legal representative" in subsection 248(1) contemplates a wide category of persons, defining the term to mean, in respect of a taxpayer, "a trustee in bankruptcy, an assignee, a liquidator, a curator, a receiver of any kind, a trustee, an heir, an administrator, an executor, a liquidator of a succession, a committee, or any other like person, administering, winding up, controlling or otherwise dealing in a representative or fiduciary capacity with the property that belongs or belonged to, or that is or was held for the benefit of, the taxpayer or the taxpayer's estate." The particular question to be considered in *Groscki* was when a director of a corporation may be considered to be its "legal representative" for the purposes of the Act.

As a starting point, the Court noted that for a director to be a legal representative, the director must act as a fiduciary of a person and be legally authorized to administer, wind up, control the distribution, or deal with the taxpayer's interests. Although a director arguably has some authority to do these things, Parliament's

omission of the word “director” from the definition of “legal representative” suggests that something more is needed for a director to be so considered. For example, a director would not be considered a legal representative by causing the corporation to distribute dividends, as that is something that directors do in the normal course of managing a corporation’s affairs and is not analogous to the acts of a liquidator or receiver.

The Court concluded that a director may become a legal representative in limited circumstances where:

(1) additional powers beyond directorship have been legally granted, or if not legally granted, available and assumed;
(2) the additional powers allowed the transformed legal representative to legally and factually dissolve (wind up) and liquidate the corporation; and
(3) the director liquidated the assets of the corporation by virtue of those powers.

On the facts in *Groscki*, the Court found that the director did not become EMI Macao’s legal representative. EMI Macao was a British Virgin Islands company and there was no evidence that EMI Macao ceased to exist under the laws of that jurisdiction. While EMI Macao lost its licence to operate in Macao, this did not cause it to be dissolved, struck, or wound up. No powers beyond those normally exercised by directors had been granted to the director to wind up or liquidate EMI Macao. It was merely abandoned. As such, the director was not EMI Macao’s legal representative, and could therefore not be liable under section 159 of the Act. This conclusion rendered moot some other disputed issues regarding the director’s alleged possession and control of EMI Macao’s property and regarding EMI Macao’s alleged tax liability.

*Groscki* provides some guidance that may help practitioners assess the risk that a director of a corporation may be considered to be a legal representative of the corporation. Based upon this decision, merely exercising the powers of directorship to distribute the corporation’s assets is unlikely to cause a director to be considered a legal representative. Additional powers must have been granted that permit the director to legally and factually dissolve and liquidate the corporation.

—*Theodore Stathakos*

## MINDING THE GAP: TAXABILITY OF HEALTH AND WELFARE TRUST DISTRIBUTIONS IN INSOLVENCY PROCEEDING

***Scott v. The Queen*, 2017 DTC 1143 (Tax Court of Canada)**

This Tax Court case was a consolidation of four appeals filed by individuals who were either former employees of the Nortel group of companies or spouses of former Nortel employees. The common issue in the appeals was the tax treatment of distributions that the individuals received from a health and welfare trust as part of the Nortel insolvency proceedings.

In 1980, Nortel established health and welfare plans for the benefit of active and former employees. Most of Nortel’s health and welfare benefits were delivered through the Nortel Health and Welfare Trust (“HWT”). The HWT was a single trust fund created for the purpose of delivering health and welfare benefits to active and retired employees of Nortel and their eligible dependents in accordance with the terms of Nortel’s health and welfare plans.

On January 14, 2009, Nortel filed for bankruptcy protection under the *Companies’ Creditors Arrangement Act* (“CCAA”). The Ontario Superior Court of Justice appointed a monitor, and during the ensuing CCAA proceeding, Nortel divested itself of substantially all of its assets and business units and terminated the employment of most of its employees in Canada.

Certain employment-related issues affecting former Nortel employees were addressed in an Amended and Restated Settlement Agreement (“ARSA”), as agreed to by representatives of the former employees, representatives of Nortel, and the court-appointed CCAA monitor. The ARSA resulted in a court-approved allocation process that used a methodology based on the present value of each approved benefit claim to calculate HWT corpus distributions on a *pro rata* basis.

