Tax Notes

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ATTRIBUTION UNDER 75(2)

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Overview

Subsection 75(2) is an anti-avoidance provision which essentially ignores the existence of a trust where the person contributing property to a trust can get it back or control who gets it. However, the provision is very broadly drafted and can apply in many surprising situations.

Practice Note:

A notable aspect of subsection 75(2) is that, in contrast to many of the other attribution rules, which explicitly or implicitly incorporate an intention on the part of the taxpayer to reduce or avoid tax and/or benefit a non-arm's length person, subsection 75(2) may apply even where the trust was established for strictly non-tax planning purposes. Any time a trust is being drafted or amended, it's very important to check to see whether or not subsection 75(2) applies to avoid unintended and possibly severe tax consequences.

Subsection 75(2) deems income or losses and taxable capital gains or allowable capital losses from property, *or property substituted for the property*, directly *or indirectly* transferred to a Canadian resident trust by a person to be income, gains, or losses of the person transferring the property instead of income, gains, or losses of the trust while the person is alive and resident in Canada if:

(1) The property *may* revert to the transferor,

(2) The property *may* pass to persons to be determined at some future time by the transferor, or

(3) The property cannot be disposed of during the lifetime of the transferor without his or her consent or in accordance with his or her direction.

Because of subsection 75(2), *inter vivos* trusts drafted in Canada normally are irrevocable, do not have the settlor or transferor as a beneficiary, and usually have three trustees (only one of whom is the settlor/transferor) with decisions of the trustees being made by majority vote.

Denial of 107(2) Roll-out

In addition to the attribution of income, gains, and losses, if any property of a trust becomes subject to subsection 75(2) at any time, subsection 107(4.1) provides that the usual tax-deferred rollover available under subsection 107(2) for distributions of property out of the trust to beneficiaries is denied while the transferor is alive, other than for distributions to the transferor of the property or to the spouse or common-law partner of the transferor. Instead, subsection 107(2.1) provides that the trust will be deemed to have disposed of the property distributed to the beneficiary for proceeds equal to its fair market value at the time of distribution, triggering any accrued and unrealized capital gains and losses on the property, as well as profits or losses on inventory and recapture or terminal losses on depreciable property, and the beneficiary will be deemed to have acquired the trust property at a cost equal to its fair market value. This denial occurs even if the application of subsection 75(2) is temporary (and possibly not even applicable at the time of distribution) and applies to all the property of the trust, even though subsection 75(2) might only apply to a small part of the trust property. The denial also occurs where subsection 75(2) would have applied but for the fact that the transferor was not resident in Canada.

Substituted Property

The property to which subsection 75(2) applies includes property substituted therefor. Subsection 248(5) provides that where one property is disposed of or exchanged and a second property is acquired in substitution for the original property and that second property is disposed of or exchanged and a third property is acquired in substitution for the second property, the third property is deemed to have been substituted for the original property. This deeming rule will apply to a fourth property acquired in substitution for the third property and so on.

Possibility of Reversion

Paragraph 75(2)(*a*) can apply whenever, under the terms of a trust, there is the possibility that trust property could revert to the person who contributed it, even if the possibility of reversion is relatively remote. It may apply, for example, where the contributor has a contingent capital interest under a "disaster" clause.

In CRA Document No. 2002-0162855, April 25, 2003, the CRA made the following comment on the word "may":

> The word "may" implies that the subsection applies even though there is only a possibility that the property reverts to the transferor. We would like to stress that the condition found in subparagraph 75(2)(*a*)(i) of the Act does not refer to the notion of control or certainty in order to be met.

In the above document, the CRA concluded that subsection 75(2) would apply where a taxpayer transferred property to a trust, under the terms of which the taxpayer's spouse was given a power of appointment exercisable through the spouse's will. Accordingly, the spouse would determine the beneficiaries who would share in the assets of the trust at the spouse's death. The assets of the trust would not become the assets of the spouse's estate. Rather, the assets of the trust would be distributed to the persons chosen by the spouse through the exercise of the power of appointment given to the spouse in the trust indenture. Since the taxpayer could be so chosen, subsection 75(2) applied. The CRA went on to state that, where the terms of the power prevented the donee of the power from appointing the taxpayer, 75(2) would not apply because the property could not return to the taxpayer through the operation of the trust.

