

## Tax Notes

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### **21-YEAR TAX ISSUES AND THE NON-SPECIALIST ADVISOR—PART 4[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: Do Nothing, the *Simple* Roll-Out, and Vesting Indefeasibly. Part 1 of the Series also reviewed the Do Nothing approach. In the second instalment of the Series, the *Simple* Roll-Out approach was reviewed in detail and the third instalment of the Series reviewed the Vesting Indefeasibly approach.

This fourth instalment of the Series will delve into more advanced issues involving planning for trusts nearing their 21st anniversaries that have non-resident beneficiaries.

#### **DISTRIBUTIONS OF APPRECIATED TRUST CAPITAL PROPERTY TO NON-RESIDENT BENEFICIARIES**

The general rules associated with distributions of appreciated trust capital property to non-resident beneficiaries are found in subsection [107\(5\)](#). Pursuant to this provision, a distribution of appreciated property to a non-resident beneficiary will be subject to subsection [107\(2.1\)](#), which will give rise to a taxable disposition of the property in the trust instead of a tax#deferred roll#out to beneficiaries that would otherwise occur under subsection [107\(2\)](#).

There is an election that can be made under subsection [220\(4.6\)](#) to defer the tax otherwise payable under subsection [107\(5\)](#) if the property distributed is taxable Canadian property,<sup>[2]</sup> provided that security is furnished that is acceptable to the Minister.<sup>[3]</sup> As was mentioned previously, in practice the decision to make the CRA a creditor of a private corporation can be problematic as security agreements can be quite restrictive.

For these reasons, direct distributions of appreciated trust capital property to non#resident beneficiaries are usually avoided.

#### **DEALING WITH NON-RESIDENT BENEFICIARIES**

Treating family members in a similar manner is often an extremely important family objective, often even more important than tax minimization. Consequently, rather than simply excluding non-resident beneficiaries of a trust from receiving their share of distributed trust property, other alternatives are usually examined. For example, sometimes the trust will own sufficient high ACB property, such as cash, so that disproportionate distributions of low ACB trust property to Canadian-resident beneficiaries can be equalized by making disproportionate distributions of the high ACB property to the non-resident beneficiaries.

If the property of the trust is incapable of being distributed tax efficiently to non-resident beneficiaries, then other equalization possibilities may include planning that is independent of the trust. For example, in a typical estate freeze situation, to compensate the non-resident beneficiaries from being excluded or receiving reduced shares of the trust property, the freezer might make disproportionate gifts from his or her personal assets to the non-resident beneficiaries while he or she is alive.

Because the freezer might need all of his or her personal property while he or she is alive, immediate gifting might not be possible and the equalization may need to occur by Will. However, Wills can be changed and/or the freezer's estate might have insufficient property to equalize the non-resident beneficiaries so that the non-resident beneficiaries might never be equalized. In addition, if equalization is to be made by Will, the non-resident beneficiaries may need to wait a long time (i.e., until the maker of the Will has died) to receive their equalizing gifts. As a result, this type of equalization planning may not resolve the potential for family disharmony, since in some situations it may leave the non-resident beneficiaries in a position of uncertainty, which they may view as unfair.

#### **Direct Distributions to Corporate Beneficiaries<sup>[4]</sup>**

Assuming there are reasons that it is desirable for the non-resident beneficiaries to get their *pro rata* shares of the trust assets, an indirect solution would be to have one or more Canadian-resident corporate beneficiaries of the trust owned by the non-resident beneficiaries or any combination of eligible beneficiaries of the trust, including the non-resident beneficiaries, receive the property.

Where the trust had been drafted to permit corporate beneficiaries this can be a straightforward process from a Canadian perspective. The trustees simply resolve to distribute the non-resident beneficiaries' shares of the trust property to the corporate beneficiary or corporate beneficiaries.

Even though the process described above is straightforward, foreign legal and taxation advice should be sought to ensure that the distributions do not give rise to foreign tax and other issues now or in the future. For example, if a distribution is made for the benefit of a US beneficiary, then PFIC/CFC, US trust throwback, and other rules will need to be reviewed by US counsel.<sup>[5]</sup> In addition, consideration should also be given to structuring the corporate beneficiary as a flow-through entity, such as an unlimited liability corporation formed under the laws of British Columbia, Alberta or Nova Scotia.

#### **Indirect Distributions That Benefit Non-Resident Beneficiaries**

Where the trust does not specifically provide for corporate beneficiaries, it may still be possible to make a distribution of trust property to a corporation in some cases. Such planning may be available where the trust deed permits distributions "to or for the benefit of" a beneficiary.<sup>[6]</sup>

"To or for the benefit of" language is common in many trusts and in such situations, the typical planning will involve a process that will allow non-resident beneficiaries to have fixed interests in the trust, often using the Vesting Indefeasibly process that was described in Part 3 of the Series. Once the non-resident beneficiaries have identifiable fixed interests in the trust, the non-resident beneficiaries will transfer those interests into one or more Canadian-resident corporations on a tax-deferred basis pursuant to the rules in section 85.<sup>[7]</sup> If the trust interests are considered to be taxable Canadian property, then filings under section 116 would be required.

If the trust meets the definition of a fully indefeasibly vested trust then the 21-year rules might not apply to the trust any longer. If subsection 75(2) is not an issue and/or if there is no reason to maintain the trust any longer, then the trust might use *Simple* Roll-Out planning to distribute property comprising the vested interests as capital distributions to the corporation or corporations.

#### **Risks and Issues Associated with "to or for the benefit of" Planning**

It appears that the primary tax risk associated with this type of planning is that the general anti-avoidance rule ("GAAR")<sup>[8]</sup> could be applicable. In the past some authors suggested that advance tax rulings should be considered. There may also be certain technical tax issues associated with this planning, and foreign advice should be sought.

Notwithstanding these risks, anecdotally it would appear that prior to November 21, 2017, many advisors were relatively comfortable with this type of planning. Perhaps this was the case since the alternatives were often unsatisfactory—cutting out the non-resident beneficiary from the trust, triggering tax, or seeking a variation of trust.<sup>[9]</sup>

### Round Table Discussion—November 21, 2017, Q.1

Unfortunately, due to the CRA's comments at the Canadian Tax Foundation's November 21, 2017, Annual Conference Round Table ("Round Table"), there now appears to be significantly greater risk associated with corporate beneficiary planning—regardless of how this planning is implemented.

In particular, question 1 of the Round Table involved a situation in which the CRA was asked whether it agreed that subsection 107(2) would apply to a hypothetical transaction involving the distribution by a Canadian-resident trust of appreciated property to a Canadian-resident corporate beneficiary ("Canco") owned by non-resident beneficiaries.

In its response, the CRA expressed significant concerns with this hypothetical transaction since, in its opinion, any capital gain distributed to Canco might potentially be deferred indefinitely, and that an indefinite deferral would only be possible because the beneficiary was a non-resident. The CRA also stated that it believes subsection 107(5) exists to ensure that Canada maintains the ability to tax the accrued gain on the trust property and that the implementation of the hypothetical transaction would contravene the underlying purpose of the capital gains tax regime of avoiding indefinite tax deferral.

Based on these concerns the CRA stated that the hypothetical transactions would frustrate the object, spirit, and purpose of multiple provisions in the *Income Tax Act* (the "Act")<sup>[10]</sup> and the Act as a whole and that it would consider applying the GAAR to such transactions unless there was "substantial evidence" that the GAAR should not apply. The CRA also advised that it would not issue any advance tax rulings on such transactions unless there was "substantial evidence" that the GAAR should not apply.

#### Impact of CRA's New Administrative Position

In many situations involving non-resident beneficiaries, the announcement by the CRA of this change in its assessing practices could have severe consequences since, in the absence of corporate beneficiary planning, there may be no way to avoid the subsection 107(5) deemed disposition if a distribution is made to or for the benefit of the non-resident.<sup>[11]</sup>

#### Does the CRA's Stated Administrative Position Mean this Type of Planning Can't Be Implemented?

Likely not, and the CRA recognized this in its response to question 1 at the Roundtable. In particular, the CRA noted (grudgingly) that there may be situations involving corporate beneficiary planning that would not be subject to GAAR. Furthermore, the CRA does not make the law. Like tax advisors and taxpayers, the CRA interprets the law and the courts have the final word.

