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Tax Notes

Report No.: 666

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21-YEAR TAX ISSUES AND THE NON-SPECIALIST ADVISOR—PART 2[1]

- –Michael Goldberg, partner through a professional corporation at Minden Gross LLP

Part 1 of this Series reviewed what the 21-year deemed disposition rules are and introduced three approaches to planning that appear to be most commonly used to manage the effects of the 21-year deemed disposition rules: Doing Nothing, the *Simple* Roll-Out, and Vesting Indefeasibly. The Doing Nothing approach was discussed in Part 1 of the Series and, in this second instalment, we will delve into the *Simple* Roll-Out approach to planning for the 21-year deemed disposition of a trust.

THE SIMPLE ROLL-OUT APPROACH

Assuming that there are no legal or technical tax issues that might restrict the ability to adopt the *Simple* Roll-Out approach, prior to the 21st anniversary of the trust, the trustees can simply resolve to distribute some or all of the capital of the trust to one or more of the capital beneficiaries.

No tax consequences will arise from the distribution, provided that the ACB and FMV of the distributed property are the same.[2] In addition, so long as the provisions of subsection 107(2) can be satisfied, trust property with unrealized gains should be eligible to be distributed on a tax-deferred basis to beneficiaries of the trust, who would inherit the ACB of the trust in the distributed property.

Subsection 107(2) General Requirements

A number of requirements must be met to qualify for tax-deferred rollover treatment under subsection 107(2). In particular, the trust making the distribution must be a personal trust and the distribution must be made to a beneficiary in satisfaction of all or part of that beneficiary's capital interest.

However, the roll#out will not be available if either the beneficiary or the trust elect not to have the rollover apply[3] or if any of the provisions in subsections 107(4) to (5) apply to deny the rollover. For example, subsection 107(4.1) may deny the roll#out if subsection 75(2) was ever applicable to a trust, and subsection 107(5) will deny the roll-out of property to non#resident beneficiaries. The subsection 107(4.1) exclusion is discussed below, and the subsection 107(5) exclusion will be discussed in Part 4 of the Series.

The *Simple* Roll-Out Approach—Some Tips

Provided that it is possible to implement a *Simple* Roll-Out, it is worth keeping the following tips in mind:

(1) Not all assets need to be distributed. For example, assets without gains can be maintained in a trust beyond the trust's 21st anniversary with no tax consequences using the Do Nothing approach, so using a combination of the Do Nothing and *Simple* Roll-Out approaches, it might be possible for the trust to distribute appreciated assets to beneficiaries who are capable of managing the property and maintain other non-appreciated property in the trust beyond the trust's 21st anniversary for the benefit of beneficiaries who may not be capable of managing distributed property at the time of the trust's 21st anniversary.

(2) Assets with accrued losses could be distributed to beneficiaries without impacting the deferred loss so that the beneficiaries can later realize the losses and utilize them. This might be beneficial to a beneficiary who has recently realized gains since the loss realized in the hands of the beneficiary

should be eligible to not only be carried forward but also carried back for up to three years to offset the previously realized gains.[4]

(3) Clients should consider freezing or refreezing existing corporate structures involving trusts when a trust is about 10 years old or at times of critical life events, such as after the marriage of their children, as doing so can often create additional planning flexibility.[5]

(4) Start planning early! Although I've referred to this approach as the *Simple* Roll-Out, as will be discussed below, other than its implementation there is really nothing simple about the *Simple* Roll-Out and even a year may not be enough time.

THE NOT SO SIMPLE ROLL-OUT

Because of the many non-tax and tax issues that will typically complicate *Simple* Roll-Out transactions, more often than not, this option would probably more accurately be referred to as the *Not So Simple* Roll-Out approach.

Issues to be Considered by Trustees

There are many issues that must be considered by trustees in exercising the discretions and powers granted to them under a trust deed or by law. However, as the topic of trustee fiduciary duties, powers, and obligations fills entire text books,[6] all that will be noted on this subject is that even where trustee-related issues are or appear to be non-controversial, it is critical that all material trustee decisions be properly documented and that the trustees act in good faith without *mala fides* (i.e., dishonest intent).

Impact on the Beneficiaries

Because the roll#out will result in one or more beneficiaries receiving property, it will be necessary for the trustees to consider how the recipient beneficiary or beneficiaries will manage the property.

It will also often be relevant for the trustees to consider whether beneficiaries will be able to fund death tax liabilities or even potential Canadian emigration tax liabilities once the property has been distributed to them.

In addition, when dealing with married beneficiaries, family law issues should be carefully considered. For example, in Ontario not all distributions from a trust are protected from matrimonial property claims. Also, it should be kept in mind that spouses are entitled to seek an equalization of matrimonial property not just on marriage break down but also on the death of a spouse.[7]

Where a Trust is Employed in Connection with an Estate Freeze—Impact on Freezor[8]

Although arguably not an issue that should be taken into account by trustees, as a practical matter, where a trust was formed in connection with an estate freeze, the impact of the distribution on interested parties such as the freezor will likely be a very real consideration, particularly where the freezor is one of the trustees. For example, issues such as how a distribution of shares might have an impact on control of a corporation or family group of corporations, the freezor's future liquidity and succession management and overall family equalization should all be kept in mind.