Directly or Indirectly

Not only will subsection 75(2) apply where the meeting of its conditions is only a hypothetical possibility, the contribution triggering it may be direct or indirect. Therefore, it would apply where property is transferred to a taxpayer who thereafter (perhaps years later) establishes a trust naming the transferor as a beneficiary (and perhaps only a contingent beneficiary at that). It is not hard to imagine how such a circumstance might arise. Say, for instance, a parent gives his or her child a property which, a number of years later, the child transfers to an *inter vivos* family trust, the primary beneficiaries of which are the child's spouse and children, but the terms of which name the parent as a contingent residual beneficiary. In such circumstances, subsection 75(2) may apply to attribute any income, loss, etc. from the property to the parent.

The Person From Whom the Property Was Received

Generally, it is the settlor who transfers or donates property to a trust to which subsection 75(2) may apply. However, subsection 75(2) appears to be worded such that it may apply to any person from whom property is received by the trust and not just the settlor. However, in the recent decision of *Sommerer v. The Queen*, 2011 DTC 1162, Judge Miller of the Tax Court of Canada held otherwise, indicating that, on a textual, contextual, and purposive interpretation of subsection 75(2), it can only apply to the original settlor of the trust. The CRA had argued that the provision could apply to a beneficiary of a trust who had sold shares to the trust for fair market value consideration. Judge Miller disagreed, holding "that subsection 75(2) of the Act is not meant to apply to more than one person, that person being the settlor". The *Sommerer* decision was appealed to the Federal Court of Appeal, which upheld the Tax Court decision. In particular, the Federal Court held that subsection 75(2) does not apply to a beneficiary of a trust who transfers property to the trust by means of a sale for consideration. The Federal Court agreed with the Tax Court judge's conclusion that "only a settlor, or a subsequent contributor who could be seen as a settlor, can be the 'the person' for purposes of subsection 75(2)".

Second Generation Income

As is generally the case with other attribution rules, subsection 75(2) does not apply to second generation income. Therefore, for example, as the CRA states in Interpretation Bulletin IT-369R (paragraph 6), "if the property received from a person is money which is deposited by the trust into a bank account, the interest on the initial deposit will attribute to that person but interest on the interest left to accumulate in the bank account will not attribute". As noted above, subsection 75(2) applies to "substituted property". Thus, while subsection 75(2) does not apply to attribute second generation income, it does appear to apply to second (and subsequent) generation capital gains.

Non-resident Trusts

Paragraph 94(4)(*h*) specifically excludes a trust deemed resident in Canada under subsection 94(3) from being subject to subsection 75(2). For property held by non-resident trusts, the 2013 federal Budget introduced subsections 94(8.1) and (8.2), which generally apply to non-resident trusts in the same circumstances as subsection 75(2) applies to resident trusts. In addition, effective for taxation years that end after March 20, 2013, the subsection 107(4.1) rollover denial noted above applies to a non-resident trust that was or would have been subject to subsection 94(8.2) but for the fact that the transferor was not resident.

CURRENT ITEMS OF INTEREST

Comfort Letter Update

The Department of Finance has recently sent several comfort letters that recommend changes to the *Income Tax Act* (the "Act"). The first, dated August 26, 2019, proposes to exclude investment management fees paid by the holder/

annuitant of a registered plan from the advantage penalty under section 207.01. The second, dated September 3, 2019, recommends that a taxpayer can be reassessed for a statute-barred year in order to claim additional paragraph 20(1)(*v*) deductions for increased mining taxes reassessed in respect of that year. The third, dated September 4, 2019, proposes to allow an *inter vivos* trust for the benefit of a disabled beneficiary to be eligible for the principal residence exemption. The last letter, dated December 2, 2019, recommends that the Act be amended to exclude post-mortem pipeline transactions carried out by a graduated rate estate from the non-resident surplus stripping rule under subsection 212.1(6).

Annual Indexation Adjustment

The CRA has updated its indexation adjustment on its website for 2020. The increase for 2020 is 1.9%, which affects various credits, limits, and other amounts.

FOCUS ON CURRENT CASES

This is a regular monthly 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.

Disproving a Dividend Reported on a T5 Information Return

***Trower v. The Queen*, 2019 DTC 1060 (Tax Court of Canada — Informal Procedure)**

This case is an interesting example of a situation where a taxpayer was successful in challenging the Minister's reassessment to add dividends to her income on the basis of the T5 information slip issued by the corporation that purported to pay the dividend. It also illustrates some common issues that might arise when a closely-held private corporation pays out dividends, when what takes place in the real world does not conform with what might be regarded as "best practices".

In *Trower*, the Tax Court (*per* Monaghan J) found that, even though dividend-paying resolutions should normally be considered, voted on and recorded in writing at the relevant time, it does not always happen in practice, particularly in the case of closely-held private corporations. The Tax Court allowed for the possibility that directors and/or shareholders may make a decision and act upon it without contemporaneously documenting the decision in writing but the Tax Court ultimately found that this was not the case in *Trower*.