However, a definite impact of the CRA's new administrative position is that planning for non-resident beneficiaries involving corporate beneficiaries is now far more uncertain than was thought to be the case prior to November 21, 2017. Therefore, trustees of trusts involving non-resident beneficiaries will need to even more carefully consider the particular situation and the alternatives available to them, including whether the risk of GAAR being applicable is acceptable in any particular situation.

## CURRENT ITEMS OF INTEREST

### CRA PROVIDES UPDATE ON REAL ESTATE COMPLIANCE ACTIVITIES

On May 17, 2018, the CRA provided an update on its tax compliance activities regarding the real estate sector in British Columbia and Ontario. In the past three years, audits have identified \$592.6 million in additional taxes, resulting in \$43.7 million in penalties; 30,000 files were reviewed by auditors. That being said, the CRA acknowledges that there continue to be compliance risks in the Toronto and Vancouver markets, and intends to "crack down". To address non-compliance in the real estate sector, the CRA generally focuses on the following areas:

- questionable sources of funds;

- property flipping;
- unreported GST/HST on the sale of a new or substantially-renovated property, and the GST/HST new housing rebate;
- unreported capital gains; and
- unreported worldwide income.

### **TAXPAYERS AFFECTED BY FLOODING CAN REQUEST RELIEF**

In a recent news release, the CRA reminded the public that taxpayers (including first responders) affected by the flooding in British Columbia and New Brunswick can request taxpayer relief if they are unable to pay or file their taxes on time.

### **NEARLY ALL COUNTRIES COMPLIANT WITH COUNTRY-BY-COUNTRY REPORTING OBLIGATIONS**

An OECD peer review on BEPS Action 13, Country-by-Country (“CbC”) Reporting, has found that nearly all countries that serve as a headquarters to large multinationals have implemented reporting obligations that are compliant with the transparency requirements. The first exchange of information is scheduled for June 2018. This will consist of financial information on each MNE being shared with all other participating jurisdictions. More than 1,400 bilateral relationships are in place for CbC exchanges, and more are to come this year.

### **QUEBEC WANTS INDIVIDUALS TO FILE A SINGLE TAX RETURN**

Last week, the Assemblée Nationale voted unanimously in favour of Quebec’s residents being able to file a joint federal-provincial tax return, on the condition that Revenu Québec handles all aspects of the process, and the province maintains its current fiscal privileges. Premier Philippe Couillard commented on these conditions: “We don’t want to find ourselves in a situation where Quebec would be tied to choices made by the federal government or dependent on (Ottawa) to decide its fiscal issues.”<sup>[12]</sup> However, the federal government promptly rejected this proposal, citing a lack of consultation, job losses, and loss of expertise.<sup>[13]</sup>

### **IRS WARNS OF W8-BEN SCAM**

The IRS is warning the public that scammers are getting more creative with an old phishing scam targeting international taxpayers and non-resident aliens. Scammers are sending fake W8-BEN forms to individuals in order to verify their personal and financial information. Scammers have been sending these requests as letters and emails that appear to have come directly from the IRS or the individual’s tax advisor. Withholding agents are the only persons who will legitimately accept W8-BEN forms.

### **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.

### **STAY OF TAX-RELATED CRIMINAL CHARGE OVERTURNED ON APPEAL**

#### ***R. v. Balogh*, 2018 DTC 5022 (British Columbia Supreme Court)**

Section 11(b) of the *Canadian Charter of Rights and Freedoms* (the “Charter”) guarantees an accused person the right to be tried within a reasonable time. The Supreme Court of Canada case of *R. v. Jordan* (2016 SCC 27) changed the framework for assessing whether the length of a delay prolonging the period

between the laying of a charge and the conclusion of a trial infringes upon the accused person's section [11\(b\)](#) rights.

In this appeal, after assessing the BC Supreme Court's application of the Supreme Court of Canada's decision in *Jordan*, the BC Supreme Court overturned the BC Provincial Court's decision to enter a judicial stay of proceedings in respect of a taxpayer's trial for making false or deceptive statements and failing to report income.

The taxpayer was a dentist who had incorporated his professional practice. In 2006, after engaging with a "de-taxer" organization, the taxpayer began underreporting the amounts he received from his professional corporation and categorized the amounts he did report as contractor's fees as opposed to salary or dividends. The taxpayer was warned repeatedly by his accountant that failure to properly report the payments he received was likely a contravention of the *Income Tax Act* (the "Act") and could not be supported in the event of an audit.

The taxpayer was charged on May 17, 2012, with making false or deceptive statements and five counts of failing to report taxable income under the Act, and a summons was issued for him to appear in BC Provincial Court on June 28, 2012.

Between the date the taxpayer received the original summons to appear in court and the June 10, 2013, date on which the parties agreed to a timetable for the proceedings—which contemplated a three-day *voir dire* application (to address procedural and evidentiary matters before trial) in October 2013 and dates in early 2014 for a three-week trial—the matter was adjourned no less than seven times for various reasons, including a relatively short 15-day adjournment granted 127 days after the commencement of the proceedings to allow the then-unrepresented taxpayer to obtain legal counsel.

After the original timetable was set, several further adjournments followed, mainly as a consequence of the taxpayer's original counsel withdrawing from the case and the requests of the taxpayer's replacement counsel. These delays led to a revised timetable for the proceeding being entered in February 2014 which contemplated the *voir dire* being heard in March 2015 and the trial being held over two weeks in June 2015.

In September 2014, the timetable was revised again to accommodate the non-availability of the taxpayer's new counsel for the *voir dire* dates. The new timetable would have seen the *voir dire* heard in June 2015 and a two-week trial in July 2015 but this schedule was vacated five months later when the trial judge assigned to the proceeding was no longer available for those dates. A final timetable was established in April 2015 which provided that the *voir dire* would be heard in April 2016 and the trial would take place between May 2 and June 3, 2016. It appears that Crown counsel and the court could have been available for dates in October 2015 but that the taxpayer's counsel was not available until spring 2016.

The trial was a three-day trial over May 25 and May 27, 2016, with judgment reserved. On May 30, 2016, the taxpayer made an application to stay the convictions on the grounds that there had been an unreasonable delay in the proceeding which had violated his section [11](#) Charter right to be tried within a reasonable time. On August 9, 2016, the trial judge found the taxpayer guilty of all offences, some 1,546 days after the swearing of the initial information, but deferred issuing a decision on the stay application.

Before the trial judge made a determination on the stay application, the Supreme Court of Canada issued its landmark decision in *Jordan* to establish a new framework for determining whether there is an unreasonable delay for bringing an accused to trial for purposes of section 11(b) of the Charter. The Supreme Court of Canada held that there is an 18-month ceiling for provincial court matters and a 30-month ceiling for superior court matters within which the trial of the accused should be completed after being charged, beyond which a delay will be presumed to be unreasonable for purposes of section 11(b) of the Charter. Where the delay is more than the 18-month or 30-month period, as applicable, the Crown can rebut the presumption if it can establish that there were exceptional circumstances. If, after reducing the delay period for any time attributable to defence delays and exceptional circumstances, the total period of delay falls below the presumptive ceiling, the onus is on the accused to show that the delay was unreasonable. For cases that were already in the system when the *Jordan* decision was released, the *Jordan* analytical framework would still apply but the application of the pre-*Jordan* framework, as outlined in *Morin* ([1992] 1 SCR 771), would be taken into account if the party seeking to rely on the pre-*Jordan* rules can show that the party reasonably relied on the previous state of the law as it would have applied to the circumstances of the particular case.

Thus, in BC Provincial Court cases like this one, if the delay period exceeded the presumptive 18-month threshold, the Crown would be permitted to demonstrate that the delay was reasonable according to the *Morin* framework if the Crown could show that it reasonably relied on the previous state of the law.

When applying the *Jordan* decision to the taxpayer's application, the trial judge found that there had been a total delay of 1,544 days (51.5 months). The trial judge excluded the first 6 months of the delay in respect of certain matters including the adjournment of the first and second trial dates and found the taxpayer was responsible for 4.8 months of additional delay due to his failure to appear in accordance with the initial summons and his failure to retain replacement counsel after his initial counsel resigned. In total, the trial judge attributed a total of 21.8 months of delay to the taxpayer, which left 29.7 months of delay that was not attributable to the taxpayer's actions. Notably, in computing the delay period, the trial judge refused to subtract the seven-month delay between October 2015 and April 2016 that would not have occurred if the taxpayer's replacement counsel had been available for trial when the Crown and court had availability in October 2015. The trial judge's reasoning was that if the taxpayer had retained further new counsel to replace his replacement counsel solely because the replacement counsel was unavailable for trial in October 2015, there would likely have been additional procedural delays caused by the further change in counsel.