Technical Issues

There are also a number of technical issues that can make the *Simple* Roll#Out not so simple:

(1) Trust provisions Particularly for older trusts, which tended to be drafted with more limited classes of beneficiaries, it is not uncommon for the freezor or corporate beneficiaries to have been left out of the class of beneficiaries. In such cases, if it is desirable to make a distribution to such beneficiaries, including prior to the 21st anniversary of the trust, the limited class of beneficiaries would be problematic.[9] While some opportunities may exist to overcome these types of limitations, the solutions will typically not be simple to implement, and the results may often prove to be less than satisfactory.

(2) Non-resident beneficiaries Direct distributions to non#resident beneficiaries will be taxable under subsection 107(5) and will therefore not be eligible for a tax-deferred roll-out under subsection 107(2).

(3) Denial of the roll-out due to the application of subsection 107(4.1) Probably the most significant technical issue that can apply to preclude a tax-deferred roll-out is if subsection 75(2) or 94(8.2) has ever potentially been applicable to any property of a trust.[10] In such situations a tax-deferred distribution under subsection 107(2) could be prohibited due to the application of subsection 107(4.1). You may recall that subsection 75(2) is a complex attribution rule that can potentially apply in situations where property has been transferred to a trust on condition that the property can revert to the transferor or where the transferor maintains direct or indirect control over the property. This provision can apply to anyone who settles or contributes property to a trust, not just the original settlor. Consequently, all contributions to a trust that meet the criteria in this provision need to be considered. When subsection 75(2) is applicable, all income, losses, and capital gains and capital losses associated with property of a trust that has been contributed by a particular contributor will attribute back to that contributor. What is unique about subsection 107(4.1) is that no income or losses or capital gains or capital losses actually need to have been attributable under subsection 75(2) to cause subsection 107(4.1) to apply. All that is necessary is that subsection 75(2) might, during the existence of the trust, have ever potentially been applicable. Although there are exceptions to the subsection 107(4.1) roll-out denial,[11] the application of these exceptions can be quite technical. As a result, prior to a trust's 21st anniversary, considerable time should be spent reviewing whether subsection 107(4.1) could deny the roll-out of property from the trust under subsection 107(2).

PRE-DISTRIBUTION REORGANIZATIONS

Hopefully it has become clear that the *Simple* Roll-Out approach is often quite complex. In fact, very often some type of a pre-distribution reorganization will either be beneficial or even necessary to implement prior to a trust's 21st anniversary.

There are many reasons why a pre-distribution reorganization might be considered before distributing trust property. Some of the possible objectives of pre-distribution reorganizations are briefly discussed below:[12]

(1) Freeze and refreeze transactions These types of transactions might involve freezing corporate interests owned by a trust to permit future growth to be capable of being maintained in the trust beyond the trust's 21st anniversary or to benefit parties other than the trust and the trust's direct beneficiaries. For example, a new trust with modern beneficiaries, including any one or more new beneficiaries, such as corporate beneficiaries, the freezor, and key employees, could be created to enjoy the benefit of the future growth.

(2) Crystalize capital gains exemptions It may be desirable to take steps to crystallize the capital gains exemptions of beneficiaries as part of or prior to a distribution of trust property.

(3) Avoid distributing preferred shares to beneficiaries Transactions such as refreezes and crystallizations may require the use of preferred shares. However, it may not be desirable to provide beneficiaries with shares that can automatically be redeemed by the holder of the shares (and possibly the creditors of beneficiaries). Therefore, additional planning may be required to ensure that preferred shares are not distributed to the beneficiaries while still accomplishing the other planning objectives.

(4) Create agreements that will help beneficiaries to manage distributed property Prior to distributing property to beneficiaries, agreements, such as unanimous shareholder agreements, could be put in place to help the beneficiaries to manage the distributed property.

(5) Ensure control stays with the trust/freezor In some situations a reorganization may be required to bifurcate the shareholdings of the trust so that only non-voting shareholdings are distributed to beneficiaries while the trust maintains the voting shares or distributes the voting shares to only certain of the beneficiaries.

(6) Provide possible family law benefits In Ontario a gift made after marriage is ordinarily exempt from a matrimonial property claim by an aggrieved spouse.[13] It is possible that a refreeze transaction that is implemented by way of a gift of cash to subscribe for new common shares or the new common shares themselves may allow a beneficiary who was not married at the time of the original freeze to enjoy family law benefits in respect of income and growth in value associated with the new common shares.[14]

REQUIREMENT FOR INFORMATION AND INEVITABILITY OF A CRIMINAL INVESTIGATION: REVISITING JARVIS

- –Cameron Mancell, CFP®, Analyst, Wolters Kluwer

The CRA has broad powers to collect nearly any documentation it asks for in the course of an audit. Recent decisions have added or clarified exceptions to this rule, for example: solicitor-client privilege (*AG v. Chambre des notaires du Québec*)[15] and working papers (*BP Canada v. MNR*).[16] Another important exception established by the Supreme Court of Canada in *Jarvis v. The Queen*[17] is that the CRA cannot issue a requirement for information ("RFI") where the predominant purpose of the inquiry is the determination of penal liability. There are two recent court decisions involving scenarios where it appears that a criminal investigation is more likely than not following the conclusion of an audit. The taxpayers sought to apply the principles of *Jarvis* in order to avoid complying with an RFI, and despite the appearance of a criminal investigation in the making, they were both unsuccessful.