The taxpayer in *Trower* is an individual who was a former shareholder in Cove BD Inc. Prior to October 2, 2016, the taxpayer and her former spouse were the only two shareholders and directors of Cove but since October 2, 2016, the spouse was the sole shareholder and director. During the hearing, it was clear to the Tax Court that the relationship between the taxpayer and her husband was strained.

The issue in the appeal was whether the Minister was entitled to reassess and increase her income for the 2016 taxation year by $58,900, representing a grossed-up dividend that Cove paid to the taxpayer according to a T5 information slip that Cove issued to the taxpayer, in circumstances where the taxpayer disputed receiving such dividend.

In issuing the reassessment, the Minister made the assumption of fact that the taxpayer received the dividend. In a tax case, the onus is the taxpayer to disprove assumption of facts that the Minister relied on to issue the reassessment. Thus, to prevail on the appeal, the taxpayer was required to convince the Tax Court, on a balance of probabilities, that she did not receive any dividends from Cove in 2016 despite the fact that the corporation issued a T5 information return reporting that she received dividends from the corporation.

Based on the evidence provided, it appears that funds were historically transferred directly from Cove's bank account either to a joint account that the taxpayer and her spouse maintained prior to separation, or to the taxpayer or her former spouse's personal accounts. The Tax Court noted that:

> the character of any of these payments cannot be determined simply from the fact that there were transfers. For example, those payments could have been advances, loans, consulting fees, employment income earned by Mr. Trower, returns of capital on shares, dividends, reimbursement of expenses, repayment of advances from shareholders, etc. Accordingly, to determine whether any or all of these payments were dividends requires an examination of other evidence.

The taxpayer testified that, although she had agreed to income-splitting with her former spouse for years prior to 2016, she had consistently advised him that she was not interested in income-splitting for 2016. Also, even though she had agreed to income-split in prior years, effected through a dividend payment to her by Cove, she did so without understanding the tax consequences.

Interestingly, the taxpayer's former spouse did not dispute that the taxpayer had told him a number of times that she did not want any dividends. However, Mr. Trower was of the opinion that the taxpayer should have understood that income splitting would have to occur in 2016 since she had agreed to the pattern of receiving the dividends in prior periods. Mr. Trower stated that, as they were both shareholders, they both should receive dividends and that, because the taxpayer had full access to the funds in the joint bank account, funds deposited by Cove to the joint bank account should be treated as dividends paid to her.

The Tax Court noted that funds deposited to the joint account does not mean that they are income to the taxpayer or Mr. Trower. While it is true that both joint holders may have access to the funds, that does not determine the character of the funds deposited to the account. To determine character of the funds, the tax analysis flows from the commercial relationships of the parties. Under corporate law, no dividend is payable until such time as it is declared. In this case the dividend was not declared (or approved) until February 2017 and thus no dividend was payable in 2016.

The taxpayer was a director of Cove from January 1, 2016 until October 2, 2016, a period during which she consistently was objecting to dividend payments. In the Court's view, payments made when she was one of two directors would have required her acquiescence to be authorized and declared as dividends. So no amount paid by Cove in 2016 before October 2, 2016 could be a dividend. The taxpayer ceased to be a shareholder on September 30, 2016 and thus could not have received any dividends Mr. Trower himself might have approved after that date.

The Tax Court found that all of the evidence leads to the conclusion that the two persons who were required to authorize dividends on behalf of the corporation — Mr. Trower and the taxpayer — never agreed that the transfers would be dividends. The decision was a unilateral one by Mr. Trower, as he admitted in his testimony that the resolution approving the dividend payments was prepared and signed in 2017, at the time he was the sole director and shareholder of Cove. The Tax Court found that neither the character nor the allocation of the funds as between the taxpayer and Mr. Trower of the funds transferred by Cove in 2016 to the various bank accounts was determined before the taxpayer ceased to be a director and shareholder.

Ultimately, the Tax Court found that at no time prior to October 2, 2016, had the relevant transfers been approved as dividends. Absent the taxpayer's agreement, the Tax Court found the payments could not be and are not dividends paid to the taxpayer in 2016. The Tax Court was convinced that the taxpayer had demolished the Minister's key assumption of fact underlying the assessment of her 2016 taxation year regarding dividends.

The *Trower* case illustrates that, even for a closely-held private corporation, it is always advisable to have contemporaneous record-keeping because misunderstandings can often occur and personal relationships between owner-managers can become strained.