Given the 29.7-month delay period computed by the trial judge, the delay was presumed to be unreasonable because it exceeded the 18-month period contemplated by *Jordan*. Since this was a case that was well into the system at the time the *Jordan* decision was released, the trial judge then considered whether the longer delay could be justified under the transitional exceptional circumstances on the basis of the Crown demonstrating that it reasonably relied on the prior state of the law. The trial judge found that the Crown did not meet that burden of showing its reasonable reliance on the previous law, but then went on to express its view that the 29.7-month delay in this case would have been an unreasonable delay for purposes of section [11\(b\)](#) of the Charter even under the *Morin* framework.

On appeal, the BC Supreme Court undertook both a review of the trial judge's computation of the delay period and application of the *Jordan* transitional exceptional circumstances framework.

The main issue with the trial judge's computation of the delay period was the treatment of the seven month period between October 2015 and April 2016 that was required to accommodate the taxpayer's replacement counsel's availability for trial.

The BC Supreme Court found that both the *Jordan* decision and subsequent jurisprudence applying *Jordan* supported the notion that delays attributable to defence counsel's inability to be available for trial on dates that the Crown and court are available are to be attributed to the defence and excluded from the delay period computation. Noting that the trial had already been adjourned twice, the appellate court reasoned that, in a post-*Jordan* world, defence counsel should not expect to have trial dates moved to accommodate his or her future trial commitments. The BC Supreme Court thus found that the trial judge had erred in not excluding the seven-month delay from October 2015 to April 2016 when computing the delay. The Court further noted that, when calculating other delays attributable to the taxpayer, the trial judge had miscalculated the cumulative amount of time in the periods and thereby understated the delays attributable to the taxpayer. Based on these two errors, the Court found that the time period subject to the 18-month *Jordan* ceiling should have been approximately 22 months, a delay still in excess of the presumptive ceiling.

The Court then considered whether the Crown could justify a delay in excess of the 18-month presumptive ceiling on the basis of the transitional exceptional circumstances framework.

At the outset, the BC Supreme Court held that a pre-*Jordan* analysis of the delay in this case should be permitted on the basis of transitional exceptional circumstances since the case was almost entirely disposed of pre-*Jordan*, including the trial itself and closing submissions. Presumably, in such circumstances, it would be reasonable for a party to rely on the delays in the case being evaluated based on the state of the law before *Jordan* and it seems that the Court was prepared to infer that the Crown did in fact rely on this being the case given the stage the proceeding had reached when the *Jordan* decision was released.

Before considering the period of delay in this case under the pre-*Jordan* rules, the BC Supreme Court made the preliminary observation that, since it had found the correct delay period to be only four months more than the presumptive 18-month ceiling, it was necessary for the Court to conduct a more detailed analysis of the delay under the pre-*Jordan* framework than the BC Provincial Court.

As noted earlier, prior to *Jordan*, the judicial test for whether there was unreasonable delay for purposes of section 11(b) of the Charter was established by *Morin*, which relied on four factors: the length of the delay, waiver of time periods, the reasons for the delay, and prejudice to the accused.

The BC Supreme Court found that the length of the delay was in excess of the *Morin* guidelines for a proceeding in provincial court even after taking into account delays attributable to the accused, but that the accused had waived quite a bit of that time period. The Court then found that the reasons for most of the delays were either attributable to the accused or institutional reasons, but that the amount of institutional delay was not outside of the bounds of what counsel would normally expect to have to endure under the *Morin* framework. The Court acknowledged that there was prejudice to the accused as a consequence of the delay but that the prejudice was mitigated by the fact that the accused was released from custody after being charged and the nature of the charges would not have caused the same restriction on liberties, loss of reputation, or other adverse consequences that would normally result from being charged with other types of crimes.

In evaluating whether there were mitigating factors to offset the prejudice to the taxpayer, it is interesting to note that the BC Supreme Court felt that a further mitigating factor was the fact that the charges arose from the accused's own implementation of accounting practices that were reflected in his tax filings against the advice of the company's accountant. It is not clear how this is meaningfully worse than the motivation or consequences associated with other types of criminal offences. Nonetheless, the BC Supreme Court seemed to think that there was an important distinction to be made here.

Having determined that the delay would have been reasonable and justifiable under the *Morin* framework, the BC Supreme Court held that the delay did not violate the taxpayer's section 11(b) Charter rights under the transitional exceptional circumstances framework and thus set aside the stay of proceeding entered by the trial judge.

This is a useful case for showing the differences between evaluating whether there was an unreasonable delay in bringing an accused to trial in a criminal matter under the *Jordan* framework and the *Morin* framework. If nothing else, in light of how the BC Supreme Court evaluated the prejudice to the accused in this case, it perhaps demonstrates why the Supreme Court of Canada felt that the *Morin* framework needed to be replaced with something that was easier to apply, has fewer ambiguous elements, and has less of the feel of a "smell" test.

—Justin Shoemaker

**BALANCING ACT BETWEEN PUBLIC INTEREST IN DISCLOSURE  
OF INFORMATION REQUESTED BY TAXPAYER AND PARTICULAR  
PUBLIC INTEREST IN NON-DISCLOSURE ALLEGED BY MINISTER**

***Canada (Attorney General) v. Chad*, 2018 DTC 5034 (Federal Court)**

This case addresses the scope of the Minister's right to object to the disclosure of information under the *Canada Evidence Act*. In the case, the Court set out a process to determine the scope of the Minister's right to object to the disclosure of information before a court on the grounds of a specified public interest. In addition, given that there were no affidavits filed by the Minister to support its objection, the Court also determined whether the taxpayer would be permitted to cross-examine the author of a Crown document certifying that non-disclosure was required in the public interest.

The taxpayer was being audited by the Minister and, in the course of the audit, received Requirement Letters from the Minister requiring the taxpayer to produce information and documents. The taxpayer filed applications for judicial review to set aside the Requirement Letters issued by the Minister on the basis that they were improperly issued, overly broad, and not compliant with the *Income Tax Act* (the "Act"). Pursuant to Rules 317 and 318 of the *Federal Court Rules*, the taxpayer requested access to all of the material relied on by the Minister in issuing the Requirement Letters. In response, the Minister provided redacted information and, in a certificate, claimed that more complete disclosure was precluded by the existence of a public interest requiring that more complete disclosure not be made.

The Minister made applications under section 37 of the *Canada Evidence Act* for orders of the Court prohibiting disclosure of the redacted information on the grounds that disclosure would be injurious to the public interest. In support of these applications, the Minister relied solely on the certification by a high-ranking Crown official, Ms. Murray, that disclosure was contrary to the public interest. This certification stated that the public interest protects documented discussions and analysis between auditors and Crown specialists, and internal tools and audit methods used during ongoing investigations. The Minister maintained that disclosure of the material in issue would prejudice ongoing audit operations and facilitate taxpayers in structuring misleading responses to audit requests. The taxpayer argued that the Minister's refusal to make complete disclosure caused procedural unfairness. The taxpayer therefore filed a motion to compel the Minister to produce Ms. Murray for cross-examination.

In determining the scope of the Minister's right to object to the disclosure of information, the Court took into account the nature of the public interest at stake, the factual and statutory context of the Minister's objection to disclose information, and the sensitivity of the redacted material. As a result, the Court determined that it would proceed as follows:

- (1) Determine if the Minister has established the specified public interest claimed.
- (2) If the determination cannot be made on the certified document alone, request further submissions in support of the privilege claimed; these additional submissions will be dealt with on an *ex parte* basis.
- (3) Determine whether the taxpayer has established an "apparent case" for disclosure of the redacted information.
- (4) If an "apparent case" for disclosure has been established, consider reviewing the redacted information.
- (5) If the Court finds that the disclosure of the redacted information would encroach on the specified public interest, conduct a balancing of interests and determine whether the redacted information should be disclosed.