This analysis begins with a quick refresher on the CRA's power to request information, followed by the principles established by *Jarvis.* Next, the application of these principles in two recent decisions is discussed.

THE CRA'S AUDIT POWERS

Subsection 231.1(1) permits the CRA to audit the books and records of a taxpayer that relate to taxes payable under the Act. Subsection 231.2(1) allows the CRA to serve taxpayers with an RFI, which requires the taxpayer to provide any additional information or documents within a reasonable time. Both of these provisions are subject to the constitutional limitations that were confirmed by the Supreme Court's *Jarvis* decision.

BACKGROUND ON JARVIS

This decision involved a taxpayer who failed to report income from the sale of art. After several interactions with the auditor and complying with multiple information requests, and following the submission of the file to the Special Investigations team, more taxpayer information was collected using an RFI.

The Court found that requiring a taxpayer to provide information where the predominant purpose of the inquiry was to investigate penal liability would violate the taxpayer's rights under sections 7 and 8 of the *Canadian Charter of Rights and Freedoms*. Specifically, section 7 provides the right to life, liberty, security of the person, and the right not to be deprived thereof except in accordance with the principals of fundamental justice (i.e., individuals are protected from self-incrimination). Section 8 is the right to be secure against unreasonable search and seizure. Note that these Charter rights do not apply to corporations.[18] As a result of this conclusion, the Court found that when the predominant purpose of an inquiry is to determine penal liability, the CRA loses its authority to request information under subsections 231.1(1) and 231.2(1). The criminal investigation began on the day the file was referred to Special Investigations, so information obtained after that date through an RFI was to be excluded from any criminal proceedings.

To aid in ascertaining whether the predominant purpose of a request for information is the determination of penal liability, the Court provided a list of factors that should be examined:[19]

A. Did the authorities have reasonable grounds to lay charges? Does it appear from the record that a decision to proceed with a criminal investigation could have been made?
B. Was the general conduct of the authorities such that it was consistent with the pursuit of a criminal investigation?
C. Had the auditor transferred his or her files and materials to the investigators?
D. Was the conduct of the auditor such that he or she was effectively acting as an agent for the investigators?
E. Does it appear that the investigators intended to use the auditor as their agent in the collection of evidence?
F. Is the evidence sought relevant to taxpayer liability generally? Or, as is the case with evidence as to the taxpayer's *mens rea*, is the evidence relevant only to the taxpayer's penal liability?
G. Are there any other circumstances or factors that can lead the trial judge to the conclusion that the compliance audit had in reality become a criminal investigation?

The discussions that follow relate to two recent decisions where taxpayers made *Jarvis* applications.

UNREPORTED SWISS BANK ACCOUNT: CIVIL AUDIT OR CRIMINAL INVESTIGATION?

MNR v. Stankovic[20] involves an application by the Minister to require the taxpayer to provide the records and information that were requested. The CRA obtained a list of Canadians who had bank accounts at HSBC Private Bank in Switzerland from the French tax authorities. This information came from a list stolen by an HSBC employee (the famous Falciani List). Stankovic (the taxpayer) did not report any income from a Swiss bank account, and at first denied the existence of any such account. The CRA sent multiple letters requesting the complete bank records of the account, to which Stankovic would not comply unless the CRA agreed to conditions including no interest or penalties and immunity from prosecution. Eventually Stankovic admitted to the existence of the account, but still refused to comply with the request on the grounds that the request related to a criminal investigation.

The Minister applied for a compliance order under section 231.7. The taxpayer submitted that the predominant purpose of the request was for a criminal investigation, and she was therefore not required to comply with the request on constitutional grounds. The taxpayer also suggested that the Minister had no right to use stolen data, which the court did not accept. Regarding the predominant purpose, the taxpayer presented several factors which suggested "that there is likely a criminal investigation going on behind the scenes of which the Auditor has no knowledge."[21] Some of these factors include:[22]

- the previous and current Canadian governments have expressed intent to prosecute tax evaders, specifically mentioning Canadians using secret Swiss bank accounts;
- the taxpayer was selected for audit specifically because her name appeared on the leaked list, which demonstrates that the purpose of the audit was not regulatory compliance;
- the taxpayer was being audited for years outside the normal reassessment period, which the CRA can reassess in cases of misrepresentation or tax evasion; and
- the auditor requested records beyond the six-year requirement to keep records, which indicates an intention other than a regulatory audit.

Unfortunately for the taxpayer, these factors were found to be "subjective fears" and "speculative theories" rather than any direct evidence of a predominant purpose. The *Jarvis* test must be based on evidence, not subjective suspicions. As a result, the Minister's application for a compliance order under subsection 231.7(1) was allowed. Although failing to report income from a foreign account (with a balance exceeding $1 million) seems to be an obvious referral for the CRA's Criminal Investigations Program, the predominant purpose was not to determine penal liability during the course of the audit, and therefore the taxpayer was required to comply with the CRA's RFI.