Under the terms of the ARSA, and notwithstanding its continued financial hardship, Nortel continued to fund certain health and welfare benefits until December 31, 2010, a date which marked both the end of Nortel’s obligation to make contributions to the HWT and the effective date for the determination and satisfaction of

the expenses, claims, and obligations of the HWT. As of that date, Nortel was insolvent and the HWT had insufficient assets to deliver the vested employee benefits. Payments in the form of *pro rata* distributions were made to HWT beneficiaries commencing in 2011.

Two of the appellants in the tax case, Mary Ellis and Susan Kennedy, were former Nortel employees who received distributions from the HWT corpus in satisfaction of their vested entitlements to coverage under the terms of the Nortel group life insurance plan. For taxation years ending before 2011, both Ms. Ellis and Ms. Kennedy had included the amount of the group life insurance premiums paid on their behalf by the HWT in computing their respective incomes, as required by subsection 6(4) of the *Income Tax Act* (Canada) (the "Act") and prescribed by Part XXVII of the *Income Tax Regulations* (the "Regulations"). When distributions from the corpus of the HWT were made in 2011, Ms. Ellis received a distribution of $1,371 and Ms. Kennedy received an aggregate distribution of $9,011.88. The CCAA monitor subsequently issued T4A slips to Ms. Ellis and Ms. Kennedy. Both of them included the distributed amounts in the income they reported in their tax returns for 2011. However, they also both objected to the Minister of National Revenue's assessments which accepted the tax returns, as filed, and later appealed the Minister's decision on the objection to the Tax Court of Canada.

The other two appellants in the tax case, James Scott and Ann McCann, had each been married to former Nortel employees and, by reason of their respective spouses' former employment, were entitled to death benefits after their spouses had passed away. Mr. Scott received monthly survivor income benefits, while Ms. McCann was in receipt of monthly survivor transition benefits for a fixed term. For taxation years ending before 2011, both Mr. Scott and Ms. McCann had included their survivor benefits in computing their respective incomes, as required by subparagraph 56(1)(a)(iii) of the Act. When distributions from the corpus of the HWT were made in 2011, Mr. Scott received an aggregate distribution of $8,526.17 and Ms. McCann received an aggregate distribution of $6,152.42. The CCAA monitor subsequently issued T4A slips to Mr. Scott and Ms. McCann, both of whom reported the distributed amounts as income in their 2011 returns. Again, both parties subsequently objected to and appealed the Minister's assessments accepting their tax returns as filed.

In considering the taxability of the HWT distributions, the Tax Court was tasked with considering whether the distributions should properly be considered to be income to the appellants.

Acknowledging that the taxability of an award for damages or a settlement payment is generally determined by reference to the nature and purpose of the payment that the damages or settlement amounts replace, often expressed as the *surrogatum* principle, the Tax Court (*per* Sommerfeldt J) was reluctant to apply the classical formulation of the principle to the case at hand. In consideration of the fact that the classical statement, as expressed by Diplock LJ in *London and Thames Haven Oil Wharves* ([1967] 2 All ER 124), applies where an individual receives compensation for that person's failure to receive a sum of money, the Tax Court found that applying the principle to the situation of Ms. Ellis and Ms. Kennedy was difficult given that neither of them was otherwise entitled to receive the life insurance proceeds or the life insurance premiums from which they benefited. Rather, the Tax Court chose to rely on the alternative expression of the *surrogatum* principle as delivered by Morgan J in *Dumas* (2000 DTC 2603) to consider *why* the compensatory amounts had been paid. In doing so, the Court determined that the distributions paid to Ms. Ellis and Ms. Kennedy constituted a benefit as partial compensation for the termination of the relevant group life insurance plan, while the distributions paid to Mr. Scott and Ms. McCann were partial compensation for the termination of their respective survivor benefits.

The Tax Court then turned to the issue of classifying the distributions made by the HWT and determining whether they should properly be considered as income or capital payments. Noting a line of jurisprudence to the effect that a lump-sum payment paid to commute a stream of periodic payments otherwise includable in income is a capital payment, the Tax Court relied on the concept of capitalization as set out in the Court's decision in *Beninger* (2010 DTC 1237 (TCC)) to find that the distributions by the HWT to Ms. Ellis and Ms. Kennnedy were not paid to commute the HWT's obligation to pay future insurance premiums, and as a result did not represent capitalization. Conversely, because Mr. Scott and Ms. McCann were entitled to receive monthly survivor benefits, the distributions made by the HWT to them *did* represent a capitalization.

