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TAX ON SPLIT INCOME: APPLICABILITY FOR INVESTMENT AND HOLDING COMPANIES

— Alessandra De Palma and Aaron Schechter, CPA, CA

Since the Tax on Split Income ("TOSI") legislation was released, there has been much debate among tax professionals over how many of the rules apply in specific situations. The legislation contains ambiguous definitions and complicated provisions which have led to the notion that the only way to approach the TOSI rules is to assume all income amounts received by shareholders, beneficiaries, and partners are "in" (i.e., subject to TOSI), until you can find an exemption to "get out" (i.e., not be subject to TOSI). To make matters more challenging, the Canada Revenue Agency ("CRA") and Department of Finance have released vague and, at times, conflicting interpretations on how the rules should apply to various scenarios.

At the October 2018 Association de planification fiscal et financière ("APFF") Financial Strategies and Instruments Roundtable (the "Roundtable"), additional clarity was provided by the CRA on the applicability of the TOSI rules to corporations and trusts that earn investment and rental income. The CRA's preliminary written responses to questions it was asked have given practitioners and taxpayers more guidance on how the TOSI exceptions based on the "excluded shares"[1] and "related business"[2] definitions should apply.

In Question 2 and Question 9(a) of the Roundtable, the CRA was asked to reconcile its response to a question posed to it at the 2018 Society of Trust and Estate Practitioners ("STEP") Roundtable with the seemingly contradictory guidance it had provided previously. Interestingly, the CRA's response hinged on whether the corporation was earning "income from property" or income from a "business". It admitted that corporations whose principal purpose is to derive income from property, including interest, dividends, rents, and royalties, could be carrying on a "business" by virtue of engaging in a sufficient level of activity. Even though the CRA added its standard caveat, "*the question of whether a particular income constitutes income from a business or income from property is a question of fact that can only be resolved following a comprehensive analysis of all the facts present with respect to a particular situation*", it noted that in subsection 248(1) of the *Income Tax Act* (Canada) (the "Act"), the term "business" includes "*an undertaking of any kind whatever*".

As a result, it appears that for corporations earning investment income, including rental income from non-related parties, whether dividends paid to its shareholders may be subject to TOSI will depend on whether it has a sufficient level of activity, such that it can be considered to be carrying on a "business".

If it is determined that an investment corporation is not earning income from a "

[1] Definition of "excluded amount" in subsection 120.4(1) of the Act, subparagraph (*g*)(i).

[2] Definition of "excluded amount" in subsection 120.4(1) of the Act, subparagraph (*e*)(i).

business", dividends paid to a specified individual 18 years of age or older will not be subject to TOSI, so long as the amount is not derived, directly or indirectly, from a "related business" in the year. On the other hand, if it is determined that the investment corporation is carrying on a "business", dividends paid to a specified individual 25 years of age or older will not be subject to TOSI, so long as the amount is paid on an "excluded share".

A share of a corporation owned by a specified individual will generally be an "excluded share" if:

(1) Less than 90 per cent of the "business" income of the corporation for the prior year (or if there is no prior year, then the current year) was from providing services;

(2) The specified individual owns shares having 10 per cent or more of the votes and fair market value of the corporation; and

(3) All or substantially all of the "business" income in item (1) above was not derived from the "related business" of another corporation.[3]

Therefore, for a stand-alone investment corporation (i.e., no other corporation, trust, or partnership carries on a "related business" in the year), dividends paid to a specified individual who turns 25 years of age in that calendar year (18 years of age if the corporation is not carrying on a "business") should not be subject to TOSI.

The CRA's preliminary written response to Question 9(c) of the Roundtable further explained that in some cases, dividends paid to specified individuals from holding and investment companies which previously received their investment capital from another corporation (say, dividends from a wholly owned subsidiary ("Opco")) may also not be subject to TOSI. The CRA was asked to comment on the situation where a holding company has earned investment income from its passive investment portfolio and uses this income to pay dividends to its shareholders. The CRA responded that assuming the holding company's investment activities constitute a "business", and all or substantially all of its income for the prior year was not from dividends or other income from Opco, any dividends paid by the holding company to a specified individual could meet the TOSI exception for income received from "excluded shares" (assuming the other criteria are met).

Surprisingly, the CRA commented that:

> In light of the foregoing, the CRA is of the view that the condition provided in paragraph (c) of the definition of "excluded shares" in subsection 120.4(1) would be satisfied in respect of Holdco, notwithstanding the fact that the capital used in the acquisition by Holdco of the property used in carrying on the business was derived from dividends received by Opco.

In the discussed examples, the CRA only addresses dividends paid to a specified individual out of the after-tax investment income; not dividends paid out of the capital (i.e., the dividends from Opco). It appears that the CRA takes the position that dividends paid out of the funds initially received from Opco would be from a "related business" so long as a "related business" exists in the year the dividend is paid, such that these dividends would be subject to TOSI; however, dividends received by a specified individual older than 24 years of age out of the initial funds received from Opco may escape TOSI by virtue of the "excluded shares" exception if no dividends were received by the holding company from Opco in the prior year and the holding company's investment activities are sufficient to constitute a "business".

While these are certainly welcome clarifications, we caution taxpayers to continue to tread carefully when navigating and applying the TOSI rules. Further clarification and guidance is expected from the CRA at the annual Canadian Tax Foundation conference in November.

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[3] Subsection 120.4(1) of the Act.

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CURRENT ITEMS OF INTEREST

2018 Fall Economic Statement

The 2018 Fall Economic Statement announced several tax measures that will benefit Canadian businesses. The most notable among them is the Accelerated Investment Incentive for capital cost allowance ("CCA") and full CCA write-offs for manufacturing and processing property and eligible clean energy property. The mineral exploration tax credit will also be extended for five years. Moreover, the government is promising several tax incentives to support the Canadian media — more clarity on these will be provided in Budget 2019.