TAX PREPARERS CLAIMING FICTITIOUS BUSINESS LOSSES FOR CLIENTS

The other recent case relating to this topic is *R. v. Patry*.[23] Two former CRA employees who operated a tax preparation business that aided clients with claiming fictitious business losses were facing a six-count indictment. Following an audit of one of the Patrys' clients, the CRA's enforcement division identified the Patrys by obtaining a production order to retrieve the IP address and telephone number of the client's tax representative, and discovered the Patrys' identities as a result.

The Patrys sought to bring a *Jarvis* application to exclude evidence obtained via an RFI during the course of the audit of their client. They provided several factors that, in their view, demonstrated that they were already under investigation by the CRA when their client was under audit and "the CRA was out to get them". According to the Patrys, Mr. Patry had a history of conflict in his employment with the CRA (e.g., allegations of stockpiling office supplies and improper computer use), and there had been investigations that suggested the CRA was concerned with Mr. Patry's tax work on the side. It is based upon these circumstances that the taxpayers argued that the CRA planned to get back at Mr. Patry.

Obviously these circumstances are not factual evidence. Understandably, the Crown requested a *Vukelich* hearing, which is essentially used to stop applications which have no reasonable prospect of success. The Court found that the Patrys failed to show a reasonable basis to embark upon a *Jarvis* hearing. However, this decision did not close the door on applying *Jarvis* for the Patrys. When CRA employees are called as witnesses at trial, the Patrys might be allowed to revisit the *Jarvis* issue should the relevant factors emerge during cross-examination.

The *Jarvis* application being found to have "no reasonable prospect of success" when taxpayers face criminal charges is not the result one might expect. This decision is another cautionary tale of the difficultly in proving that the CRA's predominant purpose of requesting information was to determine penal liability—only hard facts about the CRA's conduct and intentions will suffice.

IS THIS THE RESULT THE SUPREME COURT INTENDED?

Without impeding our ability to efficiently prosecute tax cheats, one must wonder if the fine line between a civil and criminal investigation has been drawn in the correct place. The lack of success for taxpayers in these cases raises concern for where a *Jarvis* application is allowed. It is reasonable to anticipate a criminal investigation following an audit relating to preparing returns with fictitious businesses losses or offshore tax evasion. But it appears that taxpayers have an uphill battle, even in exceptional cases. Some might conclude that these are cases of a criminal investigation disguised as a civil audit—a wolf in sheep's clothing. In a recent opinion piece in the *Canadian Accountant*, David J. Rotfleish expresses exactly this sentiment:

> In my opinion, this is the wrong way for CRA to proceed. This is really an exception to *Jarvis* and Charter protection ought to be available in these instances. It is unfair to use the civil audit power to compel a taxpayer to provide information to be used in a criminal tax prosecution that is inevitable but not yet commenced due to the institutional way in which the CRA approaches these cases.[24]

Given recent information leaks revealing taxpayers' offshore holdings (e.g., the "Panama Papers") and the additional resources the government is providing to the CRA to increase its tax compliance efforts, I anticipate that further disputes on this issue are to come.

CROSSING PROVINCIAL LINES: ALBERTA COURTS TACKLE 20(1)(C)

- –Sophie Virji, Associate, Dentons Canada LLP, Calgary and Ahmed Elsaghir, Associate, Dentons Canada LLP, Calgary

PARAGRAPH 20(1)(C)

Paragraph 20(1)(c) of the *Income Tax Act* (Canada) (the "Act") provides a specific statutory authority for the deduction of interest payments on borrowed money that is used for the purpose of earning business or property income. There have been a myriad of commentaries on the application of paragraph 20(1)(c) of

the Act and courts have gone to substantial lengths to define the parameters of interest deductibility and its components.

The Supreme Court of Canada in *Shell Canada Ltd. v. Canada*, 99 DTC 5669, set out a four-part test for interest deductibility under subparagraph 20(1)(c)(i):

(1) the amount must be paid in the year or be payable in the year in which it is sought to be deducted;
(2) the amount must be paid pursuant to a legal obligation to pay interest on borrowed money;
(3) the borrowed money must be used for the purpose of earning non-exempt income from a business or property; and
(4) the amount must be reasonable, as assessed by reference to the first three requirements (the "Shell test").

The third part of the Shell test, the purpose requirement, has attracted the bulk of the judicial consideration while the fourth part, the reasonableness requirement arising from the wording contained in the post-amble to paragraph 20(1)(c) "or a reasonable amount in respect thereof, whichever is the lesser", has attracted far less attention.

ALBERTA V. ENMAX ENERGY CORPORATION, 2018 DTC 5054 (ABCA) ("ENMAX")

In this recent Alberta Court of Appeal ("ABCA") decision, ENMAX, a tax-exempt entity, made inter-company loans to two of its subsidiaries, ENMAX Energy Corporation ("Energy") and ENMAX PSA Corporation ("PSA"). Both Energy and PSA were tax-exempt entities as well; however, unlike ENMAX, they were subject to Alberta legislation requiring them to make annual payments in lieu of tax that would otherwise be payable under the Act and the *Alberta Corporate Tax Act*, RSA 2000, c. A-15. These payments were required to be made to a "Balancing Pool" established under the *Alberta Electric Utilities Act,* SA 2003, c. E-5.1 (the *"Utilities Act"*), and the *Payment in Lieu of Tax Regulation*, Alta. Reg. 112/2003 *("PILOT Regulation"),* for the benefit of Alberta electricity consumers (collectively the "balancing pool payments regime").