— Dean M. Xiao

Court Dismisses Motion by Third Parties To Gain Access to Taxpayer's Discovery Evidence

***Silver Wheaton Corp. v. The Queen*, 2019 DTC 1131 (Tax Court of Canada)**

This is a decision on a motion brought before the Tax Court of Canada by applicants who are not parties to a tax appeal of Silver Wheaton for an order declaring the rule of implied undertaking of confidentiality does not apply to the discovery evidence of Silver Wheaton provided in its appeal or, in the alternative, an order waiving the implied undertaking of confidentiality in respect of the discovery evidence.

As discussed below, the Tax Court held that the implied undertaking rule applied to Silver Wheaton's discovery and refused to waive the rule, finding that the applicants had failed to demonstrate a pressing public interest in the disclosure of the relevant materials that would outweigh the public interest in safeguarding the confidentiality of civil litigants in order to promote the efficient administration of civil justice. The Tax Court's decision on the motion is being appealed by both the applicants and the Crown.

The underlying tax appeal in this case related to notices of reassessment issued by the Minister in 2015 in respect of Silver Wheaton's 2005 to 2010 taxation years. The Minister took the position that subsection 247(2) of the *Income Tax Act* (Canada), dealing with transfer pricing, applied to increase Silver Wheaton's income from certain precious metal streaming contracts that it had entered into with its Cayman subsidiaries. The reassessments would have increased the company's tax liability for the period by approximately $353 million (including interest and penalties).

In the course of the appeal, the parties conducted discoveries, resulting in the disclosure of approximately 32,000 documents and over 23 days of examinations for discovery of Silver Wheaton's two nominees. In late 2018, Silver Wheaton and the Crown entered into a settlement agreement, which apparently resulted in no additional cash taxes being payable by Silver Wheaton (after applying its accumulated non-capital losses). With the exception of the Notice of Appeal, Reply to the Notice of Appeal, and Answer, all documents filed with the Tax Court in the appeal were subject to a sealing order that was initially set to expire on September 30, 2019, but had been extended until after the Federal Court of Appeal had rendered its decision in the appeal of the applicants' motion.

Soon after Silver Wheaton disclosed the reassessments to its shareholders, a U.S. federal securities class action was commenced against it for putative losses suffered by shareholders as a result of a drop in Silver Wheaton's share price. The applicants, as representative plaintiffs in the class action, claimed that these losses were caused by Silver Wheaton's failure to disclose in a timely manner the likelihood that the CRA would reassess Silver Wheaton's tax liability under subsection 247(2) in respect of its precious metals streaming income during the relevant period. The applicants brought a motion before the U.S. District Court seeking production of (among other things) the discovery evidence of the company in the tax appeal. The U.S. District Court found, based on expert testimony from Justice Bastarache, that the Canadian doctrine of implied undertaking of confidentiality appeared to apply to Silver Wheaton's discovery and that since the implied undertaking was made by the parties to the Tax Court and not to each other, only the Tax Court had the jurisdiction to determine whether the discovery was subject to an implied undertaking and, if so, whether the undertaking should be waived.

Before the Tax Court, the applicants argued that the implied undertaking rule did not apply to Silver Wheaton's discovery, on the basis that the rule is intended only to prevent the disclosure by a party of information obtained in discovery from the other party, and that since the applicants were seeking information contained in Silver Wheaton's own discovery, the implied undertaking of confidentiality could not shield such evidence. In the alternative, the applicants sought an order from the Tax Court waiving the implied undertaking. Interestingly, despite its statement of disinterest in the motion, the Crown filed a detailed brief with the Tax Court in which it advanced the applicants' position that the implied undertaking rule should not apply to a litigant's own discovery evidence and "strongly argued" that the applicants' motion should be granted.

The Tax Court began its analysis of the issues by noting that the implied undertaking of confidentiality is a duty of the parties to litigation not to use the discovery documents, transcripts of oral discovery, or answers to discovery questions for any purpose other than securing civil justice in the proceeding in which the answers were compelled, and that this duty is owed by the parties to the court in which the discovery occurs. Accordingly, the Tax Court held that only it could waive the implied undertaking with respect to Silver Wheaton's discovery in the tax appeal and that, by virtue of the Court's inherent jurisdiction to control its own processes, it had the jurisdiction to grant the relief sought by the applicants.

The Tax Court also held that, contrary to the applicants' and the Crown's submissions, the implied undertaking rule extends to a party's own discovery, reasoning that the implied undertaking rule is a rule of confidentiality that is intended to facilitate full disclosure during discovery and that this purpose would be undermined (if not entirely thwarted) if the rule were to be applied narrowly, as suggested by the applicants and the Crown.