The Court stressed the importance of open and transparent judicial proceedings as fundamental to the Canadian legal system, such that public access is barred only in limited circumstances in which a court, in the exercise of its discretion, concludes that disclosure would subvert the ends of justice or unduly impair its proper administration (*Toronto Star Newspapers Ltd.* (2005 SCC 41)). The Court stated that untested ministerial claims of confidentiality can create an atmosphere that breeds suspicion and cynicism, and that one of the roles of a judge is as a gatekeeper to avoid overly broad claims of confidentiality by the Crown. The Court quoted McLachlin CJ that judges "must be vigilant and skeptical with respect to the Minister's claims of confidentiality. Courts have commented on the government's tendency to exaggerate claims of national security confidentiality." (*Harket, Re* (2014 SCC 37)).

The Court noted that there is a requirement to provide a sufficient evidentiary basis to conclude that a public interest claim is justified. The Court requested that the Minister file with the Court, on a confidential basis, an unredacted copy of the redacted documents so that the Court could properly consider the claim made by the Crown.

The Court determined that it was obliged to conduct a hearing, *in camera*, in order to deal with the *ex parte* evidence and submissions.

On the issue of whether the taxpayer could cross-examine Ms. Murray, the Court denied the taxpayer's motion and concluded that under proceedings pursuant to section 37 of the *Canada Evidence Act* cross-examination by opposing counsel is not a prerequisite to ensure fairness. The Court held that the objection by the Crown to disclosure and the certification by the Crown of a specified public interest creates an ancillary proceeding in which the taxpayer has no standing. The Court stated that cross-examination by taxpayer's counsel is not necessary for the Court to determine whether the public interest in disclosure outweighs the specified public interest in non-disclosure.

In deciding whether an "apparent case" for disclosure had been made out, the Court relied on the following factors enumerated by Rothstein J (*Khan* ([1996] 2 FC 316)):

- (1) the nature of the public interest sought to be protected by confidentiality;



- (2) whether the evidence in question will probably establish a fact crucial to the defence;
- (3) the seriousness of the charge or issues involved;
- (4) the admissibility of the documentation and the usefulness of it;
- (5) whether the taxpayer has established that there are no other reasonable ways of obtaining the information; and
- (6) whether the disclosure sought amounts to general discovery or to a fishing expedition.

The Court found that the reasons provided by the taxpayer for cross-examination established an apparent case for disclosure of the redacted information. The Court held that in judicial review applications, fairness required giving the taxpayer access to a complete certified tribunal record containing the relevant material to the application. In the Court's view, this was sufficient to meet the "apparent case for disclosure" test.

As illustrated in *Chad*, a taxpayer has the ability to bring proceedings requesting that the Minister disclose information and documents relied on for the purposes of issuing a requirement to produce information or documents. However, the Minister may object to the disclosure of information on the grounds of a specified public interest pursuant to section 37 of the *Canada Evidence Act*. The court, as in the *Chad* case, will determine the scope of the Minister's power to object to the disclosure of information, which determination is normally undertaken without the taxpayer's involvement.

—*Jaspreet Kaur*

**MINISTER ORDERED TO RECONSIDER DECISION TO  
RETAIN MONIES INAPPROPRIATELY GARNISHED**

***Cybernius Medical Ltd. v. The Queen*, 2018 DTC 5012 (Federal Court)**

This case was a taxpayer's successful judicial review of the Minister's refusal to apply a combined \$594,855 credit balance from the taxpayer's 2003, 2004, and 2005 income tax accounts towards the taxpayer's outstanding payroll source deduction remittances in September 2015. To some extent, the taxpayer had itself to blame for the difficulties it faced in recovering or otherwise using the 2003, 2004, and 2005 credit because it had not filed its tax return for each year within three years of the end of each year, as required by subsection 164(1) of the *Income Tax Act* (the "Act") for a taxpayer to receive a refund of an overpayment. However, given that almost all of the \$594,855 credit balance was derived from an amount owed to the taxpayer that the CRA garnished to pay the tax debt created by assessments for the 2003, 2004, and 2005 taxation years, a debt that appears to have been eliminated or substantially reduced following the taxpayer's objections, perhaps the real question raised by this case is why the Minister was not more co-operative in helping the taxpayer find ways to access the credit that was created by the Minister's arguably overzealous reassessment and garnishment action.

The corporate taxpayer was in the business of electronic record-keeping related to kidney disease and had not filed income tax returns for its 2003, 2004, or 2005 taxation years when the Minister assessed those years in December 2006 for a total of about \$534,000 in taxes, penalties, and interest. It appears that the Minister then issued a reassessment for the 2003 taxation year alone in November of 2009 which had a small impact on the tax debt for the three years. In December 2009, the Minister garnished some \$937,000 by issuing a requirement to pay to the taxpayer's escrow agent, of which about \$594,000 was to be applied to the taxpayer's income tax arrears created by the tax assessments for its 2003, 2004, and 2005 taxation years. Presumably, additional interest had accrued between the time the original assessments were made in December 2006 (totalling about \$534,000) and the time when the garnishment action was taken in December 2009. It is unclear the extent to which the taxpayer was aware of the Minister's garnishment activity or the underlying reasons for the Minister's aggressive collection action.

The taxpayer's evidence was that it was unaware of either the Minister's assessments of the 2003 to 2005 taxation years or the reassessment of the 2003 taxation year until several years later in January 2014, when the taxpayer attempted to file income tax returns for those years. As the Minister considered the notices of assessment for those years to have been issued in December 2006, the CRA refused to accept the returns on the basis that the normal reassessment period for those years had long expired by 2014. The taxpayer then attempted to object to the assessments for its 2003, 2004, and 2005 taxation years, presumably on the basis that the assessments were not, in fact, properly issued on the December 2006 mailing dates

that appeared on the notices. This led the taxpayer to apply to the Tax Court for permission to late-file objections to the assessments, following which the parties agreed to a consent judgment in respect of the application pursuant to which the Minister accepted that the taxpayer's objections to the assessments were filed within time and valid. (Presumably, the Minister agreed to the consent judgment because there was doubt concerning the availability of evidence to prove that the notices of assessment or reassessment had actually been mailed on the dates or to the addresses shown on the notices.)

The Minister eventually disposed of the taxpayer's objections in June 2015 by issuing reassessments that substantially reduced the taxpayer's total tax liability for its 2003, 2004, and 2005 taxation years and resulted in the taxpayer having a credit of about \$595,000 in respect of that period.

The Minister and taxpayer thus found themselves in a situation in June 2015 where the Minister had issued a garnishment order to intercept a large sum that was owed to the taxpayer by a third party to apply towards a tax debt that the Minister later determined to not exist. But the Minister would not allow the excess amount to be paid to the taxpayer because the returns for the relevant years were not filed within the three-year window as required by subsection [164\(1\)](#) of the Act.

To overcome the restriction in the Act on receiving a refund of the credit in respect of the 2003, 2004, and 2005 taxation years, the taxpayer asked the Minister to apply the credit to the taxpayer's Crown debt for payroll source deductions, consisting of amounts owed for employees' income tax withholdings under the Act, or amounts owed under the *Employment Insurance Act* or the *Canada Pension Plan*. Under section [221.2](#) of the Act, where a particular amount has been appropriated to an amount payable under the Act, the Minister may, on application by the taxpayer, appropriate the particular amount to another amount payable under the enactments referred to in paragraphs [223\(1\)\(a\)](#) to [\(d\)](#), which include the Act, the *Employment Insurance Act*, and the *Canada Pension Plan*. It seems that the Minister refused the taxpayer's request on the basis of subsection [164\(2.01\)](#) of the Act, which prohibits the Minister from issuing refunds or setting off amounts where the taxpayer has returns outstanding for certain federal taxes, principally income tax and GST/HST. Although it appears that the taxpayer had an outstanding GST/HST return and income tax returns for the 2014 and 2015 taxation years at the time of the request, which the taxpayer quickly remedied, the Minister also advised that the failure to file the income tax returns for the 2003, 2004, and 2005 taxation years within the three-year window contemplated by the preamble of subsection [164\(1\)](#) meant that those returns were to be considered outstanding for purposes of the restriction in subsection [164\(2.01\)](#) even though the taxpayer did, in fact, try to file income tax returns for those years with the Minister, albeit outside the three-year window.