Energy and PSA deducted interest that was payable to ENMAX pursuant to the inter-company loans at rates of 11.5 per cent, 10.3 per cent, and 9.9 per cent. The Alberta Minister of Finance reassessed the subsidiaries and determined reasonable rates on the three notes to be 5.42 per cent, 5.26 per cent, and 5.24 per cent. The Minister issued his reassessment on the basis that the interpretation of paragraph 20(1)(c) must be a factor for provincial policy considerations.

The Alberta Court of Queen's Bench[25] allowed the taxpayers' appeals. In determining whether the interest deducted was a reasonable amount, the Court asked "whether no business would have contracted to pay that amount, having only its business considerations in mind and under the form of transaction pursuant to which the obligation was incurred." The Court stated that the use of the actual inter-company loan interest rate to determine a company's financial status was improper in a credit rating analysis of the actual interest rate at issue. However, reasonableness was to be measured with reference to the legal transaction at issue and not a hypothetical contract the parties could have entered into. Furthermore, the adjustment made by the Minister for implicit parental support was improper because the inter-company loans did not allow for it and ENMAX carried the entire risk and could not seek recovery from any other party.

In overturning the Queen's Bench decision, the ABCA conducted a lengthy analysis of the meaning and application of reasonableness in the context of the balancing pool payments regime and paragraph 20(1)(c) of the Act. The Court found eight reviewable errors made by the trial judge in conducting the reasonableness analysis. The Court held that the question of whether interest deducted is reasonable necessarily requires the court to look at context. In this case, the context included the statutory regime under which Energy and PSA were required to make payments into the Balancing Pool pursuant to the balancing pool payments regime. In finding that the trial judge erred in not factoring in this context, it noted that what is reasonable for the purposes of calculating taxable income is not necessarily reasonable for the purposes of calculating the required balancing pool payments. The Court went on to find that the trial judge failed to conduct a proper arm's length assessment of what is reasonable. It noted that not only did the reasonableness requirement invite an arm's length check that considered what the funds could have been borrowed at in the market (as opposed to the actual transaction to which the borrower was a party), under the balancing pool payments

regime, an arm's length check was essential because, unlike in an ordinary income tax case, both the lender and borrower were not taxable due to the tax-exempt status of the parties. The Court also found that the trial judge erred in taking into account ENMAX's implicit parental support.

A REASONABLE OUTCOME?

While in the normal course interest payments deductible by a subsidiary borrower would be taxable by a parent lender, in this case ENMAX was not required to pay income tax (or balancing pool payments) by virtue of being a municipality-owned corporation.[26] Furthermore, Energy and PSA were likewise tax exempt, operating within the balancing pool payments regime designed specifically to level the playing field between municipal and private sector entities. The ABCA in this regard sought to find harmony between paragraph 20(1)(c) of the Act, the *Utilities Act*, and the *PILOT Regulation*, and in doing so took a hard-line approach to the correlation between reasonableness and arm's length. Specifically, the *Enmax* decision stands for the proposition that an arm's length transaction is necessarily reasonable and, applied in the converse, that for a transaction to be reasonable it must necessarily carry arm's length terms.

However, a look at the Federal Court of Appeal ("FCA") decision in *Petro-Canada v. Canada*, 2004 DTC 6329 ("*Petro-Canada*"), for example, shows that this is not necessarily the case. Rather, the FCA in that case accepts that in some cases, business considerations may motivate a reasonable borrower to pay a higher-than-market interest rate. So in other words, what are considered reasonable terms will not necessarily be arm's length terms.

It is not often that cases involving the Act are heard at the provincial level, although the ABCA firmly positioned this case as one of legislative interpretation (of the balancing pool payments regime) rather than income tax. In any event, for this reason and for the reasons outlined above, the *Enmax* decision was a unique one. This decision would thus likely not have broad applicability to income tax cases requiring an analysis of the reasonableness requirement in 20(1)(c) and will likely not constrict the reasonableness parameters seen in *Petro-Canada*.

For now, the window to seek leave to the Supreme Court of Canada remains open, and as such, so too does the applicability of this unique case to the broader paragraph 20(1)(c) reasonableness requirement.

CURRENT ITEMS OF INTEREST

CRA PUBLISHES Q3 INTEREST RATES

The CRA has published the prescribed interest rates for the third calendar quarter of 2018. The rates, which are mostly unchanged since the previous quarter, are as follows:

- The interest rate charged on overdue taxes, Canada Pension Plan contributions, and employment insurance premiums will be 6%.
- The interest rate to be paid on corporate taxpayer overpayments will be 2%.
- The interest rate to be paid on non-corporate taxpayer overpayments will be 4%.
- The interest rate used to calculate taxable benefits for employees and shareholders from interest free and low-interest loans will be 2%.
- The interest rate for corporate taxpayers' pertinent loans or indebtedness will be 5.16%.

