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Current Items of Interest 5

Focus on Current Cases 7

Recent Cases 20

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TRAPS FOR THE UNWARY IN US TREATIES

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This article highlights a few traps for the unwary for companies in common Limitation on Benefits provisions in a US bilateral income tax treaty. It also briefly describes situations in which discretionary competent authority relief might be available.

I. General Background

As background, the United States, like other countries, maintains an extensive network of bilateral income tax treaties. The US network includes comprehensive income tax treaties covering dozens of countries, including the vast majority of key US trading partners. Income tax treaties remove barriers to cross-border investment and trade by allocating taxing jurisdiction between countries with residence-and source-based claims to tax the income from this investment and trade. Income tax treaties also provide a framework for the exchange of information between taxing authorities in an effort to prevent tax avoidance and evasion. Income tax treaties operate by modifying the operation of internal law (e.g., reducing a statutory 30 per cent US withholding tax rate to 5 per cent in a particular case). Treaties generally cannot *increase* a taxpayer's tax liability relative to the liability under internal law. At the same time, under the "saving clause" found in all US treaties, treaties generally cannot be used by a taxpayer to reduce tax liability in the taxpayer's *own residence country*, subject to several important exceptions (e.g., for foreign tax credits and correlative transfer pricing adjustments). Under the saving clause, each country's right to tax its own residents is generally reserved under its own internal law.

The US model income tax treaty typically provides the substantive framework used by the US Treasury Department in negotiations for US bilateral income tax treaties (compared to the Organisation for Economic Co-operation and Development ("OECD") model treaty used by OECD countries). The US model income tax treaty is intended to facilitate negotiations and not to provide a text that the United States would propose that the treaty partner accept without variation.[1] Each bilateral relationship has its own special issues. The US model income tax treaty (referred to as the "1996 US Model") was updated in 2006 (referred to as the "2006 US Model") and 2016.

[1] *See also* United States Model Income Tax Convention of September 20, 1996 Technical Explanation ("Technical Explanation to the 1996 US Model"), at page 2.

II. Background on the Limitation on Benefits Article

All recent income tax treaties to which the US is a treaty party (a "US treaty", or a "non-US treaty" for those income tax treaties to which the US is *not* a treaty party) contain comprehensive Limitation on Benefits ("LoB") provisions. The LoB article, typically Article 22 or thereabouts, contains anti-treaty-shopping provisions that are intended to prevent residents of third countries from benefiting from what is intended to be a reciprocal agreement between two countries.[2] In general, unlike the LoB provisions in many non-US treaties, the LoB provision in US treaties does not rely on a determination of purpose or intention but instead sets forth a series of objective tests.[3] A resident of a Contracting State that satisfies one of the tests will receive benefits regardless of its motivations in choosing its particular business structure.[4] Non-US treaties generally do not include the elaborate anti-treaty shopping provisions found in US treaties.

Under LoB articles, it is not sufficient for a taxpayer to establish that it is resident in a treaty country. Rather, having established resident status of the treaty country, the taxpayer must be a "qualified" person by satisfying the terms of at least one prong of the LoB article. Qualified persons under a typical LoB article include an individual, a governmental entity, a company that satisfies the public company test (or subsidiary of public company test), a tax-exempt organization (charity or pension), or an entity satisfying the "ownership and base erosion" test. Treaty benefits could also be available with respect to particular items of income under a typical LoB article under the active trade or business test, derivative benefits test, and competent authority discretion.

This article discusses a few traps for the unwary in US LoB provisions common for companies. It also provides some background on the competent authority relief provision present in many US LoB articles.

A. Qualifying Public Company Test

Under paragraph 2(c)(i) of the LoB article of the 1996 US Model, in order for a company to satisfy the public trading test, all the shares in the class or classes of shares representing more than 50 per cent of the voting power and value of the company must be "regularly traded" on a "recognized stock exchange".[5] A recognized stock exchange of a US treaty typically includes the New York Stock Exchange, the NASDAQ system, and stock exchanges of the country or zone of residence.