Next addressing the Minister's argument that any payment or benefit received in respect of employment was taxable, subject to certain exceptions not applicable in these cases, the Tax Court considered the purpose

and scope of paragraph 6(1)(a) of the Act and canvassed the decisions in *Ransom* (67 DTC 5235 (Ex. Ct.)), *Savage* (83 DTC 5409 (SCC)), *Blanchard* (95 DTC 5479 (FCA)), and *McGoldrick* (2004 DTC 6407 (FCA)).

Agreeing that the jurisprudence supported the proposition that paragraph 6(1)(a) of the Act casts a wide net in capturing any material acquisition in respect of employment which confers an economic benefit on a taxpayer, the Tax Court then turned its focus to those exceptions limiting the scope of the provision's application. It was noted that one such exception arises where, in addition to the general provision in paragraph 6(1)(a), there is "a specific [statutory provision] containing detailed conditions for the inclusion of an amount in income that would not otherwise be income" (*Tsiaprailis* (2002 DTC 1563 (TCC))). In circumstances where "a crucial condition for the application of the specific provision is not met", the Court noted that "the general provision cannot be used to 'fill in all the gaps left by' the specific provision, or 'to sweep into income an amount which [does] not fit within [the specific] provision aimed at amounts of that type…'" (*Tsiaprailis* (2003 FCA 136)).

While the Tax Court acknowledged that the distributions to Ms. Ellis and Ms. Kennedy were material acquisitions which conferred an economic benefit on each of them, benefits which would otherwise be caught by operation of paragraph 6(1)(a), it was subsection 6(4) of the Act, as supplemented by Part XXVII of the Regulations, that required them to include a prescribed amount in computing their income for the taxation years during which they received benefits under the group life insurance plan and contained detailed rules for doing so. While those specific provisions required Ms. Ellis and Ms. Kennedy to include the prescribed amount in respect of their participation in the Nortel group life insurance plan, the provisions in question did not capture the distributions paid to them by the HWT in 2011. As a result, paragraph 6(1)(a) of the Act could not be used to fill the gaps left by subsection 6(4) and Part XXVII, or to otherwise sweep those distributions into income.

Returning to the appeals of Mr. Scott and Ms. McCann, the Tax Court addressed the taxability of the distributions paid out of the HWT as partial compensation for the termination of their respective death benefits. Observing that the benefits in question had been included as income prior to 2011, pursuant to subparagraph 56(1)(a)(iii) of the Act, the Tax Court considered the applicability of the *surrogatum* principle to the distributions in question. Relying on the decision in *Transocean* (2005 DTC 5201 (FCA)), the Court took the view that the principles enunciated by the Federal Court of Appeal in interpreting the phrase "in lieu of", as contained in paragraph 212(1)(d) of the Act, could also be applied to the interpretation of paragraph 56(1)(a) of the Act, which contained the same phrase. Adopting the reasoning of Sharlow JA in *Transocean*, the Tax Court found that the *surrogatum* principle need not be considered separately because the statutory words in the relevant provisions expressed a similar idea. Furthermore, because paragraph 56(1)(a) also contained the phrases "on account of" and "in satisfaction of", much like 212(1)(d), the Tax Court determined that the provision could apply to "virtually all situations in which a payment is made to discharge, in full or in part, an obligation to pay [such] compensation" (*Transocean*, 2005 DTC 5201 (FCA)). In so finding, it was held that the evidence supported the Minister's position that the distribution in question was made "on account of" the respective death benefits, and thus remained taxable under subparagraph 56(1)(a)(iii).

With respect to this last issue, the Tax Court made an alternative finding that if the payment of the distribution did not discharge the obligation to pay on account of the death benefits, the wording of 56(1)(a)(iii), as was the case in *Transocean*, expanded the scope of the paragraph to include payments other than payments that had the legal character of a death benefit. As a result, the distributions paid by the HWT to Mr. Scott and Ms. McCann in place of, or in lieu of, the death benefits were still captured by operation of the provision.