CRA REPORTS PROGRESS ON IMPROVING CALL CENTRE PERFORMANCE

Last month the CRA provided a response to a report by the House of Commons Standing Committee on Public Accounts regarding the CRA's call centre performance. The response highlights the CRA's three-point action plan to modernize its call centre technology, improve agent training, and update its service standards.

GOVERNMENT ANNOUNCES JUDICIAL APPOINTMENTS TO THE TAX COURT OF CANADA

On June 7, 2018, Jody Wilson-Raybould, Minister of Justice and Attorney General of Canada, announced two appointments to the Tax Court of Canada:

- Justice K.A. Siobhan Monaghan, partner at KPMG Law LLP in Toronto; and
- Justice Susan Wong, Regional Director and General Counsel at the Department of Justice Canada.

PROGRESS OF LEGISLATION

Bill C-74, *Budget Implementation Act, 2018, No. 1*, received Royal Assent on June 21, 2018.

RECENT CASES

APPEAL FROM DECISION DENYING EXEMPTION FROM TAX UNDER INDIAN ACT DISMISSED

The taxpayer, who was a status Indian, was the owner of 51% of the shares of a company and was the president and sole director of that company. The company's office was located on a reserve, and although the taxpayer performed most of her employment duties at that office, she did not live on a reserve. The taxpayer received bonuses from the company during the 2005 through 2008 taxation years in a total amount of approximately $3.3 million. The Minister assessed such bonuses as constituting taxable income and the taxpayer appealed from the assessment, arguing that such income was exempt under section 87 of the *Indian Act*. The Tax Court of Canada dismissed her appeal. It found that the bonuses were remuneration from employment but that the amounts paid were not reasonable in the circumstances and were, in substance, corporate distributions to a key shareholder. The Court then considered the business that was being carried on by the company and held that, since virtually all of the company's business was generated and performed off reserve, connecting factors sufficient to find that the bonuses were exempt from tax under the *Indian Act* did not exist. The taxpayer appealed from that decision to the Federal Court of Appeal.

The appeal was dismissed. The appellate Court began by noting that section 87 of the *Indian Act* provides that "the personal property of an Indian … situated on a reserve" is exempt from taxation. In order to determine whether any particular property of a status Indian satisfies this test for exemption from taxation, it is necessary for the court to identify and examine the factors that connect such property to a reserve and then to determine the amount of weight to be given to those factors. Factors identified in the jurisprudence to be considered in relation to employment income include the residence of the employer, the residence of the employee, the location where the work is performed, the nature of the services performed, and the special circumstances in which they are performed. The appellant had argued that the Tax Court's analysis of her employment income should have been restricted to these factors and that the Court had erred in considering the reasonableness of the bonuses paid and by then considering the business that was being carried on by the company in determining the connecting factors. The appellate Court agreed that the connecting factors should not be determined based on the reasonableness of the amount of remuneration, but rather should be determined based on the circumstances related to the payment of that remuneration. In the appellate Court's view, however, the Tax Court judge did not err in considering the operation of the business carried on by the company in determining the relevant connecting factors. The factors outlined in the jurisprudence were identified in relation to an arm's length employment relationship, but in this case the appellant was not dealing with the company at arm's length. In the appellate Court's view, in determining whether employment income that is paid by a corporation that is controlled by the employee is exempt under section 87, it is appropriate to look at the particular business that is being carried on by that company to determine the relevant connecting factors. The business that gave rise to the bonuses paid was the appellant's business, and she was the majority shareholder and sole director of the company. In the Court's view, therefore, it was more appropriate, in those circumstances, to consider the connecting factors that would be relevant in relation to the business of the company rather than the connecting factors that would be relevant in relation to employment income, and the Tax Court judge did not err in doing so. The Court noted that the appellant had challenged only the right of the Tax Court judge to examine the business of the company in determining the relevant connecting factors, but had not challenged any of the factual findings made by the Tax Court

judge in relation to the operation of the business or the relative weight that was given to the relevant factors. The Court concluded that it was appropriate in the circumstances for the Tax Court judge to consider the business of the company in determining the relevant connecting factors to connect the bonuses to a reserve for the purpose of an exemption under section 87 of the *Indian Act*. The appellate Court concluded that, as a result, there was no basis on which to interfere with the decision of the Tax Court judge that the bonus income received by the appellant did not qualify for an exemption under section 87.

Bell v. The Queen

2018 DTC 5060

APPLICATION FOR JUDICIAL REVIEW OF MINISTER'S DENIAL OF TAXPAYER RELIEF ALLOWED

The taxpayer and her spouse jointly owned a property in the United States, and the value of that property necessitated the filing of a Form T1135. That form was filed by the husband for the 2011 and 2012 taxation years, and the rental income for the property was included in his annual income. Instructions for the completion of Form T1135 for those years indicated that it was to be filed "with your tax return". As the taxpayer did not have any taxable income for 2011 and 2012, she was not required to file a return and believed, therefore, that the requirement to file a T1135 "with your return" did not apply to her. In 2013 the taxpayer decided to claim the Canada Child Benefit, both for the current year and retroactively. To do so, she filed returns for the 2011, 2012, and 2013 taxation years. The Minister then assessed penalties and interest in the amount of $5,540.87, for her failure to file the T1135 in 2011 and 2012. She applied for relief from such penalty and interest charges. In its reasons, the Minister's delegate indicated that the taxpayer had been required to file returns for 2011 and 2012 in order to receive the CTB, and, in addition, was required to file a T1135 for those years even if a tax return was not being filed. In the delegate's view, the taxpayer had failed to meet both such obligations and the taxpayer relief provisions did not apply where a taxpayer chose to disregard filing deadlines. However, in view of the taxpayer's record of full compliance with her obligations after 2013, the delegate determined that partial relief could be provided. Such relief was provided with respect to the 2012 taxation year, but was denied in respect of 2011. The taxpayer applied for judicial review of that decision with respect to 2011.