Finally, the Tax Court held that the implied undertaking in respect of Silver Wheaton's discovery evidence should not be waived. The Court noted that, in order to protect the integrity of the rule, the implied undertaking should be varied or waived only in exceptional circumstances, and that the public interest raised by the person seeking a variance or waiver must be weighed against the public interest in protecting a litigant's privacy and promoting an efficient civil justice process. The Court found that the applicants had failed to establish a competing public interest that would justify a waiver of the implied undertaking, taking the view that the applicants' motion was little more than a "fishing expedition" brought in the hope of finding something in Silver Wheaton's discovery evidence that would assist in the applicants' U.S. class action. The Tax Court accordingly dismissed the applicants' motion and awarded costs, 70% of which were to be paid by the applicants and 30% of which were to be paid by the Crown.

— *Kabir Jamal*

Court Grants Discharge in Respect of Tax Debt, Conditional on Payment of 1% of Principal

***The Bankruptcy of Scott Charles Morrison*, 2019 DTC 5093 (Manitoba Queen's Bench)**

This case involves the bankruptcy of Scott Morrison, and his request to be discharged from bankruptcy. Mr. Morrison owed more than $5 million, almost all of which was in respect of taxes, interest, and penalties. The CRA opposed the requested discharge, maintaining that any discharge should be conditional upon Mr. Morrison paying at least 50% of the principal owed, that is, about $1.3 million, in addition to Mr. Morrison satisfying other conditions.

This case illustrates the tension between the rehabilitative goals of Canada's bankruptcy system and the need for residents of Canada to pay their income taxes. The Court quoted Registrar Thompson in *Newson* (2014 DTC 5064) in observing that taxes are the cost of civil society. The Court noted that a bankrupt who does not pay his or her taxes does not necessarily fit into the category of the "honest but unfortunate debtors the bankruptcy system was designed to protect." Importantly, the Court noted that the bankruptcy system should not be used as a mechanism to "shed" tax debt. Mr. Morrison, however, did seem to fit into the category of an honest, but unfortunate, debtor.

Mr. Morrison had assigned himself into bankruptcy in 2016 because he was unable to satisfy his tax debt, arising from reassessments for 2007 to 2013. Mr. Morrison had originally filed notices of objection to the reassessments, claiming that certain deposits into his bank accounts were not income, but rather were loans from his father for businesses they operated together. Mr. Morrison maintained that his father had access to his bank accounts and made the deposits, and subsequent withdrawals. Mr. Morrison was partially successful in his objection for 2007; the amount owing for 2017 was reduced by $27,000. However, once Mr. Morrison assigned himself into bankruptcy, the trustee in bankruptcy took control of his assets and withdrew the objections that had not yet been dealt with: tax years 2008 to 2013.

In accordance with the provisions of subsection 152(8) of the *Income Tax Act* and as confirmed in *Baran* (2013 ONSC 7501 (Ont SCJ)), the Court considered Mr. Morrison's request for a discharge on the basis that CRA's reassessments were valid and binding because Mr. Morrison's objections were withdrawn. The Court conducted its analysis of the discharge application following the factors laid out in section 172.1(4) of the *Bankruptcy and Insolvency Act*.

The first factor considered by the Court was Mr. Morrison's circumstances at the time the tax debt was incurred. Mr. Morrison had not been living a lavish lifestyle, nor was he acquiring numerous properties or vehicles reflecting the income alleged by the Minister. Rather, Mr. Morrison was earning employment income of approximately $50,000.00 and operating businesses with his father. Mr. Morrison claimed the deposits into his bank account, on which the reassessments were based, were loans from his father for their businesses rather than income. This factor favoured the discharge application.

The second factor the Court considered was Mr. Morrison's efforts to pay the tax debt. Mr. Morrison's 2007 notice of objection was dealt with, and the reassessment reduced by approximately $27,000. Although Mr. Morrison made no voluntary payments, the Minister garnished about $46,000 of his wages. Mr. Morrison attempted to live with the garnishment of his wages, but could not make ends meet and eventually made the assignment in bankruptcy. The notices of objection for the 2008 to 2013 tax years were withdrawn by the trustee in bankruptcy. Mr. Morrison had therefore not been indifferent to his tax obligations.

The third factor considered by the Court was whether Mr. Morrison had made payments to other creditors while failing to make payments on his tax debt. In this regard, Mr. Morrison's struggles with his debt had pushed him into divorce and, as part of the divorce settlement, Mr. Morrison relinquished his half interest in the marital home, valued at approximately $80,000.00. This factor may not have favoured granting the discharge, but there was no evidence of other preferential treatment of creditors.