CRA Publishes 2019 Indexation Adjustment for Personal Income Tax Amounts

The CRA has published its annual indexation adjustment for 2019. The indexation increase is 2.2%. Notably, the 2019 TFSA dollar limit increased to $6,000. For a full list of all indexed amounts, the chart is available on the CRA website: https://www.canada.ca/en/revenue-agency/services/tax/individuals/frequently-asked-questions-individuals/adjustment-personal-income-tax-benefit-amounts.html.

New Pension Limits Announced

The registered plans directorate published the following new pension limits:

- the 2019 money purchase ("MP") limit is $27,230,
- the 2019 defined benefit ("DB") limit is $3,025.56,
- the 2020 registered retirement savings plan ("RRSP") limit is $27,230,
- the 2019 deferred profit sharing plan ("DPSP") limit is $13,615, and
- the 2019 year's maximum pensionable earnings ("YMPE") is $57,400.

Budget Bill Tabled in House of Commons

On October 29, 2018, *Bill C-86, Budget Implementation Act, 2018, No. 2*, received First Reading in the House of Commons. The bill includes all of the tax legislation that was originally included in the Notice of Ways and Means Motion that was introduced on October 25, 2018. This bill received Second Reading in the Senate on December 4, 2018.

Changes to Requesting an Advance Income Tax Ruling

The CRA has published new information circular IC70-6R8, *Advance Income Tax Rulings and Technical Interpretations*, dated November 1, 2018. This replaces the previous document, IC70-6R7, which was published on April 22, 2016.

Paragraphs 7 and 19, which list circumstances where a technical interpretation or ruling will not be issued, have been given several modifications. There is also a new paragraph, 19.1, which discusses where the directorate will not issue a ruling that is conditional on the existence of facts, especially where the facts or intentions have to be inferred. Newly added paragraphs 56 and 57 discuss the privacy of information shared with the CRA.

Appendix A — Advance income tax ruling request checklist, has been significantly revised. Most notably, a new appendix has been added: *Appendix A.1 — Advance income tax ruling request template*. Requests for an advance income tax ruling and supplemental ruling must be made using this template. Appendix A.2 has also been added, which is a reference guide to submitting a request. This new guide to submitting the request and the template itself are very lengthy and specific, so practitioners will want to review these new parts of the circular before submitting an advance income tax ruling request.

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.

Minister Has Discretion To Provide Relief From the Tax-Return-Filing Requirement for Dividend Refunds

***Bonnybrook Park v. MNR*, 2018 DTC 5090 (Federal Court of Appeal)**

This case is an appeal of the Federal Court's dismissal of an application for judicial review of the Minister's decision to not relieve the taxpayer from certain filing requirements associated with the entitlement to receive dividend refunds under subsection 129(1) of the *Income Tax Act* (the "Act"). The Federal Court dismissed the application on jurisdictional grounds. On appeal, the Federal Court of Appeal overruled the Federal Court and held that the Minister's decision was unreasonable for having interpreted the Minister's discretionary power under the relevant provisions of the Act too narrowly. In the result, the Federal Court of Appeal remitted the matter back to the Minister for reconsideration on the basis of principles outlined in the reasons for the decision, which essentially rejected the various reasons that the Minister put forward in the appeal for not exercising discretion in favour of the taxpayer.

This case focuses on the Canada Revenue Agency's ("CRA") position on requests for taxpayer relief from the requirement in subsection 129(1) that, to receive a dividend refund for a year, a taxpayer must have filed its tax return for the year within three years from the end of the year. Although subsection 220(3) grants the Minister discretion to extend the timeline for "making a return under [the] Act", the CRA's historical view has been that the extension of the deadline for filing a tax return (appearing in subsection 150(1) of the Act) cannot have the effect of providing relief from a late-filed tax return under subsection 129(1) because, according to the CRA, the notion of the tax return being filed within three years is a condition for receiving a dividend refund under subsection 129(1) and not a deadline *per se*.

In this case, the taxpayer made a written request that the Minister grant relief under subsection 220(3) or, alternatively, subsection 220(2.1) (which authorizes the Minister to waive a requirement in the Act to file a prescribed form, receipt, or other document) to allow the taxpayer to receive dividend refunds for the 2003 to 2011 taxation years, even though the taxpayer failed to file the relevant tax returns within three years of the end of the year. The subject-matter of the judicial review application was the Minister's response letter advising that the Minister did not have authority under subsection 220(3) to provide the requested relief in relation to the relevant provision. The Minister's letter referenced subsection 164(1) (which addresses refunds of overpayments and contains a similar three-year window for filing the applicable tax return) but the Federal Court of Appeal was satisfied that the taxpayer understood that this was a typographical error and the Minister meant to identify subsection 129(1). The Minister's letter did not provide reasons to support a narrow discretion under subsection 220(3) and did not address the taxpayer's request that the Minister provide relief pursuant to subsection 220(2.1).

The Federal Court heard the taxpayer's application concurrently with a judicial review application of another party (Binder Capital Corp) that raised the identical issue. The Federal Court dismissed both applications on the same basis, namely, that the Federal Court did not have jurisdiction over the question. It seems that the Federal Court misdirected itself by concluding that, if the Ministerial decision at issue involved the interpretation of a provision of the Act, the matter was within the exclusive jurisdiction of the Tax Court.

The Federal Court of Appeal started its analysis by confirming that the Minister's refusal to exercise discretion under section 220 of the Act is clearly a matter that can be judicially reviewed according to the principles from *MNR v. JP Morgan Asset Management (Canada) Inc.*, 2014 DTC 5001, an earlier decision of the Court that is the relevant authority on whether the Minister's decision can be the appropriate object of a judicial review. Rather than remitting the application back to the Federal Court, the Federal Court of Appeal went on to consider the main issue raised by the taxpayer's application: whether the Minister's refusal to exercise discretion in the circumstances called for judicial intervention.

At the outset of its analysis on the main issue, the Federal Court of Appeal held that the fact that the Minister's letter failed to address the taxpayer's request for relief to be provided pursuant to subsection 220(2.1) was itself sufficient grounds for the matter to be remitted back to the Minister for consideration.