If a company has only one class of shares, it is only necessary to consider whether the shares of that class are regularly traded on a recognized stock exchange.[6] If the company has more than one class of shares, it is necessary as an initial matter to determine whether one of the classes accounts for more than half of the voting power and value of the company.[7] If so, then only those shares are considered for purposes of the regular trading requirement.[8] If no single class of shares accounts for more than half of the company's voting power and value, it is necessary to identify a group of two or more classes of the company's shares that account for more than half of the company's voting power and value, and then to determine whether each class of shares in this group satisfies the regular trading requirement.[9] Although in a particular case involving a company with several classes of shares it is conceivable that more than one group of classes could be identified that account for more than 50 per cent of the shares, it is only necessary for one

[2] United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006 (the "Technical Explanation to the 2006 US Model"), at page 63. See also Technical Explanation to the 1996 US Model.

[3] *Id*.

[4] *Id*.

[5] The test has been tightened in recent treaties to require greater nexus to the residence country. For example, some recent treaties require primary trading in the country or zone of residence (as opposed to trading in the source country), or management and control in the residence country. *See e.g.*, US–France treaty.

[6] Technical Explanation to the 1996 US Model, at page 65.

[7] *Id*.

[8] *Id*.

[9] *Id*.

such group to satisfy the requirements of this subparagraph in order for the company to be entitled to benefits.[10] Benefits would not be denied to the company even if a second, non-qualifying group of shares with more than half of the company's voting power and value could be identified.[11]

The term "regularly traded" is not defined in the 2006 US Model. In accordance with paragraph 2 of Article 3 (General Definitions), this term will be defined by reference to the domestic tax laws of the country from which treaty benefits are sought (i.e., the source country).[12] In the case of the United States, this term is understood to have the meaning it has under Reg. § 1.884-5(d)(4)(i)(B), relating to the branch tax provisions of the US Internal Revenue Code.[13] Under these regulations, a class of shares is considered to be "regularly traded" if two requirements are met: trades in the class of shares are made in more than *de minimis* quantities on at least 60 days during the taxable year, and the aggregate number of shares in the class traded during the year is at least 10 per cent of the average number of shares outstanding during the year.[14] Reg. §§ 1.884-5(d)(4)(i)(A), (ii), and (iii) will not be taken into account for the purposes of defining the term "regularly traded" under the treaty.[15]

A trap for the unwary exists for those who assume that, by reason of a treaty-resident company being publicly traded, that company qualifies for treaty benefits. As described above, it is not sufficient for a taxpayer to establish that it has shares that are traded on a recognized stock exchange. Rather, the principal class or classes of shares must be regularly traded on a recognized stock exchange. For example, ownership of a class of high-vote shares that are not publicly traded could prevent satisfaction of the public trading test. This could arise, for example, where a class of high-vote shares are held by original founders or family members. European public companies, for example, often have multiple classes of shares with varying voting rights.

B. Subsidiary of Public Company Test

Under the 1996 US Model, to satisfy the subsidiary of public company test, at least 50 per cent of each class of shares in the company seeking treaty benefits must be owned directly or indirectly by the qualifying public company described above, provided that in the case of indirect ownership, each intermediate owner must be a person entitled to comprehensive treaty benefits (as compared to treaty benefits on an item-by-item basis, such as under the active trade or business test or derivative benefits test).

A trap for the unwary exists for those who assume that, by reason of being an indirect subsidiary of a qualifying public company, the subsidiary of the public company test would be met. As described above, each intermediate owner must be a person entitled to comprehensive treaty benefits. Thus, if the relevant treaty has such a requirement and the intermediate entity is not a same-country resident (or is a same-country resident but qualifies for treaty benefits solely under the active trade or business test or the derivative benefits test), the subsidiary of the public company test would not be met. Similarly, if a non-resident owns more than 50 per cent of a class of shares (even if the class of shares itself does not have significant vote or value), the subsidiary of the public company test might not be met under such circumstances. Tracing through the chain of ownership could be necessary, for example, if the company seeking treaty benefits is an indirect subsidiary of a qualifying public company or part of a joint venture with a mix of owners.[16]

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[10] *Id*. at page 66.