The Minister's refusal to re-appropriate the credit to the taxpayer's payroll account led the taxpayer to seek a judicial review of the Minister's decision on the topic. In support of the taxpayer's allegation that the Minister's decision was unreasonable, the taxpayer's principal argument seems to have been directed at challenging the validity of the garnishment order. In this regard, the taxpayer argued that, since the Minister agreed under the consent judgment that the objections filed on March 20, 2014, to the original assessments for the 2003, 2004, and 2005 taxation years were valid, it must be implied that the original assessments for those taxation years were issued no more than 90 days before March 20, 2014, given the 90-day deadline for an objection to an assessment to be validly filed. This, in turn, meant that when the garnishment order was issued in December 2009, there was no assessment of tax for the 2003, 2004, and 2005 taxation years to support the issuance of a valid requirement to pay.

The Court considered the taxpayer's argument that the December 2009 requirement to pay must have been invalid, as it was issued when no valid assessment existed or when collection action was barred by the Act. After all, if the consent judgment provided that the March 20, 2014, objections were valid, then there could not have been an existing valid assessment in December 2009, as in that case, the 2014 objections would have been well out of time. At the least, based on the rule that collection action generally cannot be taken until after the objection and appeal process is completed, a December 2009 garnishment could not have been done in compliance with the Act.

The Minister argued that the consent judgment did not determine the validity of the assessments on which the requirement to pay was based—it only permitted an extension of time to object, and the requirement to pay was based on valid assessments (i.e., the December 2006 assessments and the November 2009 reassessment).

Even under the Minister's argument, however, the December 2009 requirement to pay was issued less than 90 days after the November 2009 reassessment of the taxpayer's 2003 taxation year. This was sufficient, it appears, for the Court to conclude that the requirement to pay was "statute barred" because the Minister is generally prohibited from taking collection action within 90 days of a reassessment. In any event, if the consent judgment provided that the objections filed on March 20, 2014, were valid, then the requirement to pay must have been invalid because collection action generally cannot be taken until **after** 90 days have passed **after** the day on which the Minister has made a decision concerning an objection. Collection action taken before an objection is even filed in the first place cannot be valid. The Court concluded that it was unreasonable for the Minister to refuse to apply the credit to reduce the taxpayer's payroll debt given that the credit resulted from collection action taken by the Minister in violation of the Act.

Alternatively, as the taxpayer was compliant with its filing obligations by the time the matter was heard by the Federal Court, the Court concluded that it would be unreasonable not to allow the taxpayer's income tax credit to be applied to the taxpayer's payroll account. The Court noted that subsection [221.2\(1\)](#) provides the Minister with discretion to re-appropriate amounts if the taxpayer does not have any outstanding returns. The taxpayer no longer had any outstanding returns by the time this matter came before the Federal Court. As such, it is difficult to see why the Minister would not allow the credit to be transferred to the taxpayer's payroll account.

In the result, the Court ordered the Minister to reconsider the decision not to transfer the taxpayer's income tax credit to the taxpayer's payroll account. Practically speaking, this decision should result in the reduction of the taxpayer's payroll debt using the credit that resulted from the Minister's inappropriate garnishment action. Otherwise, the Minister would have received a windfall by reason of having garnished the taxpayer's funds in breach of the Act. It is puzzling as to why the Minister would refuse to transfer the credit in such circumstances, but *Cybernius* serves as a reminder that the Minister's exercise of discretion regarding the transfer of credits between accounts is subject to judicial oversight and that judicial review is a possible route for seeking to quash unreasonable decisions made by the Minister in this regard.

—*Theodore Stathakos*

**CRA DEALT FIRM REBUKE FROM BCSC FOR “REPREHENSIBLE”  
CONDUCT IN MALICIOUS PROSECUTION CASE; COURT RAISES  
BROADER CONCERNS ABOUT “UNFORTUNATE CULTURE” WITHIN CRA**

***Samaroo v. CRA, 2018 DTC 5026 (British Columbia Supreme Court)***

Mr. and Mrs. Samaroo brought actions for malicious prosecution against both the CRA and the *ad hoc* Crown prosecutor, Mr. Brian Jones. The actions stemmed from an investigation by the CRA into the Samaroos' restaurant business. The CRA investigator, Keith Kendal, reported to the Crown that the investigation revealed a significant underreporting of earnings in 2004 and 2005. This served as the basis for the prosecution of the Samaroos for tax evasion, with Mr. Jones acting as Crown counsel. The Samaroos were eventually acquitted of the charges.

In this case, a civil action by the Samaroos against both the CRA and Mr. Jones, the Court determined that the CRA was vicariously liable for the malicious prosecution of the Samaroos by Mr. Kendal. The Samaroos were awarded more than \$1.4 million in aggravated and punitive damages, in addition to compensatory damages covering the cost of their legal defence. The Court dismissed the action against Mr. Jones.

During the relevant period, the Samaroos had owned and operated a restaurant in Nanaimo. The restaurant had three shifts: the day shift, the night shift, and the graveyard shift. After each of the shifts, there was a "ring off" of the cash till, creating a "till tape" which showed how much cash was taken in during that shift. At the end of the day, the raw data from these till tapes was transferred to a Daily Cash Summary (the "Summary"). The Summary was then given to the bookkeeper and formed the basis of the Samaroos' tax returns. During the investigation, Mr. Kendal discovered that despite there being three ring offs, and thus three till tapes created, there were only two columns on the Summary, labelled "Day" and "Night". Mr. Kendal developed the theory that the Samaroos were reporting only the cash earned from two of the three shifts. This theory assumed that the columns were meant to correspond directly to the till tapes.

The Court found that in dealing with this matter Mr. Kendal had lost his objectivity as an investigator and was determined to convict the Samaroos. This finding was supported by Mr. Kendal's personal notes, which discussed ways to "defuse" and "deflect" the explanations of the Samaroos. To prove his theory, Mr. Kendal needed the bookkeeper to testify that she received till tapes along with the Summary, and that she received only two till tapes each day. However, the bookkeeper had already been interviewed and stated that she relied only on the Summary, did not look at the till tapes, and could not say how many till tapes she received each day.

Despite this, Mr. Kendal sent a letter to the Public Prosecution Service of Canada (the "PPSC") which laid out the findings of the investigation and recommended the laying of charges. Mr. Kendal's letter falsely stated that the bookkeeper could testify that only two till tapes per day were recorded in the Summary. The PPSC indicated that the bookkeeper would need to be interviewed again before any charges would be approved. Mr. Kendal therefore requested another interview with the bookkeeper, but was advised that she would answer questions only through her counsel. Mr. Kendal falsely reported back to the PPSC that the bookkeeper had refused an interview outright. The PPSC then approved charges based on the assurance from Mr. Kendal that the bookkeeper would testify to receiving only two till tapes per day. In disclosure, Mr. Kendal suppressed the notes from the initial interview with the bookkeeper in a binder which did not reference the notes in the table of contents.

The PPSC retained Brian Jones to prosecute the case. It appeared from the emails exchanged that Mr. Jones played a role in approving charges, but both he and the PPSC testified that he did not. During the trial, when it became clear that the original theory would fail without the supporting testimony of the bookkeeper, Mr. Jones changed the Crown's theory. The new theory was that there were actually two daily Summaries and that the bookkeeper received only one of them each day. This was based on an early interview with another employee, but was not supported by any other evidence. Court transcripts show that Mr. Jones was qualifying many of his statements with phrases like "I am assured". The Samaroos alleged that this indicated that Mr. Jones knew that evidence was being fabricated and that he was trying to distance himself from it.

To succeed in an action for malicious prosecution the plaintiffs must prove each of the following four elements laid out by the Supreme Court of Canada in *Miazga v. Kvello Estate* (2009 SCC 51):

- (1) the defendant initiated or continued the prosecution against the plaintiffs;
- (2) the prosecution terminated in the plaintiffs' favour
- (3) the prosecution was undertaken without reasonable and probable cause; and
- (4) the prosecution was motivated by malice or a primary purpose other than that of carrying the law into effect.

Each of these four elements was reviewed by the Court in respect of each of Mr. Kendal on behalf of the CRA and of Mr. Jones, as summarized below.