The Federal Court of Appeal went on to consider the reasonableness and/or correctness of the Minister's decision with respect to the scope of the discretion under subsection 220(3) in relation to subsection 129(1). The Federal Court of Appeal started by addressing the fact that the Minister's letter did not provide meaningful reasons for the decision to grant relief pursuant to subsection 220(3) and it did not appear that the Minister undertook a full evaluation of the taxpayer's specific case before the letter was issued. The members of the Federal Court of Appeal were divided on how to deal with this omission. Two of the three members of the panel proceeded to consider the reasonableness or correctness of the Minister's decision in this case on the basis of the merits of the arguments that the Minister put forward to support the decision in the hearing before the Federal Court of Appeal and the CRA's historical publicly disseminated positions on this exact issue. The dissenting member of the panel (*per* Stratas JA) would have ended the Federal Court of Appeal's involvement at this point and referred the entire matter back to the Minister for proper consideration and decision based on factors that the Minister considers to be appropriate, even though there can be no doubt that those factors would mirror both the Minister's arguments before the Federal Court of Appeal in the hearing of this case and the CRA's historical positions.

As discussed below, the majority of the Court (*per* Woods JA) concluded that the Minister was wrong to conclude that subsection 220(3) did not allow for the Minister to provide relief in relation to the tax return filing requirement in subsection 129(1).

First, the Court held that a textual, contextual, and purposive analysis of subsection 220(3) supports an interpretation that would allow for the Minister to have the discretion to provide relief in circumstances such as the taxpayer's in order "to blunt the harsh effects of the strict filing requirements of the Act." While the Minister's interpretation relied heavily on the concept that the timely filing of the tax returns is a condition for receiving a refund under subsection 129(1) and not a filing deadline, the Court noted that the Ministerial discretion under subsection 220(3) was previously held by the Federal Court to be broad enough allow for a similar tax-return filing condition to be waived (or relevant timeline extended) in the context of section 216, so as to allow the taxpayer to receive a refund of Part XIII tax (see *Kutlu v. MNR*, 2013 DTC 5137).

Next, the Court rejected the Minister's argument that the scope of Minister's discretion under subsection 220(3) should not be interpreted as allowing the Minister to provide relief in respect of subsection 129(1) because Parliament enacted specific provisions to allow the Minister to provide that type of relief in connection with taxpayer-requested adjustments to statue-barred tax years (subsection 152(4.2)) and refunds of overpayments of Part I tax (subsection 164(1.5)). The Court's view was that there was simply no basis for concluding that, when enacting those two provisions, Parliament was concurrently restricting the authority to grant relief under subsection 220(3) in connection with the tax-return filing requirements for claiming a refund under subsection 129(1).

The Minister raised a few other arguments to support a refusal to exercise discretion under subsection 220(3) in the circumstances. First, providing relief to the taxpayer in this situation offends the notion that the three-year deadline is designed to provide finality. Second, the hardship to the taxpayer would be mitigated by the fact that it would be theoretically possible (albeit unlikely in this taxpayer's circumstances) to receive the dividend refunds in future years. And, third, the taxpayer already received the benefit of some relief through Ministerial discretion under the CRA's voluntary disclosure program. One assumes that none of these positions was forcefully argued by the Minister at the hearing and, not surprisingly, the Court quickly concluded that the Minister could not reasonably rely on any of them as a basis for refusing to exercise the discretion under subsection 220(3) to provide relief in connection with the tax return filing requirement in subsection 129(1).

In the result, the Federal Court of Appeal allowed the taxpayer's appeal and ordered the Minister to reconsider the taxpayer's request that the Minister provide relief under subsections 220(2.1) and (3), with the majority of the Court directing that the Minister take into account the principles outlined in the reasons for decision issued by the majority when doing so. Presumably, the practical effect of the decision for this taxpayer is that, unless the Minister conceives of further reasons for refusing to grant relief in the taxpayer's case that were not put before the Federal Court of Appeal, the Minister would be compelled to grant relief to the taxpayer in this case.

This is an important case for the taxpayer community, as it should put an end to the CRA's longstanding view that the Minister does not have the authority to waive or extend the three-year tax return filing requirement in subsection 129(1) of the Act, even in appropriate circumstances.

— Jaspreet Kaur

An Unsworn Declaration That a Vendor Was Not a Resident in Canada Was Not a "Reasonable Inquiry" Under Paragraph 116(5)(*a*) Given Red Flags

***Kau v. The Queen*, 2018 DTC 1112 (Tax Court of Canada)**

In *Kau*, the Tax Court addresses the issue of whether or not the taxpayer, Mr. Kau, exercised due diligence under subsection 116(5) of the Act in obtaining an unsworn declaration that the vendor was resident in Canada.

Mr. Kau had purchased a Toronto condominium unit. Mr. Kau was aware that the vendor did not live in the condominium unit and that the unit was held as an investment property. Mr. Kau also knew that the vendor's address for service, in California, was also the vendor's address for service when the vendor initially purchased the condominium in 2009. Mr. Kau knew, as well, that the vendor was going to sign the closing documents in California.

In respect of the residence issue, the vendor signed a one-sentence unsworn statement before a California notary public stating that he was not a non-resident of Canada within the meaning of section 116. The statement did not indicate that it was a sworn declaration or a solemn declaration, nor that it was made under penalty of perjury. Meanwhile, on the same day, the vendor signed a declaration with the same notary public in respect of HST matters, which declaration was stated to be a solemn declaration made with the same force and effect as if made under oath.

Mr. Kau did not withhold 25% or any amount from the $368,000 purchase price on account of section 116 when he paid the purchase price to the vendor. Mr. Kau's real estate lawyer testified that it was a standard practice in Ontario to rely on affidavits for determination of residence and that it was not uncommon for vendors to execute documents abroad.