[11] *Id*.

[12] *Id*.

[13] *Id*.

[14] *Id*.

[15] *Id*.

[16] Another potentially available path to treaty benefits is the ownership and base erosion test. In the 1996 US Model, the ownership prong of this test similarly requires that if the person seeking treaty benefits is *indirectly* owned by "good" qualifying owners, each owner in the chain of ownership must be entitled to comprehensive treaty benefits.

III. Miscellaneous Traps

A. Active Trade or Business Test

Under paragraph 3 of the LoB article of the 1996 US Model, to satisfy the active trade or business test, three requirements must be met: (1) the resident must be engaged in the active conduct of a trade or business in the resident's country, (2) the income must be connected with or incidental to the trade or business, and (3) the trade or business must be substantial in relation to the activity in the other country generating the income. Under Article 3(2), undefined terms have the meaning under the law of the source state, unless the context requires otherwise or the competent authorities agree to a common meaning. The Technical Explanation to the 1996 US Model states:

> Accordingly, the United States competent authority will refer to the regulations issued under Code Sec. 367(a) for the definition of the term "trade or business." Reg. § 1.367(a)-2(d)(2) states that the "group of [trade or business] activities must ordinarily include the collection of income and the payment of expenses.

Interestingly, the spin-off rules contain nearly identical language that a trade or business must ordinarily include the collection of income,[17] and this requirement has been relaxed recently for purposes of Code Sec. 355[18] but potentially not in the context of Code Sec. 367(a) and thus potentially not for purposes of satisfying the active trade or business test of an LoB article.

B. Fiscally Transparent Entities

Different treaties reflect different approaches to entities that are fiscally transparent under US or foreign law, and some treaties do not explicitly address fiscally transparent entities. The application of treaties to fiscally transparent entities presents many complex, treaty-specific issues. The particular language of the relevant treaty with respect to fiscally transparent entities should be parsed with care.

C. State Taxation

Bilateral income tax treaties generally do not apply to US states but a state could voluntarily follow treaty provisions. Thus, a taxpayer should take into account state income tax considerations in analyzing a structure, even if a treaty applies to exempt US federal income tax.

IV. Competent Authority Relief

Where a taxpayer does not objectively satisfy an LoB article, a taxpayer may wonder whether treaty benefits could be available *via* competent authority relief. US treaties generally provide that a resident of a treaty country not otherwise entitled to benefits may be granted benefits of the treaty if the competent authority of the source country so determines. Thus, with respect to taxes on US source income, such as US withholding tax, a resident of a treaty country not otherwise entitled to benefits under an LoB may be granted benefits if the US competent authority so determines.

As a practical matter, the US competent authority provides discretionary relief in only very limited circumstances and the time required to go through the competent authority process may be prohibitive in many circumstances. The US competent authority will not issue a determination regarding whether an applicant satisfies an objective LOB test.[19] In

[17] Reg. § 1.355-3(b)(2)(ii) ("A corporation shall be treated as engaged in a trade or business immediately after the distribution if a specific group of activities are being carried on by the corporation for the purpose of earning income or profit, and the activities included in such group include every operation that forms a part of, or a step in, the process of earning income or profit. Such group of [trade or business] activities *ordinarily must include the collection of income* and the payment of expenses."). Emphasis added. *See also* Rev. Rul. 82-219, 1982-2 CB 82.

[18] *See e.g.*, LTR 202009002 (Sep. 4, 2019). In the LTR, Distributing conducts research and development (R&D) to identify and create new products. The Office of Associate Chief Counsel (Corporate) ruled: "The absence of income collection does not prevent Distributing's Business 2 from constituting a 'trade or business' within the meaning of Reg. § 1.355-3(b)(2)(ii) for purposes of determining whether the Distribution satisfies the active trade or business requirement of Code Sec. 355."