#### **CRA**

Regarding the first element, the CRA argued that given the division of labour between the CRA and the PPSC, the CRA does not initiate or lay charges, such that the first element was not satisfied *vis-à-vis* the CRA. In this regard, the CRA maintained that the CRA simply carries out investigations and makes recommendations. However, the Court noted that *Miazga* contemplated the element applying to police investigations and, therefore, by analogy, it should also apply to the CRA. Moreover, Mr. Kendal was in "direct correspondence with lawyers in the PPSC and Mr. Brian Jones throughout the investigation and criminal prosecution." Hence, the first element was met in respect of Mr. Kendal on behalf of the CRA.

The second element was not contested by the defence.

The third element requires lack of reasonable and probable cause. This is an objective standard, and does not consider what the defendant personally believed. Given the burden of proof in a criminal trial, this element requires that, on an objective assessment, proof beyond a reasonable doubt of all elements could be made out in a court of law. The Court found that Mr. Kendal's basis for recommending an investigation was flawed for several reasons. First, Mr. Kendal ignored evidence and explanations that contradicted his initial net-worth analysis. He did not account for the respective inheritances of the Samaroos and he did not factor in capital cost allowance, which the Court found could easily have explained the discrepancies.

Second, Mr. Kendal knew that the bookkeeper would not testify to the facts that would support the prosecution's theory, but he proceeded anyway. In this respect, the Court found the matter was similar to the situation in *Proulx v. Quebec (AG)* (2001 SCC 66) in which the prosecution proceeded "even when it was clear that a key witness had never identified the appellant and that it was impossible for him to do so." This element was satisfied in respect of the CRA.

The Court noted that the fourth element—malice or improper purpose—has a very high threshold. It requires proof, on a balance of probabilities, that the defendant "acted deliberately to subvert and abuse his office." In the Court's opinion, Mr. Kendal decided early on that the Samaros were guilty and "set out to prove that was the case even if to do so required a breach of his proper role and responsibilities." Further, "Mr. Kendal knew that the necessary evidence was not available from [the bookkeeper]," so instead, "[i]nculpatory evidence was created." This "high-handed, reprehensible and malicious" conduct represented a "marked departure from [the] conduct expected" and "offend[ed] this court's sense of decency."

Mr. Kendal was found liable for malicious prosecution, and the CRA was found vicariously liable.

In discussing damages, the Court rebuked the CRA for its practice of publicizing tax evasion cases in the media, and "boasting" on its website about the number of years to which people have been sent to prison as a result of its investigations. The Court wondered what the public reaction would be to other law enforcement agencies doing the same. Further, the Court criticized the "unprofessional glee" shown by the CRA and its employees when discussing the possibility of conviction. The Court also noted what appeared to be a joke about the Samaros receiving the death penalty. In the view of the Court, this pattern of behaviour raised concerns about an "unfortunate culture" within the CRA.

The Samaroo family was devastated by the negative publicity that the original prosecution had garnered. Their daughter stopped using their family name due to the embarrassment, Mr. Samaroo began drinking heavily, and Mrs. Samaroo showed signs of depression and anxiety. Mr. and Mrs. Samaroo no longer lived together.

The Court awarded the Samaros both compensatory damages covering the cost of their legal defence and \$1.4 million in aggravated and punitive damages.

The CRA has filed a notice of appeal challenging the Court's interpretation of the third element, which the CRA says erroneously required the CRA to have reasonable grounds to believe that the Crown could prove the actual mechanics of fraud beyond a reasonable doubt. The CRA also claims that the Court made an overriding and palpable error in its factual finding of malice, among other grounds.

### **Brian Jones**

The first and second elements for malicious prosecution in the claim against Mr. Jones were not contested by the defendants.

The third element was met as against Mr. Jones. Although Mr. Jones relied very heavily on the CRA, the Court found that from an objective standpoint, he had no reasonable basis on which to believe that a conviction could be obtained. Mr. Jones knew of the original interview in which the bookkeeper stated that she relied on only the Summaries and did not look at the till tapes, and he should have known that this was devastating to the Crown's theory. Moreover, Mr. Jones continued the prosecution even when the bookkeeper would not be providing the testimony that Mr. Jones was supposedly expecting.

Finally, regarding malice or improper purpose, the Court found that Mr. Jones displayed "casual inattention" and "too readily left control of prosecution" to the CRA. However, given the high threshold required for this requirement to be met, Mr. Jones' conduct fell short of malice.

The action of malicious prosecution against Brian Jones was therefore dismissed.

—*Brendan Festeryga, Summer Student*

## **RECENT CASES**

**CORPORATION CARRYING ON BUSINESS LIQUIDATING ITS INVENTORY;  
TAXPAYER THUS ENTITLED TO ABIL CLAIM RELATED TO THAT CORPORATION**

Radio Progressive was incorporated on April 23, 1991, and was operated by the taxpayer. Its business consisted of the sale and repair of radio telecommunication equipment. During the 90s its sales began to diminish but it did continue with its repair operations. From 2000 to 2007 it concentrated on selling off its merchandise inventory but made no further sales in the conventional sense after 2007. Between 2007 and 2011 it merely responded to requests for the sale of its inventory, during which time the taxpayer sought to sell its inventory to its principal competitor, as well as to dispose of it, albeit unsuccessfully, to flea markets. Radio Progressive was dissolved on April 26, 2011. On reassessment for 2011, the Minister disallowed the taxpayer's claim for an ABIL deduction relating to Radio Progressive, on the ground that it was not a "small business corporation" within the meaning of the Act. In the Minister's view it had not actively carried on business during 2011 nor during the twelve months preceding 2011. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was allowed. Subsection 248(1) defines the phrase "small business corporation" to mean, in essence, a particular corporation that is a Canadian-controlled private corporation all or substantially all of the fair market value of the assets of which at that time is attributable to assets that are used principally in an active business carried on primarily in Canada by the particular corporation or by a corporation related to it. The same subsection defines the words "[active business](#)" to mean any business carried on by the taxpayer other than a specified investment business or a personal services business. The purpose of this legislation is that it is sufficient for a business to be carried on in order for it to be carried on actively. In this case the evidence was that Radio Progressive remained active during the years preceding its dissolution in order to sell off its merchandise inventory. Indeed, it was difficult to see how the taxpayer could have done more than he actually did to try and sell off Radio Progressive's stock of merchandise, and he maintained those efforts until such stock had no further value. Radio Progressive's business was therefore being actively carried on during 2011 and the twelve preceding months, although in a minimal way, in an attempt to sell off its stock. The Minister ought, therefore, to have allowed the taxpayer's ABIL claim for 2011. The Minister was ordered to reassess accordingly.

*Hébert v. The Queen*

2018 DTC 1049

**APPEAL FROM INTERPLEADER ORDER PROVIDING  
PRIORITY TO CRA OVER HOLDBACK FUNDS DISMISSED**

As the result of a general contractor's default in paying subcontractors working on a renovation project, the property owner who had engaged the general contractor withheld payment, and a bonding company that had acted as surety under a labour and material payment bond paid some of those subcontractors. Subsequent to the completion of the project, the Canada Revenue Agency issued a requirement under section [224\(1.2\)](#) of the *Income Tax Act* to the owner, requiring it to pay to the Receiver General of Canada monies that were payable by it to the general contractor, but the bonding company claimed priority over the CRA with respect to those funds. An interpleader application was brought, and the decision on that application was that the disputed funds should be paid into Court, following which the owner's liability would be extinguished, any lien notices and trust claims would be vacated, and the CRA would be entitled to the funds. The bonding company appealed from that decision, arguing that it was entitled to the disputed funds pursuant to the equitable principles of mitigation and subrogation and the law of guarantee. It took the position that there were no monies owing by the owner to the general contractor because it, as surety, was entitled to the disputed funds pursuant to those equitable principles. It conceded, however, that if the funds were payable to the general contractor, then the CRA would be entitled to payment of those funds.

The appeal was dismissed. The Manitoba Court of Appeal held the standard of review of the decision of the applications judge was one of correctness. The applications judge had held that the owner had no obligation to pay the subcontractors and that the principles of mitigation and subrogation did not apply to the owner.