Justice Russell considered whether Mr. Kau's lawyer, on behalf of Mr. Kau, satisfied paragraph 116(5)(*a*) by making a "reasonable inquiry" such that Mr. Kau had no reason to believe that the vendor was not a resident in Canada. The judge stated that what is "reasonable" depends upon the relevant facts.

The Court noted that the Ontario Real Estate Association ("OREA") standard form agreement of purchase and sale stated that a purchaser shall not withhold an amount from the purchase price if the Seller delivers on completion a prescribed certificate or a statutory declaration that the Seller is not then a non-resident of Canada. With respect to the statutory declaration contemplated by the standard form agreement, Justice Russell indicated that where there are red flags the purchaser should elicit "satisfactory evidence" to support the residency declaration.

Justice Russell concluded that Mr. Kau, through his lawyer, did not elicit "satisfactory evidence" because the declaration was not sworn, the vendor executed the documents in California, and the vendor's address for service was in California. These red flags should have prompted Mr. Kau to follow-up (e.g., to ask why the vendor's address for service was in

California, to ask what the vendor's permanent address was (as opposed to his "address for service"), and to request a copy of the vendor's driver's license). Justice Russell indicated that a "reasonably inquiry" entails a consideration of not just what was asked but also of the responses received and whether the responses should lead to follow up requests.

It is noteworthy that Justice Russell concluded that paragraph 116(5)(*a*) requires more than a brief, baldly-stated affidavit or solemn declaration when there are factual red-flags potentially suggestive of non-residency. Accordingly, although the OREA standard form agreement of purchase and sale contemplates a statutory declaration in respect of residency status of the vendor (or a prescribed certificate under section 116), purchasers should be aware that based upon Justice Russell's decision, a statutory declaration in and of itself may be insufficient where there are red flags that suggest that the vendor may not be a resident of Canada.

This decision has been appealed to the Federal Court of Appeal.

— Yaroslavna Nosikova

Arrears Interest Under a GAAR Reassessment (Still) Accrues From Balance-Due Date

***Quinco Financial Inc. v. The Queen*, 2018 DTC 5091 (Federal Court of Appeal)**

In this case, the Federal Court of Appeal confirmed the Tax Court of Canada's decision on a question that the parties put before the court concerning the computation of arrears interest under the *Income Tax Act* (the "Act") if the underlying tax debt arose as a consequence of the Minister's reassessment that applied the general anti-avoidance rule ("GAAR"). The taxpayer's position was that arrears interest accrues from the date that the Minister issues the reassessment that relies on the GAAR to make the underlying adjustments. The Tax Court adopted the Minister's position that arrears interest under a GAAR-based reassessment is computed the same way that arrears interest is computed under a reassessment that is not based on the GAAR, namely, arrears interest on unpaid tax arising under the reassessment begins to accrue from the taxpayer's balance-due date for the reassessed tax year. The Tax Court decision in this case was consistent with prior Tax Court decisions on the same issue.

The taxpayer was a corporation that was created on the August 27, 2004 amalgamation of two predecessor corporations. The question put to the Tax Court arose in the context of the appeal of the Minister's reassessments of the predecessor corporations for their taxation years ending immediately before the amalgamation. The relevant tax returns, which were presumably filed by the predecessor corporations in February 2005, reported aggregate capital losses of approximately $573 million. The Minister's original assessments accepted the capital losses as filed but the Minister later issued reassessments reducing the aggregate capital losses to $566 million. A second set of reassessments was issued in April 2009 in which the Minister applied the GAAR to reduce the capital losses of the predecessor corporations to nil. It was this second set of reassessments, issued almost five years after the end of the relevant taxation year, that was the subject of the Tax Court appeal. At the early stages of the Tax Court appeal, the Tax Court agreed to the parties' request to have the Tax Court order a separate proceeding under Rule 58 of the *Tax Court Rules* to answer the parties' question about the computation of arrears interest for the reassessments under appeal.

Although the taxpayer gave several reasons in the Tax Court to support its interpretation of the arrears interest regime in the Act, the taxpayer's position seems to have been mainly driven by its view that it is inherently unreasonable to require taxpayers to anticipate a future GAAR-based reassessment at the time of filing their tax return, as the accrual of arrears interest during the period between the balance-due date and the date that the Minister issues the GAAR-based reassessment can only be justified from a policy perspective if one accepts that the additional tax arising under the application of the GAAR is an amount that the taxpayer should have known — when preparing its tax return — that the Minister would consider to be an appropriate amount in the circumstances. Interestingly, the Tax Court specifically took on this issue and concluded that, in its view, "while not simple or uncomplicated, a taxpayer is able to approach, anticipate and account for GAAR as a taxpayer is obligated to do with all other taxing sections of the *Act* to which GAAR, by necessity must correlate."

The computation of arrears interest under the Act is governed by subsection 161(1), which provides that, starting on the taxpayer's "balance-due date" for a tax year (generally two or three months after the end of the year for a corporate taxpayer depending on whether the corporation is a Canadian-controlled private corporation), a taxpayer is to pay arrears interest at the prescribed rate in respect of unpaid taxes for the year computed (i) on the amount by which the taxes payable for the year exceed the aggregate amount paid by the taxpayer or applied by the Minister on account of those taxes, and (ii) "for the period during which the excess is outstanding."

On appeal to the Federal Court of Appeal, the technical basis for the taxpayer's position was focused on the second aspect of the arrears interest computation. The taxpayer's main argument was that, in the case of a GAAR-based reassessment, the excess (consisting of the additional tax payable as a consequence of the GAAR-based reassessment) only arises when the reassessment is issued and not on the taxpayer's balance-due date. This, according to the taxpayer, is because subsection 245(2) of the Act requires the Minister to determine the tax consequences to the taxpayer that are reasonable in the circumstances to deny the tax benefit that offended the GAAR and the Minister only makes this determination when the GAAR-based reassessment is issued. In response to the taxpayer's argument, the Federal Court of Appeal observed that the Minister's determination of the tax consequences under a GAAR-based reassessment is really no different from the Minister's decision to reassess to disallow expenses or include income in accordance with other provisions of the Act. Accordingly, the Federal Court of Appeal could see no reason to deviate from the concept reflected in section 157 of the Act that the tax liability for a tax year is due and payable on the taxpayer's balance-due date for that year.