The fourth factor the Court considered was Mr. Morrison's financial prospects. The Court found that his prospects were "modest, at best." Mr. Morrison was 41 years old, earned roughly $50,000.00 per year, had shared custody of his children, and, although he paid no child support to his ex-wife, he paid $450 in child support in respect of a previous relationship. Mr. Morrison resided with his parents and paid $430 per month in rent. He essentially had no assets and owed his family lawyer about $2,500 for his divorce proceedings. This factor favoured granting the discharge.

Finally, the Court considered both the rehabilitative goals of the bankruptcy system and the objective of imposing sufficiently burdensome conditions to reflect the seriousness of the matter. The Court took into account the outcome in *Baran*, which had somewhat similar circumstances, and granted Mr. Morrison a discharge conditional on paying $26,000.00, or 1% of the principal amount owed, at a minimum rate of $5,200.00 per year. The Court imposed a three-year suspension of the discharge, required monthly income and expense statements to be filed with the trustee, and ordered Mr. Morrison to comply with future tax obligations. These conditions were much move favourable to Mr. Morrison than the conditions sought by the Minister.

The Court noted that although tax-driven bankruptcies require more scrutiny from the Courts, the more onerous conditions of discharge should be reserved for bankrupts who are indifferent to their tax obligations. Unlike some tax-driven bankrupts, Mr. Morrison was not indifferent — in fact, he had objected to the 2007 reassessment, achieving some relief, but because he had to assign himself into bankruptcy as a result of the Minister garnishing his wages, the trustee took control of Mr. Morrison's assets and liabilities, and withdrew his notices of objection. Thus, Mr. Morrison lost his right to object to the reassessments and, therefore, was stuck with the binding and presumptively valid reassessments. In these circumstances, the Court was of the view that it would be unfair to burden Mr. Morrison with a $1.3 million payment requirement. Not only would Mr. Morrison be unlikely to be able to pay the amount in his lifetime, such a condition would deprive him of the fresh start promised by the bankruptcy regime.

— *Emily Leduc Gagne, Articling Student*

Court Rejects CRA's Assessments Deeming Corporations To Be Associated

***Prairielane Holdings Ltd. v. The Queen*, 2019 DTC 1118 (Tax Court of Canada)**

In this case, the taxpayers defeated the Minister's position that one of the main reasons that their corporate structure was implemented was to access the small business deduction ("SBD"). The Minister had reassessed the taxpayers as associated pursuant to the anti-avoidance provisions in subsection 256(2.1) of the *Income Tax Act*, which had the effect of denying the SBD to each of the taxpayers. However, as discussed below, the Minister was not successful based upon the Tax Court's findings of fact.

The taxpayers, Prairielane Holdings Ltd. ("PHL") and Streifel Consulting Ltd. ("SCL"), were partial owners of Moody's Equipment Ltd. ("MEL"), a farm implement and construction equipment dealer. In 2009, MEL's business underwent a restructuring. Prior to the restructuring, MEL had a number of business issues that it needed to address: it was acquiring three dealerships; the partnership needed cash to acquire these dealerships; a new partner, Belsher Equipment Ltd., was acquiring a 5% interest in MEL; some partners were planning to retire; and other partners were looking to increase their ownership interests.

To deal with these issues, Mr. Mathison, the majority owner of MEL through his PHL shares, and sole director and officer of PHL, sought the advice of MEL's accountant, who in turn sought the advice of an experienced tax lawyer. (Interestingly, as discussed below, the fact that Mr. Mathison and PHL were driving the tax planning becomes relevant when analyzing the liability of the other taxpayer, SCL.)

In the reorganization, several companies were incorporated and formed a partnership, Moody's Equipment, which in turn owned MEL. Generally, each of the corporate partners was in turn wholly-owned by a parent corporation and each parent corporation was itself wholly-owned by one of the individuals involved in the business. The Court referred to this structure as a "stacked corporation" structure.

Two results of the reorganization were that: (1) the corporations were able to achieve a tax deferral of up to 25 months; and (2) PHL and SCL were each able to claim an SBD in 2011 (and, for SCL, in at least 2012 as well) notwithstanding that neither of them had been able to claim the SBD prior to the reorganization.

The CRA believed that PHL's and SCL's main reason (or one of their main reasons) for creating the stacked corporation structure was to allow the taxpayers to claim the SBD. CRA assessed the taxpayers pursuant to subsection 256(2.1), which deemed the taxpayers to be associated with the seven other corporations in the structure. Once associated, the corporations became large business corporations. Thus, the SBDs that the taxpayers claimed were eliminated by reason of subsection 256(2.1). The provision reads as follows:

> For the purposes of this Act, where, in the case of two or more corporations, it may reasonably be considered that one of the main reasons for the separate existence of those corporations in a taxation year is to reduce the amount of taxes that would otherwise be payable under this Act [. . .], the two or more corporations shall be deemed to be associated with each other in the year [. . .]. [emphasis added]

As noted by the Court, the test under subsection 256(2.1) is an objective one. The Court indicated that an important question to answer, although not determinative, is "If there had been no tax advantage, would the plan have been adopted in any event?" The Court noted also that the onus was on the taxpayers to prove that reducing taxes was not one of the main reasons for the corporations' separate existence.