She concluded that in the absence of an obligation to mitigate or a right of subrogation, and given that the project was completed, the disputed funds were payable to the general contractor under the terms of the agreement, and were subject to the CRA's requirement to pay. The appellate Court noted that there was no suggestion that the work was not fully performed, and, in its view, irrespective of whether there was an event of default or whether that default had been remedied, the funds were payable to the general contractor. The applications judge made no error in her conclusions, and the appellate Court concluded that her decision to grant the interpleader order was entitled to deference.

*Guarantee Company v. Manitoba Housing and Renewal Corp.*

2018 DTC 5046

#### **APPEAL FROM IMPOSITION OF PENALTIES FOR GROSS NEGLIGENCE DISMISSED**

On his return for the 2009 tax year, the taxpayer claimed non-existent business losses in an amount approximately equal to his aggregate income for 2006 through 2009. Those losses were denied by the Minister on assessment, and penalties for gross negligence in the amount of \$32,633.91 were imposed. The taxpayer acknowledged that the business losses claimed were properly denied, but he appealed from the imposition of penalties under section [163.2](#).

The appeal was dismissed. The Tax Court of Canada held that a false statement had clearly been made on the taxpayer's return for the 2009 taxation year, and that the issue for determination was whether the appellant had knowingly, or under circumstances amounting to gross negligence, made or participated in, assented to, or acquiesced in the making of that false statement. The Court noted first that the Minister bore the onus of establishing that the imposition of a penalty under section [163.2](#) was justified in the circumstances. It then applied the criteria set out in the jurisprudence on the application of section [163.2](#) in light of the appellant's background, education, and experience, and the circumstances in which the return was prepared and filed. The Court held that there was no evidence to indicate that the appellant had had actual knowledge that his return contained false statements. Consequently, it was necessary to determine whether the appellant was wilfully blind, such that knowledge of the false statements made could be imputed to him. The Court concluded, in light of its review of the circumstances in which the return was prepared, that there were several warning signs which should have alerted the appellant to make further inquiries. However, in the Court's view, the appellant's actions indicated that he deliberately chose not to make such further inquiries. The Court concluded that such actions constituted wilful blindness, by reason of which knowledge of the false statements in the return could be imputed to the appellant. In addition, the Court held that the appellant had made no effort to review or to verify the accuracy of the return filed and that such failure has been held by the jurisprudence to constitute gross negligence. It concluded that both the "knowingly" and the "gross negligence" requirements of section [163.2](#) had been satisfied, and that the appellant was therefore properly subject to penalties under that provision. The Court held, however, that in light of the appellant's current financial circumstances and the difficulty he would have in paying the assessed penalty plus accrued interest, it was not appropriate to order costs against him.

*Manhue v. The Queen*

2018 DTC 1062

#### **APPEAL FROM DENIAL OF INTEREST DEDUCTION DISMISSED**

In 2007, the taxpayer borrowed \$300,000 to purchase units of a mutual fund, and claimed a deduction in each of the tax years from 2007 to 2015 for all of the interest paid on that borrowing. Each year from 2007 to 2015, the taxpayer received a return of capital from the fund, which totalled \$196,850 over that period. Some of that return of capital was used to reduce the outstanding debt, but the majority was used for personal purposes. The Minister reassessed the taxpayer for the 2013, 2014, and 2015 taxation years to deny a portion of the interest deduction claimed. The Minister took the position that the taxpayer was not entitled to deduct interest relating to the returns of capital that had been used for personal purposes, as such borrowed funds were no longer being used for the purpose of gaining or producing income. The taxpayer appealed from those reassessments.

The appeals were dismissed. The Tax Court of Canada held that the facts were not in dispute and that the only issue for determination was whether, as required by section [20\(1\)\(c\)](#) of the *Income Tax Act* and the appellate jurisprudence interpreting that provision, the money borrowed by the appellant was used for the purpose of earning non-exempt income from a business or property. In order to satisfy that requirement, the taxpayer had to establish that there was a sufficient direct link between the borrowed money and the current use of that money to gain or produce income from property. The Court reviewed the arguments put forward by the appellant and concluded that he had failed to establish that such requirement had been met. In the Court's view, during the years in question, almost two-thirds of the original amount invested was returned to the appellant, and more than one-half of that money was put to use for personal purposes. During the years in question, those personal purposes were the current use of the funds, and the Court found that, as a result, there was no longer any direct link between those borrowed funds and the investment in the mutual fund. The appellant was not entitled to deduct the interest relating to the portion of the funds used for personal purposes.

*Van Steenis v. The Queen*

2018 DTC 1063

### **APPEAL FROM TAX COURT DECISION ON CORPORATE CONTROL DISMISSED**

A company's claim for refundable scientific research and experimental development ("SR&ED") tax credits was denied by the Minister on assessment, on the basis that the company was not a Canadian-controlled private corporation ("CCPC") and therefore was not entitled to the refundable investment tax credits ("ITCs") claimed. That assessment was upheld by the Tax Court of Canada, which held that the factual circumstances surrounding the commercial agreements and arrangements entered into by the appellant company were sufficient to establish that there was control in fact of the corporation by a non-resident, within the meaning of the applicable provisions of the *Income Tax Act* (the "Act"). In doing so, the Tax Court set out a test for operational control, and, applying that test, found that a non-resident individual and corporation had direct or indirect influence over the company that, if exercised, would result in control in fact of the company, in such a fashion that it was controlled directly or indirectly by them within the meaning of section [256\(5.1\)](#). Consequently, the company could not qualify as a CCPC eligible for refundable ITCs. The company appealed, arguing that the Tax Court had erred in its finding that the company was not a CCPC, and, in particular, in its interpretation and application of the relevant statutory provisions and the jurisprudence with respect to its determination of corporate control.

The appeal was dismissed. The Federal Court of Appeal held that the errors alleged to have been made by the Tax Court raised issues of both law and fact. The Federal Court of Appeal first considered the Tax Court's interpretation with respect to section [256\(5.1\)](#) of the Act, and agreed with the appellant that the Tax Court had erred in that interpretation. The appellate Court concluded that the Tax Court had erred by considering irrelevant factors in assessing whether there was control in fact of the appellant company, and had erred as well by considering the fact that the two companies were related and not dealing with each other at arm's length before the relevant time period during which control in fact was alleged to have existed. The appellate Court held, however, that notwithstanding those errors there was no basis for appellate interference, as the errors made were immaterial to the result reached. The appellate Court concluded that the agreement which the appellant company had entered into constituted a legally-enforceable arrangement capable of establishing control in fact under subsection [256\(5.1\)](#) of the Act in the circumstances of the case. With respect to the alleged errors of fact, the appellate Court held that there was ample evidence for the findings made by the Tax Court that the relationship between the two companies was not an arm's length relationship during the relevant period. The Federal Court of Appeal concluded that, overall, there was no basis to interfere with the Tax Court decision, and the appeal was therefore dismissed, with costs.

*Aeronautic Development Corp. v. The Queen*

2018 DTC 5044



**APPEAL FROM ASSESSMENT ALLOWED WHERE  
INDIVIDUAL NOT A DIRECTOR IN LAW OR IN FACT**

In 2007 the taxpayer entered into a business arrangement with two other individuals. One of those individuals prepared articles of incorporation for a new corporation and those articles were signed by the taxpayer as an "incorporator". A partnership agreement was also prepared and the taxpayer signed that agreement as well. In 2009, the taxpayer determined that she wanted to end her involvement with the business, and her shares in the corporation were purchased by the other business owner. In 2013 the taxpayer was notified by the Canada Revenue Agency that the corporation was delinquent in remittances of source deductions and goods and services tax. Although the taxpayer advised the CRA that her involvement in the business had ended four years earlier, three assessments were issued against her. Those assessments were issued under section [227.1](#) of the *Income Tax Act* and section [323](#) of the *Excise Tax Act* for unremitted source deductions and goods and services tax owed by the corporation in her capacity as a director of that corporation. She appealed from those assessments to the Tax Court of Canada on the basis that she was never, in law or in fact, a corporate director.