Even though the evidentiary record for the Rule 58 proceeding and the appeal in the Federal Court of Appeal did not include any details about the actual transactions that the predecessor corporations undertook to create the capital losses that were the subject of the Minister's GAAR-based reassessment, both the Tax Court and Federal Court of Appeal seemed satisfied that the situation involved a sophisticated taxpayer that undertook the transactions for the purpose (in whole or in part) of producing the capital losses that the Minister subsequently disallowed and that the taxpayer was fully capable of evaluating prior to the taxpayer's balance-due date the likelihood that the Minister would eventually want to apply the GAAR to the transactions. Consequently, it would have been difficult for either court to conceive of the taxpayer suffering genuine financial hardship from having the Minister issue the GAAR-based reassessments almost five years after the end of the relevant tax year, which would result in the additional tax triggered by the application of the GAAR accruing arrears interest as if the amount was due and payable on the balance-due date.

To the extent that a taxpayer is truly unaware at the time of filing its tax return that the Minister might apply the GAAR to increase the tax payable from the amount reported in the return and the taxpayer is blindsided by the Minister's decision to apply the GAAR several years later to increase the tax payable for that year, it is worth considering whether some arrears interest relief might be appropriate in those circumstances for the period between the taxpayer's balance-due date for the year and the date of the Minister's GAAR-based reassessment. This case confirms that the statutory regime under the Act for arrears interest cannot provide that relief. However, it seems that the Minister would have the authority and discretion to provide that relief pursuant to subsection 220(3.1) of the Act in an appropriate scenario.

— John Yuan

The Importance of Understanding How Residence Is Determined Under a Tax Treaty One Intends To Rely On

***Landbouwbedrijf Backx B.V. v. The Queen*, 2018 DTC 1104 (Tax Court of Canada)**

The taxpayer in this case was a company incorporated in the Netherlands. The issue in the appeal was whether the corporation was liable for Canadian income tax on a gain from the disposition of an interest in a partnership that carried on a dairy business in Ontario, either under Part I of the Act — on the basis that the taxpayer was a resident of Canada at the time — or, alternatively, under Part XIV of the Act (i.e., branch tax), if the taxpayer was a non-resident of Canada at the time. As discussed below, the Tax Court held that the taxpayer was liable for tax on the gain under Part I of the Act as a resident of Canada.

The taxpayer was incorporated in 1997 by a husband and wife, Michiel and Marion Backx, who were the sole shareholders of the taxpayer at all material times. The couple functioned as the sole directors of the corporation until they emigrated to Canada in May 1998. Prior to leaving the Netherlands, the Backxes resigned as directors and a Netherlands-resident family member was appointed as sole director and remained in that role going forward. It appears that the corporation was initially created and maintained as part of a professionally-advised plan to facilitate the orderly disposition of a farming business that the Backxes operated in the Netherlands prior to their permanent move to Canada.

In June 1998, the Backxes and the taxpayer established a partnership to operate a dairy farm in Ontario. The Backxes held a 51% interest in the partnership and the taxpayer held a 49% interest, having contributed $2,975,000 of operating capital to the partnership by the end of 1998. For the period from 1998 to 2009, the taxpayer filed Canadian tax returns as a non-resident of Canada and paid Part I tax on its 49% share of the annual income from the partnership.

In November 2009, the Backxes formed a Canadian-resident corporation, Backx Limited, to acquire and hold the interests in the partnership that operated the Ontario dairy farm. The taxpayer sold its 49% interest in the partnership to Backx Limited for a purchase price of $4,500,000. The sale resulted in the taxpayer realizing a capital gain of $1,739,049 on the disposition. As the parties to the sale considered the taxpayer to be a non-resident of Canada, the Minister was given notification of the sale in December 2009 pursuant to section 116 of the Act. In the notification, the taxpayer took the position that the Minister was precluded from taxing the gain on the disposition of the property by virtue of an applicable tax treaty, which is a position that the Canada Revenue Agency initially accepted in a letter issued in January 2011, but from which it later resiled before the Minister decided to issue the Part I assessment that was the subject of the appeal in the Tax Court.

The Minister sought to impose tax on the taxpayer's disposition of the partnership interest through two assessments. The first assessment was an assessment of Part I tax issued on the basis that the partnership interest was taxable Canadian property that was not "treaty-protected property" for purposes of paragraph 115(1)(*b*) of the Act, the gains from which are subject to Part I tax even though the taxpayer is a non-resident of Canada. The second assessment was an assessment of branch tax under Part XIV of the Act on the basis that the taxpayer was a non-resident person that operated a branch in Canada at the time of the disposition. The Minister's rationale for imposing branch tax in the circumstances was not clear from the Tax Court decision and the issue became irrelevant once the Tax Court came to the conclusion that the taxpayer was a resident of Canada. However, at the hearing, the Minister acknowledged that the Part XIV assessment was intended to operate as an alternative basis for imposing Canadian tax on the gain from the disposition of the partnership interest. Once the matter came before the Tax Court, the Minister abandoned its original position on the Part I assessment and, instead, sought to support that assessment on the basis that the taxpayer was a resident of Canada.

As one would expect, the Tax Court (*per* Smith J) decided the residency issue by applying the traditional "central control and management" test. The jurisprudence establishes that central management and control is normally found in the board of directors, even if they are under significant influence of others. However, if non-directors make significant management decisions, the place where those persons live might be the residency of the corporation (see: *St. Michael Trust Corp. v. The Queen*, 2010 DTC 5189 (FCA) and 2012 DTC 5063 (SCC)).