The application was allowed. The Federal Court first reviewed the findings made by the Minister's delegate, and the basis on which relief was refused to the taxpayer. It held that the standard to be applied to the decision to refuse relief was one of reasonableness. The Court held that the decision made with respect to the 2011 taxation year did not meet that standard. In the Court's view, the delegate's conclusion that the taxpayer had failed to exercise reasonable care with respect to her tax filing obligations was unreasonable. It held that such conclusion arose in part from the delegate's erroneous belief that the taxpayer was required to file a return for 2011 by the filing deadline for that year, in order to qualify for the CTB. The Court held, rather, that the requirement to file a return for that year (one in which the taxpayer had no taxable income) only arose when the taxpayer decided to make a retroactive claim for child tax benefits in 2014. The obligation to file a T1135 for 2011 was independent of an obligation to file a return. The Court noted, however, that the Guidelines with respect to the circumstances in which taxpayer relief may be granted state that "errors in material available to the public, which [lead] taxpayers to file returns or make payments based on incorrect information" are grounds for relief. The Court held, in agreement with the applicant, that the pre-2013 T1135 form's instructions were unclear, confusing, and bordered on misleading, and that other taxpayers had made the same error. The Court concluded that the delegate's mistaken belief that the taxpayer was required to file a return for 2011 prior to the filing deadline influenced his determination that she had not acted diligently. It was not, in the Court's view, possible to know whether the same decision would have been reached but for the error in interpreting the taxpayer's filing obligations. As a result, the Court concluded that the delegate's decision lacked justification and was not intelligible. The Court then considered the taxpayer's hardship claim and held that the delegate's failure to even acknowledge such claim was unreasonable. Consequently, the application was allowed and the matter with respect to the 2011 taxation year was remitted to the Minister for redetermination by a different delegate.

Takenaka v. Canada (AG)

2018 DTC 5055

TAXPAYER TRUST AVOIDED TAX ON TAXABLE DIVIDEND RECEIVED BY ATTRIBUTING DIVIDEND BACK TO SETTLOR; MINISTER'S GAAR ASSESSMENT TAXING DIVIDEND IN TRUST'S HANDS AFFIRMED ON APPEAL

The taxpayer, the Fiducie Satoma, was established to meet the requirements of subsection 75(2) of the *Income Tax Act* (the "Act") in order to take advantage of the attribution rule provided in that subsection. According to this rule, income derived from assets transferred by a taxpayer to a trust under circumstances where such assets or assets substituted therefor may revert to the taxpayer is deemed to be the income of the taxpayer-transferer. A numbered company, 9134, was designated as a beneficiary of the Fiducie Satoma. 9134 gifted $100 to the Fiducie Satoma, with the proviso that this $100 could revert to 9134, thus bringing the attribution rule in subsection 75(2) into operation. The Fiducie Satoma used the $100 to purchase shares of another numbered company, 9163, and these shares thus constituted "property substituted for" the $100 as contemplated by subsection 75(2). This in turn meant that these shares of 9163, as well as any dividend income therefrom, could be attributed by the Fiducie Satoma to 9134 under subsection 75(2). With this structure in place, the Louis Pilon Family Trust (the "Pilon Trust") received a dividend on its shares of Gennium, which it distributed to 9134, which was one of its beneficiaries. The Pilon Trust deducted this dividend from its income under paragraph 104(6)(b) of the Act, and 9134 also deducted it as an inter-corporate dividend under subsection 112(1) of the Act. The amount of the dividend was then transferred to 9163 as surplus, and 9163 paid it to the Fiducie Satoma as a dividend. The Fiducie Satoma, however, attributed it to 9134 under the subsection 75(2) attribution rule, and 9134 deducted it under subsection 112(1) as an inter-corporate dividend. Conversely, the Minister viewed this series of transactions as involving abusive tax avoidance and thus included the dividend received by the Fiducie Satoma from 9163 in the Fiducie Satoma's income under paragraph 12(1)(j) of the Act, refusing to permit it to be attributed to 9134 as the Fiducie Satoma had attempted to do. In dismissing the Fiducie Satoma's appeal, the Tax Court of Canada concluded, in essence, that the series of transactions involved in this case permitted dividends received by the Fiducie Satoma to be transferred into tax-free receipts, thus constituting an abuse of subsections 75(2) and 112(1) of the Act. On further appeal to the Federal Court of Appeal, the Fiducie Satoma argued, in part, that the Tax Court judge's findings were premature, inasmuch as the Fiducie Satoma had not yet distributed to its beneficiaries, who were individuals, the dividend received by it from 9163.