The appeal was allowed. The Tax Court first reviewed the provisions of the corporations legislation which governed the appointment of directors. That legislation provided that, in order for an individual to be designated as a first director of a corporation, he or she must be an "incorporator" as that term is defined by the statute. In order for a person to be an incorporator, he or she must sign the incorporation agreement respecting the company. The Court reviewed the documents which had been prepared and signed when the corporation was created and held that those documents conflated the concepts of partnership and corporation, such that there was no actual incorporation agreement. The appellant could not, therefore, be an incorporator and any designation that she was a director in law was consequently invalid. On the question of whether the appellant was a director in fact, the Tax Court noted that the jurisprudence provides that the concept of director in fact should be limited to persons who hold themselves out as directors, and that a person could not be considered a director in fact where that person did not believe him or herself to be a director and never thought that he or she had any authority to control the management or direction of the company. The Court decided that, based on the evidence, the appellant manifestly did not at any time hold herself out as or conduct herself as a director. As well, the appellant's uncontradicted evidence showed that it was not until the time she was contacted by the CRA that she learned that she was considered to be a director. Finally, it was not clear to what extent the appellant was, at least until she sold her shares in 2009, even aware of the existence of the corporation. The Court concluded, therefore, that the appellant was not a director in fact of the corporation. The section [227.1](#) and section [323](#) assessments were therefore invalid, and the appeal from those assessments was allowed and the assessments vacated, with costs to the appellant.

*Le v. The Queen*

2018 DTC 1055

**MINISTER JUSTIFIED IN DENYING CORPORATE TAXPAYER SR&ED-RELATED ITCs ON  
GROUNDS THAT FORM FILED BY TAXPAYER DID NOT CONTAIN PRESCRIBED INFORMATION**

The Minister denied the corporate taxpayer Westsource certain SR&ED-related investment tax credits (the "ITCs") claimed, on the ground that Westsource failed to provide certain prescribed information required by subsections [37\(11\)](#) and [\(12\)](#) of the Act. In dismissing Westsource's appeal (2017 DTC 1063 (TCC)) the Tax Court of Canada held that Westsource did not comply with the requirement in subsections [37\(11\)](#) and [\(12\)](#) of the Act to file a prescribed form with prescribed information. On further appeal to the Federal Court of Appeal, Westsource argued that it did supply the required information even though three boxes on the prescribed form were left blank.

The taxpayer's appeal was dismissed. The underlying legislation was not ambiguous, requiring, as it did, that prescribed information must be provided by the taxpayer on the prescribed form to qualify for the ITCs being claimed. In Westsource's case the information missing from the form was required to be included, but was

not. Accordingly, although Westsource had argued that this result was harsh, relief could not be granted to it on the basis of fairness alone. In conclusion, the Tax Court judge made no reviewable error in this case.

*Westsource Group v. The Queen*

2018 DTC 5036

#### **CRA CLAIM FOR UNPAID TAXES HAVING PRIORITY OVER ASSETS OF INSOLVENT ESTATE**

The Public Trustee was appointed as personal representative of the deceased taxpayer's estate for the purpose of administering that estate. The estate was insolvent and there were competing claims for the assets, including a claim by the Canada Revenue Agency for unpaid taxes, the existence and amount of which was documented by a clearance certificate. On the closing of the accounts of the estate, the Registrar of Probate determined that, following section 83(3) of the provincial *Probate Act*, the remaining balance of funds in the estate should be paid to the funeral home. The Public Trustee, which had taken the position that the CRA had first claim on such funds, appealed from that decision.

The appeal was allowed. The Court noted that section 83 of the *Probate Act* dealt with insolvent estates and that the estate involved was clearly insolvent. It noted as well that the *Probate Act*, in listing the priorities for payment, did not make any mention of the status of any debt owed to the Crown, either in right of Canada or in right of the provincial government. Section 159 of the *Income Tax Act* ("ITA"), however, created a priority in favour of the CRA in respect of any monies held in an insolvent estate. Following a review of the jurisprudence and the commentary on the question, the Court concluded that the CRA had priority over the estate assets, on two separate bases. First, both British and Canadian jurisprudence provides that in circumstances where, as in this case, the statute is silent with regards to the priorities affecting debts of the Crown, such debts are not subject to the priorities set out in the statute. Second, the principle of paramountcy provided that the federal legislation regarding income taxes, and priority to payment of a federal debt, as identified in section 159 of the ITA, takes priority over the unsecured debts enumerated in section 83 of the provincial *Probate Act*. The Court concluded that the Court of Probate had been provided with the clearance certificate identifying the CRA debt. That being the case, it was obligated to honour the priority to the federal debt identified in that clearance certificate, as such debt had priority over the funeral debt.

*Public Trustee, for Estate of Evans*

2018 DTC 5039

#### **TAXPAYER'S RPP CONTRIBUTIONS ONLY DEDUCTIBLE AGAINST HIS EMPLOYMENT INCOME BUT NOT AGAINST OTHER SOURCES OF INCOME**

The taxpayer's employment income as a registered Indian was totally exempt from tax. In assessing the taxpayer for 2015, the Minister refused to permit him to deduct contributions made to his RPP against sources of income other than his employment income which was tax exempt. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was dismissed. Paragraph 8(1)(m) of the Act is located under Part I, Division B "Computation of Income", Subdivision a "Income or Loss from an Office or Employment". This heading indicates that these provisions are restricted to income from an office or employment. The opening words to subsection 8(1), moreover, make reference to the computation of a taxpayer's income "from an office or employment" and list deductions that are permitted that are "wholly applicable to that source". This statutory language is straightforward and unambiguous, so that the deduction for RPP contributions cannot be treated as a deduction in the general sense, which would enable it to be separated from its income source. The taxpayer's RPP contributions in this case, therefore, were required to be taken only against his employment income which was exempt, and not against his other sources of income, thus producing a nil result for him. As a result, the Minister's assessment was affirmed.

*Smith v. The Queen*

## Footnotes

- [1] Unless otherwise noted, defined terms in this article have the meaning designated in the first instalment of the Series.
- [2] As that term is defined in subsection [248\(1\)](#). The most common class of property that is taxable Canadian property is property that is or derives its value primarily from Canadian real property.
- [3] The election, for which there is no prescribed form, must be made on or before the trust's balance due date for the year of distribution. Interest and penalties are deferred until the balance-due date of the year that the trust sells the property that is the subject of the deferral. At the option of the Minister, the election can be late filed under subsection [220\(4.63\)](#).
- [4] As will be discussed at the end of this article, recent comments by the CRA will impact all corporate beneficiary planning involving non-resident beneficiaries.
- [5] Whenever US beneficiaries are involved in a trust, managing these types of issues will almost always be an extremely involved, time consuming, costly, and often unsatisfactory process.
- [6] Timothy G. Youdan, "Planning to Deal with the 21-Year Deemed Disposition Rule," in 2008 Ontario Tax Conference (Toronto: Canadian Tax Foundation, 2008), 4:1-16 at page 9. See also M. Elena Hoffstein and Corina S. Weigl, "Overview of the Twenty One Year Rule—A Trust Lawyer's Perspective", in 2014 Ontario Tax Conference (Toronto: Canadian Tax Foundation, 2014), 7:1-62 at page 47. This exception relies on the extended meaning of "beneficially interested" provided in subsection [248\(25\)](#), which applies to the definition of "beneficiary" in subsection [108\(1\)](#).
- [7] A capital interest in a trust is "eligible property" for purposes of subsection [85\(1.1\)](#) (see CRA Document 2012-0459541E5 dated May 1, 2013).
- [8] See section [245](#).
- [9] A variation of trust can be a complex and costly process that is not without tax risk. For more on the subject of variations of trust see Hoffstein and Weigl, *supra* note 6 at 19.
- [10] In particular, subsections [107\(5\)](#), [107\(2.1\)](#), [70\(5\)](#), [104\(4\)](#) and [107\(2\)](#) were all noted.
- [11] As noted previously in this article, it might be possible to make an election under subsection [220\(4.6\)](#) if the distributed property is taxable Canadian property. If this election is unavailable, immediate taxation under subsection [107\(5\)](#) could be deferred if the Do Nothing approach is implemented so that the trust will be taxable under the 21-year deemed disposition rules provided that the trust posts security and elects to pay the tax over 10 years pursuant to subsection [159\(6.1\)](#). For more on the subsection [159\(6.1\)](#) election see Part 1 of the Series.
- [12] <http://business.financialpost.com/pmn/business-pmn/quebec-agrees-in-principle-with-a-single-tax-return-administered-by-the-province>.
- [13] <https://www.theglobeandmail.com/politics/article-ottawa-rejects-quebec-proposal-to-collect-and-transfer-federal/>.