The taxpayer attempted to support its assertion that it was a resident of the Netherlands on the basis of the following factors:

- It was incorporated in the Netherlands, its directors have always resided in the Netherlands, it holds a bank account in the Netherlands, its annual financial statements are prepared in the Netherlands, and it filed its tax returns in the Netherlands;
- It holds an annuity in the Netherlands that requires it to maintain its corporate existence there;
- It was incorporated pursuant to a plan devised by professional advisors in the Netherlands, initially for holding and then selling farm assets in the Netherlands;
- The involvement of the taxpayer in the partnership was limited to contributions of finances and certain farm equipment; and
- All documentation for the sale of its interest in the partnership was signed by the sole director of the taxpayer, an individual who was a resident of the Netherlands.

By contrast, the Minister asserted that, as a practical matter, the Backxes managed and controlled the taxpayer from Canada, with the Netherlands-resident director only performing tasks that were of an administrative nature.

The Tax Court agreed with the Minister. The taxpayer's director had no experience in farming. She delivered financial documents and paid bills only on the direction of the Backxes, and did not participate in the decision to invest in the partnership. She was merely implementing instructions given by the true deciding minds — the Backxes — from Canada. The Tax Court thus held that the taxpayer was a resident of Canada and liable for Part I tax on the gain from the disposition of the partnership interest. There was a secondary issue of determining whether the taxpayer became a resident of Canada after it acquired the partnership interest and, therefore, entitled to a "step-up" in its cost for the property to its fair market value on the date it became a Canadian resident. On this issue, the Tax Court concluded that the taxpayer likely became a resident of Canada when the Backxes immigrated to Canada, which predated the taxpayer's acquisition of its partnership interest.

While the result of this case was predictable given the factual circumstances, it was somewhat surprising that the interpretation of the *Canada–Netherlands Income Tax Convention* was not more prominent in the analysis, particularly in light of the fact that the parties reported the sale to the Minister as a disposition of treaty-protected property at the time of the transaction.

By virtue of subsection 250(5) of the Act, had the taxpayer been able to persuade the Tax Court that it was a resident of the Netherlands for purposes of the Canada–Netherlands treaty, the taxpayer would be deemed to be a non-resident of Canada for purposes of the Act and would be exempt from Canadian taxation on gains from the disposition of certain capital properties under Article 13 of that treaty. However, an examination of Article 4 of the Canada–Netherlands treaty perhaps sheds some light on why the taxpayer was not more forceful in asserting that it was a Netherlands resident under the terms of that treaty.

Article 4 provides that, where both countries consider a person (other than an individual) to be a tax resident of their own country (i.e., dual resident), the question of residence for purposes of the treaty is to be settled by mutual agreement of the competent authorities of both countries having regard to the place of effective management, place where incorporated or constituted, or by considering "any other relevant factors". This is to be contrasted with Article IV of the *Canada–U.S. Income Tax Convention*, which includes a tie-breaker rule in paragraph 3, under which a dual-resident corporation is deemed to be a resident in the country in which it was created. Consequently, in the absence of a tie-breaker rule and by assuming that the Netherlands considered the taxpayer to be a Dutch tax-resident, the taxpayer would have had to invoke the mutual agreement procedure under Article 4 of the Canada–Netherlands treaty. The taxpayer would only be able to rely on Article 13 of the treaty to exempt the gain from Canadian taxation if, under the mutual agreement procedure, the competent authorities of the two countries agreed that the taxpayer should be treated as a Dutch tax-resident for the purposes of the treaty.

In the appeal before the Tax Court, it does not appear that the taxpayer led any evidence to demonstrate that the Netherlands considered the taxpayer to be a Dutch tax-resident or that efforts had been made to ask the competent authorities to make the determination required by Article 4 of the Canada–Netherlands treaty. Consequently, one is left with the impression that the taxpayer (or, more likely, its professional advisors) were counting on the taxpayer's place of incorporation being determinative on the residence question, as would be the case if Article 4 of the Canada–Netherland treaty had the tie-breaker rule that appears in Article IV of the Canada–U.S. treaty.

— Sarah Ferguson, Articling Student

RECENT CASES

Notes held by non-resident entity constituting debt for purposes of section 94.1(1)(*a*)

The corporate appellant filed a tax appeal in 2014, and, in the course of that appeal, brought a Rule 58 motion for the determination of a question before the Tax Court. That question required the Tax Court to consider whether certain instruments held by a non-resident entity constituted debt for the purposes of the *Income Tax Act* (the "Act"). The Tax Court determined that such instruments did constitute debt and the taxpayer's appeals from that decision were unsuccessful. The taxpayer then brought a follow-up question under Rule 58, seeking the Tax Court's determination of whether those same instruments constituted debt for purposes of paragraph 94.1(1)(*a*) of the Act.

The Court determined that the Notes held constituted debt under section 94.1. The Tax Court determined that in its view, which incorporated the reasons, analysis, and conclusions provided in the first Rule 58 application, the Notes in question did constitute debt for purposes of paragraph 94.1(1)(*a*). In reaching that conclusion, the Court held that the appellant had not made any submissions that specifically addressed the question of why the use of the term "debt" in paragraph 94.1(1)(*a*) should be different from the meaning of debt for the purposes of the Act as a whole (as set out in the first Tax Court decision), or that the text of the provision even suggested otherwise. The appellant had also not argued that the relevant context of that paragraph might be different from the Act as a whole. Finally, the appellant had not put forward any purpose of section 94.1, or the offshore investment fund rules, that might warrant a different analysis. Overall, there had been no attempt to show the Court that there was any reason to give the term "debt" when used in paragraph 94.1(1)(*a*) of the Act any different meaning than its meaning for the purposes of the Act as a whole, as set out in the previous decision of the Tax Court. The Court concluded, therefore, that for purposes of the appellant's tax appeals, the two Notes held by the non-resident entity constituted debt for the purposes of paragraph 94.1(1)(*a*) of the Act.