PHL called the tax lawyer, a Mr. Gaucher, as a witness (waiving any claim of privilege). At the outset of his retainer, Mr. Gaucher had been made aware that MEL's partners did not have access to the SBD. He further testified that while tax reduction was a consideration, access to the SBD was not one of the main reasons for the separate existence of the newly created corporations. Mr. Gaucher believed that the taxable capital attributed to PHL under subsection 181.2(3) — the provision that contains the formula for determining taxable capital attributed to a corporation that is a member of a partnership — would exceed $15 million, such that PHL would not qualify for the SBD.

In developing the plan that was implemented, Mr. Gaucher explored various alternatives concerning PLH's potential taxable capital, such as having PLH give up a portion of its interest in the partnership, to determine whether PLH could have access to the SBD as part of the reorganization. In each alternative considered by Mr. Gaucher, PLH had over $15 million in taxable paid-up capital, such that it would not have access to the SBD.

The fact that PLH was able to claim the SBD in 2011 was said by Mr. Gaucher to be "a result of an anomaly in the Act". As taxable capital is allocated to corporate partners based upon the prior year's allocation of income, the allocation of taxable capital arises only to the extent that income has been allocated to the partners in the prior year. Due to this one-year look-back and the creation of a new partnership, no partner had had any income allocated to it in 2011.

Mr. Gaucher testified that he was not aware of this look-back rule at the time that the tax plan was developed. He said PLH's use of the SBD was "dumb luck". The Court accepted Mr. Gaucher's testimony. The Court also reasoned that the costs of creating and maintaining the new entities far exceeded the benefits of the SBD obtained by PHL in 2011, such that PHL's access to the SBD would not have been one of the main reasons for creation of the new corporate structure.

While the new structure was being considered, the tax advisors acting for SCL knew that SCL would gain access to the SBD under the new structure. However, it was PHL that was the dominant partner driving the tax planning. Further, the Court reasoned that it was the taxpayers, not the tax advisors, whose intention must be determined. Mr. Streifel, as operating mind of SCL, testified that he had limited knowledge of the tax benefits of the structure.

Another minor-ownership partner, Mr. Belsher, the incoming partner and an accountant, testified that the main reason for the new structure was to allow new employees to quickly become owners of the enterprise. While Mr. Belsher knew of the availability of the SBD, he never discussed it with the tax advisors, nor did he receive information from them regarding it.

The Court also criticized the Minister's method of seeking to impugn the credibility of Mr. Steifel. Mr. Streifel gave evidence-in-chief, but the Minister, instead of cross-examining Mr. Streifel, chose to read in evidence that Mr. Streifel had given in an examination for discovery, and attempted to take issue with that evidence in closing submissions. The Court was puzzled by this approach, rather than the Minister simply cross-examining Mr. Streifel. However, the Court indicated that it needed more evidence than Mr. Steifel's testimony alone to find in favour of SCL. In this regard, the Court quoted the following passage from *Covertite* (81 DTC 5353):

> the mere denial of the taxpayer, whether or not accompanied by a simple indication of the other causes that could have prevailed, can be given no weight. Being a mere assertion of a negative fact, and a fact which has to do with the state of mind of the witness, it can have no convincing probative force; it cannot constitute the proof required to annihilate the conclusion of the Minister. To succeed, the taxpayer must: (a) disprove the facts assumed by the Minister in reaching his conclusion; or (b) convince the Court that the inferences drawn by the Minister from the facts assumed were unreasonable and unwarranted; or (c) add further facts capable of changing the whole picture and leading to different inferences pointing to the conclusion that the other reasons alleged have actually been prevalent.

The Court then considered the evidence as a whole — the testimony of and documents entered by trial witnesses, being the partners, their accountant, and Mr. Gaucher — and determined that Mr. Streifel was neither aware of, nor motivated by, the potential access to the SBD.

Ultimately, the court accepted that the main reasons for creating the new entities, including PLH and SCL, were only: (i) to obtain tax deferrals of up to 25 months; (ii) to be more flexible in moving partners in and out of the structure; and (iii) to deal with concerns of the other partners regarding the retirement of one of the partners.