The Fiducie Satoma's appeal was dismissed. In this case there clearly was a tax benefit to the Fiducie Satoma through its ability to access the attribution rule in subsection 75(2), and in reaching this conclusion the Tax Court judge made no error. There was also tax abuse through the parties' inter-connected use of subsections 75(2) and 112(1). As a result, taxable dividends were transformed into tax-free amounts as the Tax Court judge had observed. The Minister's avoidance reassessment rectified this situation by removing the tax benefit received by the Fiducie Satoma and requiring it to include in its income under paragraph 12(1)(j) the dividend received by it from 9163.

Fiducie Financière Satoma v. The Queen

2018 DTC 5049

TAXPAYER'S SENTENCE FOR TAX EVASION NOT FOUND TO BE UNDULY HARSH, BUT REQUIRED CORRECTION IN CALCULATION OF ACTUAL FINE IMPOSED

The accused, who was 41 years of age with two young children, was the president and sole shareholder of a corporation, One World, which offered its customers, for a membership fee, certain money-saving opportunities. One World solicited loans from contributors in return for fictitious invoices showing fictitious business losses which those customers used to claim income tax deductions. Among other things, the accused received a personal benefit of some $1 million from this scheme.

The accused was convicted of tax evasion under both the *Income Tax Act* and the *Excise Tax Act*, and was fined $1 million for the income tax evaded, and $88,183.50 for the GST evaded. He was also sentenced to three years' incarceration; the fines were ordered to be paid immediately; and, in default, an additional year

of incarceration was imposed. The taxpayer's principal argument on appeal to the Manitoba Court of Appeal was that the sentence was unduly harsh. Although the Crown filed no cross appeal, it raised certain errors on the part of the sentencing judge that required correction: (a) the fines imposed did not comply with the relevant statutory provisions in that they were less than the statutory minima; (b) the victim surcharge should not have been imposed since it did not apply to offences under the *Income Tax Act* or the *Excise Tax Act*; and (c) the sentencing judge did not offer the accused time to pay the fine before ordering that it be paid immediately.

The taxpayer's appeal was dismissed. The sentence in this case was neither unduly harsh nor demonstrably unfit or crushing. The minimum fine, however, should have been equal to the total amount of taxes evaded, i.e., $2,366,367, and should therefore be increased accordingly. In addition, the victim surcharge should be set aside.

R v. Dyck

2018 DTC 5050

Footnotes

[1] Unless otherwise noted, defined terms in this article have the meaning designated in the first instalment of the Series.
[2] The trustees will still be required to ensure proper reporting of the distribution, if required, in the annual T3 filings of the trust.
[3] In this regard see subsections 107(2.001) and (2.002).
[4] The "loss restriction event" rules in the Act should be reviewed to ensure that they will not restrict the ability of a beneficiary to utilize such losses.
[5] Some examples of the benefits of a freeze or refreeze transaction are discussed at the end of this article.
[6] Oosterhoff, A.H., Chambers, Robert & McInnes, Mitchell, "Oosterhoff on Trusts: Text, Commentary and Materials", 8th ed. (Toronto: Carswell, 2014); and Donovan W.M. Waters, Mark Gillen, and Lionel Smith, "Waters' Law of Trusts in Canada", 4th ed. (Toronto: Carswell, 2012).
[7] For more on the subject of family law in Ontario, a specialist in family law matters should be consulted. See also *Family Law Act*, R.S.O. 1990, c. F.3 ("FLA").
[8] Even though the focus in this discussion is an estate freeze, in other contexts the impact on the matriarch or patriarch of a family may be relevant even when an estate freeze is not involved.
[9] A distribution to persons who are not beneficiaries of a trust would result in a breach of trust from a trust law perspective. In addition, a distribution in breach of trust would not be eligible for a tax deferred roll-out under subsection 107(2).
[10] Subsection 94(8.2) deals with non-resident trusts that are deemed to be resident in Canada pursuant to section 94. No further comments will be made regarding this provision.
[11] For example, property of a trust that has been contributed by a particular contributor can roll-out to that contributor or his or her spouse. In addition, subsection 107(4.1) will cease to apply at a time when no contributors of property to the trust are alive.
[12] It is assumed that all actions of trustees necessary to implement any reorganization will be implemented following due consideration of the trustees' fiduciary obligations. It is also assumed that the course of actions taken by the trustees will be authorized by the applicable trust deed and would not be restricted by any legal or tax impediments.
[13] See section subsection 4(2) of the FLA.
[14] *Supra*, footnote 7.
[15] 2016 DTC 5067 (SCC).
[16] 2017 DTC 5028 (FCA).
[17] 2002 DTC 7547 (SCC).
[18] *Kligman v. MNR*, 2004 DTC 6296, para. 74.
[19] 2002 DTC 7547, para. 94.
[20] 2018 DTC 5056 (FC).
[21] 2018 DTC 5056, para. 47

[22] 2018 DTC 5056, para. 48.
[23] 2018 DTC 5058 (BCSC).
[24] http://www.canadian-accountant.com/content/taxation/a-world-of-difference.
[25] 2016 ABQB 334.
[26] Falling within the parameters of paragraph 149(1)(d.5) of the Act.