Barejo Holdings v. The Queen

2018 DTC 1144

Leave to appeal decision overturning judicial stay of proceedings granted

The applicant had been charged with offences under the federal *Income Tax Act*. At trial, the judge held that all counts of the offences had been proven beyond a reasonable doubt, but a judicial stay of proceedings was entered based on the fact that there had been an unreasonable delay of 29.7 months, and that such delay was not attributable to the accused. However, the stay provided was overturned on appeal, the summary conviction appeal judge finding that seven months of the delay was attributable to the accused. The summary conviction appeal judge concluded that, taking that seven-month time period into account, the Crown had established that the case fit within the time allowance provided by the jurisprudence for cases already in the criminal justice system. The accused then brought an application before the British Columbia Court of Appeal, seeking leave to appeal the decision of the summary conviction appeal judge.

The application was allowed. The British Columbia Court of Appeal held that, in order to obtain leave to appeal, the applicant was required to establish that the grounds of appeal raised an issue of law alone, that the issue was one of importance, and that there was sufficient merit to the appeal to warrant leave being granted. The Court held as well that the issue involved the exercise of discretion, and that the overriding consideration in exercising that discretion was the interests of justice. The appellate Court held that the first requirement had been met, in that the proposed appeal concerned the characterization and allocation of periods of delay, which was a question of law alone. The Court then reviewed the circumstances which had given rise to the critical seven-month delay. Such delay had been related to the unavailability of defence counsel, and the appellate Court held that the consideration by the courts of the issues which arose in such circumstances was significant, such that the second criterion of importance had been met. Finally, the Court noted that the issue engaged in the proposed appeal was a not uncommon circumstance, and that there was the potential, if the appeal should succeed, that the convictions should not have been registered. The Court concluded that, overall, the interests of justice favoured the granting of leave, and the application for such leave to appeal was allowed.

R. v. Balogh

2018 DTC 5115

Cost of taxpayer's trip to International Space Station paid for by his corporation a shareholder's benefit to be included in his income

The taxpayer was the controlling shareholder of Cirque du Soleil. During 2009 he made a twelve-day trip to the International Space Station (the "ISS") that was paid for by Cirque du Soleil. The latter produced a documentary of this trip that it used for business promotional purposes. On reassessment, the Minister added to the taxpayer's income, as a shareholder's benefit, the $41.8 million cost of the trip to the ISS minus a $4 million amount reported by the taxpayer as a shareholder's benefit. On his appeal to the Tax Court of Canada, the taxpayer's position was that the whole $41.8 million was deductible by Cirque du Soleil as a marketing or promotional expense, and that there had been no shareholder benefit for himself.

The taxpayer's appeal was allowed in part. The taxpayer's trip to the ISS was a personal trip with some significant business aspects, although the overarching reasons for the trip were personal. In the absence of more precise evidence, the business-related portion of the taxpayer's trip was in the 10% range at most. Accordingly, 90% of the cost of the trip (i.e., $37.6 million) was the amount of the shareholder's benefit to be included in his income. The Minister was ordered to reassess accordingly.

Laliberté v. The Queen

2018 DTC 1132

The Law Society of Upper Canada does not perform a function of government in Canada

The Lawyers' Professional Indemnity Company (the "appellant") argued that under paragraph 149(1)(*d*.5) of the ITA, the Law Society of Upper Canada (the "LSUC") was a public body performing a function of government in Canada and that it was thus exempt from tax. The LSUC owned the appellant, which provided professional liability insurance to lawyers and paralegals. The LSUC was a corporation established by statute to regulate the legal professions. The LSUC set professional standards of competence and conduct, and enforced professional rules through a tribunal. Four statutory factors guided LSUC's decision-making, including one to protect the public interest.

The taxpayer's appeal was allowed on a narrow basis entitling it to limited deductions in respect of concessions made by the Minister for charitable gifts. The issue of whether the LSUC performed a function of government was decided in the negative. The tax exemption in paragraph 149(1)(*d*.5) applied to municipalities, and municipal and public bodies performing a function of the government of Canada. The paragraph contemplates a two-part test: (a) the entity is a public body, and (b) the entity is performing a function of government in Canada. There is a three-part test for public bodies: (i) it owes a duty to the public, (ii) it is subject to significant government control, and (iii) it does not use any of its profit for the personal benefit of its members. While the LSUC satisfied the public body test, it did not perform a function of government. The LSUC did not govern the public. The legal professions were self-regulating professions and regulating them was not a function of government. The LSUC's legislative powers were limited to making by-laws relating to the professions. While the regulations benefited the public, they did not govern the public. The LSUC, furthermore, did not perform another function of government, the judicial function. The decisions of its tribunal are appealable to Ontario courts. A judicial function is performed only by a judge of one of Canada's courts. The tribunal's role in regulating the professions was not unlike other professional bodies. Therefore, the appellant was not entitled to the exemption from tax under paragraph 149(1)(*d*.5).

Lawyers' Professional Indemnity Co. v. The Queen

2018 DTC 1141

Partnership allocated all of its taxable income to arm's length public corporation with accumulated tax losses; such allocation set aside as abusive under the GAAR

The corporate taxpayer Holdco was a member of a corporate group in the business of real estate development managed by the De Cotiis family. Nuinsco was an unrelated public corporation which had available tax losses and deductions. A limited partnership (the "Partnership"), of which Holdco was the parent of one of the limited partners, was organized to develop and market a strata development project. An arrangement was made under which Nuinsco became the sole limited partner of the Partnership just before the Partnership's year end and all of the Partnership's income was then allocated to Nuinsco for that year end. The result was that none of the Partnership's taxable income was allocated to entities owned by the De Cotiis family through the Partnership. The Minister assumed that this arrangement involved an abuse of both the transferor-transferee provisions of section 160 of the Act, and the partnership income allocation rules in sections 96 and 103 of the Act. Accordingly the Minister assessed Holdco under the GAAR, effectively setting aside the allocation of the Partnership's income to Nuinsco. The Tax Court of Canada allowed Holdco's appeal and vacated the Minister's assessment. In essence, the Tax Court's position was that: (a) the series of transactions in this case did not involve loss trading; (b) the Crown failed to analyse fully the relevant statutory provisions, including the object, spirit, or purpose of subsection 96(1) of the Act; and (c) partnership income may be allocated to persons who are partners at the partnership year end (see *Mathew v. The Queen* (2005 DTC 5538 (SCC)). The Crown appealed to the Federal Court of Appeal.