In light of the foregoing findings, the Tax Court allowed the appeals of Ms. Ellis and Ms. Kennedy. Ms. McCann's appeal was partially allowed solely for the purpose of allowing the Minister to correct an administrative error that had been made by the CRA with respect to the value of the distribution. Mr. Scott's appeal was dismissed.

This case will be of interest to practitioners for two reasons. The first is that the decision lends support to the principle that paragraph 6(1)(a) of the Act cannot be used as a catch-all provision to capture as income amounts which do not otherwise fit within specific provisions aimed at amounts of that type. The second reason is that it supports a line of jurisprudence that stands for the proposition that simply because a future income stream is capitalized does not always mean that the capitalized payment is excluded from income.

Of note in this decision specifically, the Court found that a payment representing a capitalization of monthly death benefits, or a payment in consideration of a surrender or release of a right to receive monthly death benefits, can also constitute an amount received by the recipient on account of, in satisfaction of, or in lieu of payment of those monthly death benefits, in which case it will be included as income pursuant to subparagraph 56(1)(a)(iii).

*—Kelleher Lynch*

## RECENT CASES

### DENIAL OF PENALTY AND INTEREST RELIEF RETURNED TO MINISTER FOR REDETERMINATION IN PART

The applicant corporation, which had been assessed a penalty and interest for failure to file a required T1135 form for the 2005 through 2013 taxation years in respect of its foreign property holdings, requested relief from such interest and penalties under the Voluntary Disclosure Program. Such relief was denied by the Minister's delegate on the basis that the disclosure made did not meet the definition of "voluntary", as the Minister had already commenced enforcement action against the taxpayer which would have likely uncovered its T1135 disclosure obligations. The corporation applied for judicial review of that denial.

The application was allowed in part. The Federal Court held that the standard of review of the decision of the Minister's delegate was that of reasonableness and that the only issue in dispute was whether the applicant's disclosure was voluntary. The key issues for determining voluntariness were whether the CRA was engaged in enforcement action, and, if so, whether that enforcement action was likely to uncover the disclosed T1135 returns. The Court reviewed the filing history of the applicant and the actions taken by the Minister with respect to those filings. It concluded that the decision of the Minister's delegate regarding the applicant's 2011, 2012, and 2013 T1135 returns was reasonable, as enforcement action taken by the Minister would likely have uncovered the applicant's obligation to file such returns. The Court also held, however, that adequate reasons to support the conclusion that similar enforcement action would likely have uncovered the applicant's T1135 filing obligation for the 2005 to 2010 years had not been provided. The application for judicial review was allowed and the matter returned to the Minister for redetermination in accordance with the Court's reasons.

*Boadi Professional Corp. v. Canada (AG)*

2018 DTC 5013

### REASSESSMENT RESULTING FROM RETROACTIVE REVOCATION OF INDIVIDUAL PENSION PLAN UPHELD

In 2009, the taxpayer established an individual pension plan ("IPP") and transferred the commuted value of his employer pension plan into that IPP. In November 2013 the Minister issued a notice of revocation for that IPP but later acknowledged that such notice was ineffective as having been issued prematurely. On the same day the notice of revocation was issued, the Minister reassessed the taxpayer to include the commuted value of his RPP in income for 2009, on the basis that the IPP had been revoked. Subsequently, in June 2017, the Minister issued a valid notice of revocation for the IPP, which was made retroactive to January 1, 2009. The taxpayer challenged the Notice of Reassessment issued in 2013 on the basis that the IPP was still in existence when that reassessment was issued, as the notice of revocation then in place was invalid. He also argued that the Minister was precluded by section 152(9) of the *Income Tax Act* from relying on the June 2017 notice of revocation as a new basis for reassessment.

The appeal was dismissed. The Tax Court of Canada held that the taxpayer's argument failed because of the retroactive nature of the June 2017 notice of revocation. In the Court's view, the facts necessary to support the reassessment existed at the time it was issued in 2013, because of the retroactive effect of the notice of revocation issued in 2017. On the question of whether the Minister had the authority to pursue the reassessment in 2017, the Court held that the reassessment was issued within the normal reassessment

period and that the factual basis of the reassessment was and had always been that the commuted value of the appellant's registered pension plan had been transferred to a non-registered pension plan. Due to the retroactive nature of the revocation the facts underlying the basis of the reassessment were always present. As there was no change to the factual basis of the reassessment the Court therefore concluded that the restrictions contained in section 152(9), on which the taxpayer relied to dispute the Minister's authority to issue that reassessment, did not apply in the circumstances.