— *Hilary Smith*

RECENT CASES

Appeal from Minister's denial of SR&ED tax credits dismissed

The corporate taxpayer, which carried on the business of custom manufacturing, was asked to create a specific product using a new material. Despite encountering technical difficulties relating both to the project specifications and the nature of the materials used, the taxpayer was eventually able to design and manufacture the requested product. It then claimed scientific research and experimental development ("SR&ED") tax credits related to that design and manufacturing process, but its claim was denied. The taxpayer appealed from that denial to the Tax Court of Canada.

The appeal was dismissed. The Tax Court of Canada reviewed the criteria set out in the jurisprudence with respect to claims for SR&ED tax credits and held that the project undertaken by the taxpayer did not meet such criteria. In the Court's view, while the appellant taxpayer was faced with several technical difficulties related to design and construction, the resolution of those issues involved the application of standard procedures or routine engineering. The Court held that the appellant taxpayer did not resolve or attempt to resolve any technological uncertainty, as the issues identified and addressed were routine technical issues associated with the design and construction of an existing product using different materials. As well, such technical issues were resolved on a trial and error basis, and the appellant had not established that the procedures adopted for the project utilized established and objective principles of the scientific method, characterized by trained and systematic observation, measurement, and experiment, and the formulation, testing, and modification of hypotheses. Finally, there was, in the Court's view, a complete absence of the necessary documentation.

Kam-Press v. The Queen

2019 DTC 1154

Motion by Crown to consolidate separate appeals brought by two related corporate taxpayers granted

Two related corporate taxpayers each appealed from their tax assessments, with one such appeal brought under the Tax Court of Canada informal procedure and the other under the Court's general procedure. The respondent Crown brought a motion seeking to have the two appeals heard at the same time and on common evidence.

The Crown's motion was granted. The Tax Court noted that the consolidation of the two appeals would mean that the appeal brought under the informal procedure would be conducted under the Court's general procedure, and that the issue for determination was whether the Court had jurisdiction to make such order. It held that the Tax Court was a superior court of record created by statute and that it possessed all powers reasonably necessary to accomplish its mandate. Such powers included the implied jurisdiction to manage and control the proceedings conducted before it, which necessarily provided the Court with flexibility regarding how and to what extent the statutory rules on pleadings, practice, and procedure were to be applied to a particular circumstance. The Court concluded that it had the implied jurisdiction to order that an appeal under the informal procedure and an appeal under the general procedure be consolidated where, as in this case, the appeals had in common a question of law or fact or mixed law and fact arising out of one and the same transaction or occurrence or series of transactions or occurrences. Such order was, in the Court's view, entirely consistent with the Court's implied jurisdiction to manage and control the proceedings conducted before it. The Crown's motion to consolidate the two appeals was granted.

407 International Inc. v. The Queen

2019 DTC 1153

Appeal from rectification order issued by chambers judge dismissed

The directors of a private corporation, acting in reliance on the advice of a professional tax adviser, declared and paid out a dividend. The intention was that such dividend would be paid out entirely from the company's capital dividend account ("CDA") and would therefore be received by the recipient shareholders on a tax-free basis. Owing to an incorrect calculation, the amount in the company's CDA was less than the amount of the dividend declared, and the Canada Revenue Agency assessed a penalty equal to 60% of the amount overpaid. The company applied to the Supreme Court of British Columbia for an order rectifying the resolution to correct the dividend amount so as to bring it within the balance of the company's CDA. Such order was granted and the Crown appealed from that order to the British Columbia Court of Appeal. On appeal, the Crown argued that, as held in Supreme Court of Canada jurisprudence, the remedy of rectification was precluded where the goal was to obtain a favourable tax result and, in addition, that there were alternative remedies available to the taxpayer.

The appeal was dismissed. The appellate Court held that the chambers judge had correctly determined that the directors' agreement to pay the entire dividend out of the company's CDA was clear and definite throughout, with the only flaw being the incorrect figure supplied by the company's tax adviser. In the appellate Court's view, such error was akin to a typographical error, for which the remedy of rectification was typically granted, and that the result of rectification would be to accomplish the original intention properly. The Court of Appeal concluded that the facts as found by the chambers judge clearly came within the Supreme Court of Canada's formulation of circumstances in which rectification was appropriate and that there was no basis for appellate interference with the conclusions reached by the chambers judge. As well, the appellate Court held that it found no error in the conclusion of the chambers judge that the risks, delays, and expenses of alternative remedies put forward by the Crown were clearly outweighed by the factors favouring rectification. The appeal from the order allowing rectification was therefore dismissed.

5551928 Manitoba v. Canada (AG)

2019 DTC 5124

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