The Crown's appeal was allowed. The Tax Court failed to have due regard for the purpose of section 96 as stated in the Matthew case. It is contrary to the object, spirit, or purposes of subsection 96(1) to use that provision to allocate taxable income in a manner that does not assist the organizational structure of the partnership or the efficient conduct of the partnership business. The Tax Court judge's reasoning in concluding that there had been no abusive tax avoidance was therefore flawed. The Tax Court judge's decision was set aside accordingly.

The Queen v. 594710 British Columbia Ltd.

2018 DTC 5111

TFSA penalty provision held to be within constitutional authority of federal government

Section 207.05 of the *Income Tax Act* imposes a penalty tax where the holder of a registered plan receives an advantage resulting from the abuse or misuse of the provisions governing the intended use of that registered plan. The Minister had assessed the taxpayer for the 2010 through 2013 taxation years as the result of an advantage which he had received in connection with his transfer of private company shares to his tax-free savings account, and a tax under section 207.05 was imposed. In the course of challenging that assessment, the taxpayer brought a motion before the Tax Court for the determination of the question of whether such provision of the *Income Tax Act* was unconstitutional. The taxpayer argued that section 207.05 represented an improper delegation to the Minister of National Revenue of the authority to set a tax rate, and was as well a federal infringement on the exclusive provincial authority to make laws respecting "Property and Civil Rights".

The motion was dismissed, with costs to the respondent. The Tax Court held first that it had the authority to consider the constitutionality of a provision of the *Income Tax Act* on which an assessment was based, and to vacate such assessment where that provision is found to be unconstitutional. It reviewed the appellant's arguments with respect to the rate of tax imposed under section 207.05 and held that the plain language of that section and related provisions did not support his view that there had been an implicit delegation to the Minister of the authority to set a tax rate. Rather, the impugned provision had been properly passed by Parliament into law and was constitutionally valid. On the question of the encroachment on provincial jurisdiction, the Court held that the effect of the provision did not create rights of confiscation or seizure, ownership, or regulation of the purchase and sale of any property. In the Court's view, the appellant had wrongly conflated the severity or high rate of taxation imposed with legal confiscation or seizure. The Court found as well that the legal effects, practical effects, and purpose of section 207.05 all pointed to taxation as the pith and substance of the provision and that it was therefore within the constitutional authority of the federal government.

Hunt v. The Queen

2018 DTC 1139

REGISTERED AND DEFERRED PLANS IN CANADA

The below excerpt is from the upcoming book, Registered and Deferred Plans in Canada. This book is a hands-on reference with helpful tips, real-life examples, and guidance on a variety of saving plans available to Canadians. If you wish to order this book, please visit http://www.cch.ca/product.aspx?WebID=5472 or call customer service at 1-800-268-4522.

Registered Supplementary Unemployment Benefit Plans

General

A supplementary unemployment benefit plan is a plan established by an employer or group of employers to top up employees' employment insurance ("EI") benefits during a period of unemployment because of training, sickness, accident or disability, maternal or parental leave, or a temporary stoppage of work (i.e., temporary lay-off).

Certain payments to a trustee in trust by an employer are deductible in computing business income.

Any amount an employer receives from a trustee under a registered supplementary unemployment benefit plan to which the employer has made payments, resulting from an amendment, modification, or termination of the plan, is to be included in the employer's income.

The trust itself is not taxable on its income as the employee or former employee who receives the periodic payments is taxable on such amounts when received by the employee or former employee.

Those wishing to establish such a plan should review Information Circular IC 72-5R2. As is recommended for new pension and deferred profit sharing plans, professional advice should be obtained before attempting to establish this type of plan.

Registration

A registered supplementary benefit plan is a plan that has been accepted by the Minister for registration in respect of the plan's operations and constitution. Applications for registration should be made by letter directed to the Registered Plans Directorate of the CRA.

The minimum requirements for registration are that:

(1) the employer's contributions must be made to a trust with a fiscal period ending on December 31;

(2) the plan must not be a superannuation or pension plan or an EPSP;

(3) the funds of the trust must be used exclusively for the benefit of employees or former employees who are laid off for an indefinite period for reasons other than sickness or accident and who are not retired;

(4) most employees should be those covered by unemployment insurance (e.g., a plan covering only executives and senior personnel will not be acceptable); and

(5) the amounts and timing of employer contributions should be laid down in the plan and the amounts should be reasonable.

Tax Advantages of Registration

Only registered supplementary unemployment benefit plans can derive the following tax advantages:

(1) the trust governed by a registered plan is not taxable on its income;

(2) the employer may deduct payments made to the trustee during a taxation year or within 30 days thereafter, to the extent not previously deducted;

(3) an employee or former employee is taxable on any amount received from the trustee during the year;

(4) an employer must include in income any amounts received in the year from the trustee of the plan as a result of an amendment or modification of the plan, or as a result of the termination or winding-up of the plan; and

(5) an amount paid by a taxpayer to a trustee of the plan is deductible.

Contributions

Where an employer makes a payment to a trustee in trust under a supplementary employment benefit plan, exclusively for the payment of periodic amounts to employees or former employees who are or may be laid off for any temporary or indefinite period, such payments are deductible in computing business income if they were made in the year or within 30 days after the end of the year providing the plan has been registered with the Minister of National Revenue.

Withdrawals

Any amount received by an employee from a trustee under a registered supplementary unemployment benefit plan (sometimes referred to as a guaranteed annual wage plan), must be included in income.

Any amount received by an employer on the amendment or wind-up of a supplementary employment benefit plan must be included in the income of the employer in the year received.

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