*Mammone v. The Queen*

2018 DTC 1024

**Footnotes**

[1] Max Reed is a cross-border tax lawyer at SKL Tax. He can be reached at max@skltax.com. I would like to acknowledge the invaluable input of Peter Megoudis, Michael Miller, and Charmaine Ko on this article.

[2] Zanet and Ruchelman, A New Tax Regime for C.F.C.'s: Who Is G.I.L.T.I.?, *Insights*, Vol. 5 No. 1, January 26, 2018; online at: http://publications.ruchelaw.com/news/2018-01/tax-reform-gilti-fdii.pdf.

[3] This is a technical term that includes (but is not limited to): income from dividends, interest, certain rents, certain royalties, capital gains from the sale of passive assets, commodities transactions, net foreign currency gains, and income from notional principal contracts and certain personal service contracts, as well as (a) the sale of certain property purchased from a related person; (b) the sale of personal property to, or on behalf of, a related person; or (c) the purchase of personal property on behalf of a related person, where the property is (i) manufactured, produced, grown, or extracted outside the country in which the CFC is organized, and (ii) sold or purchased, as the case may be, for use, consumption, or disposition outside such non-US country. Finally, foreign base company income also includes income derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which are performed (A) for or on behalf of a related person and (B) outside the country in which the CFC is organized.

[4] GILTI is treated for certain purposes of the Code as Subpart F income and the ordering rules suggest that Subpart F income is taxed to the recipient prior to the dividend.

[5] Reg. section 1.904-6(b)(2).

[6] The exact mechanics of this are complex, but put generally the conversion of a Canadian corporation to a ULC is a liquidation for US federal tax purposes. After the application of Code section 965, the US taxpayer should have high basis in the CFC shares, because Code section 965 increases the US shareholder's basis in the CFC to the extent of the Subpart F inclusion under Code section 965. Alternatively, if the gain is considered to be a dividend under Code section 1248, then the dividends (to the extent of the 965 inclusion) should be distributable tax free to the US shareholder. The results of such a conversion are fact specific and shouldn't be undertaken without a full analysis.

[7] Rental income could be considered Subpart F income if the management of the rental properties is delegated to a third party. See Treas. Reg. section 1.954-2(c)(3) Example 3.

[8] Code section 951A(e).

[9] Reg. section 1.951-1(e)(3)(i).

[10] Code section 1297(d).

[11] Summarized briefly, the technical argument runs as follows. Code section 962 states that an individual US taxpayer can elect to be subject to "an amount equal to the tax which would be imposed under section 11 if such amounts were received by a domestic corporation." Under Section 11(a), "a tax is hereby imposed for each taxable year on the taxable income of every corporation." A corporation receiving the 951A inclusion would be eligible for the section 250 deduction, so an amount equal to the tax imposed under section 11 if the 951A inclusion was received by a domestic corporation also implicitly includes the deduction. There are regulations under Reg section 1.962-1(a) that outline the benefits of the Code section 962 election (corporate tax rates and foreign tax credits), but they do not expressly state that this is all the benefits that the taxpayer receives. In turn, Reg. section 1.962-1(b) defines taxable income under section

11 to mean the sum of the income included by S. 951A and section 78. On its face, that would seem to preclude any deductions. However, the final words of Reg. section 1.962-1(b) are "For purposes of this section, such sum shall not be reduced by any deduction of the United States shareholder even if such shareholder's deductions exceed his gross income." That would imply that the taxable income cannot be reduced by any deductions of the US shareholder, rather than simply no deductions period. This distinction is important because the section 250 deduction is not a deduction of the US shareholder as it is not found in Part V or VI (the parts of the tax law relating to individuals). Instead, it is a deduction against the 951A inclusion. Further, the regulations under Code section 962 were enacted prior to the enactment of the GILTI regime so one questions whether or not they are still valid. The point remains that while there is an equity based argument in favour of the deduction being available to individual US citizens, that position is not without risk.

[12] https://www.bnn.ca/canada-will-study-issue-of-taxing-tech-giants-morneau-1.1032710.