[19] Rev. Proc. 2015-40, IRB 2015-35, 236. Procedures for requesting and obtaining assistance from the US competent authority under US tax treaties is on the Treasury Department's priority guidance plan, available at www.irs.gov/pub/irs-utl/2021-2022-pgp-3rd-quarter-update.pdf.

(continued on next page)

determining whether to provide discretionary benefits, the US competent authority requires that the applicant represent that, and explain why, it does not qualify for the requested benefits under the relevant LoB provisions.[20] The US competent authority in its sole discretion may grant benefits under the discretionary provision of an LoB article in an applicable US tax treaty.[21] A decision by the US competent authority not to grant discretionary benefits is final and not subject to administrative review.[22]

To qualify for discretionary competent authority relief, the applicant must demonstrate that it has substantial non-tax nexus to the treaty country, and that, if benefits are granted, neither the applicant nor its direct or indirect owners will use the treaty in a manner inconsistent with its purposes. Treasury guidance contains a non-exclusive list of situations for which the US competent authority typically will not exercise its discretion to grant benefits, for example, where:

(i) The applicant or any of its affiliates is subject to a special tax regime in its country of residence with respect to the class of income for which benefits are sought (e.g., notional interest deduction with respect to equity in the residence country);

(ii) No or minimal tax would be imposed on the item of income in both the country of residence of the applicant and the country of source, taking into account both domestic law and the treaty provision ("double non-taxation"). For example, double non-taxation would occur if a payment under a hybrid instrument was exempt from withholding and generated a deduction in the country of source, while being treated as income exempt from tax in the country of residence of the applicant; or

(iii) The applicant bases its request solely on the fact that it is a direct or indirect subsidiary of a publicly traded company resident in a third country and the relevant withholding rate provided in the tax treaty between the United States and the country of residence of the applicant is not lower than the corresponding withholding rate in the tax treaty between the United States and the country of residence of the parent company or any intermediate owner.

Thus, as discussed above, discretionary treaty benefits are available in only limited circumstances. Satisfying an objective LoB provision is generally the preferred approach, if possible.

V. Conclusion

Taxpayers should be careful in parsing the relevant treaty language to determine whether it satisfies the relevant LoB requirements. If the relevant LoB requirements are not met, discretionary treaty benefits could be available in limited circumstances.

CURRENT ITEMS OF INTEREST

Ontario Budget Bill Re-Introduced

Ontario's government re-introduced *Plan to Build Act (Budget Measures), 2022* on August 9. With regards to tax measures, the bill proposes to:

- Enhance the Low-income Individuals and Families Tax ("LIFT") Credit for 2022 and subsequent years;
- Implement the new Ontario Seniors Care at Home Tax Credit;
- For the book publishing tax credit, permanently remove the requirement that a literary work be published in an edition of at least 500 copies of a bound book; and
- Extend the temporary enhancement of the Regional Opportunities Investment Tax Credit.

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The guidance plan lists projects that will be the focus of the Treasury Department's efforts in the near term. Based on informal communications with Treasury personnel, it seems the updates are part of a periodic update of the revenue procedure.

[20] *Id*.

[21] *Id*.

[22] *Id*.

General Anti-Avoidance Rule Consultation

The Department of Finance has released a consultation paper on proposals to reform the country's general anti-avoidance rule ("GAAR").

In general, the Minister can apply the GAAR to deny a "tax benefit" obtained by a taxpayer if the tax benefit results from an "avoidance transaction" and if it may reasonably be considered that the transaction results in a misuse of the provisions of the *Income Tax Act* (the "Act") or in an abuse having regard to those provisions read as a whole.

According to the paper, from the enactment of the GAAR in 1988 to March 2021, the application of the GAAR was considered at the audit stage in approximately 1,600 cases. In 80 per cent of those cases (over 1,300 times), the GAAR was ultimately applied by the CRA as a primary or alternative reassessing position. Of this number, the GAAR has been the primary assessing position in approximately 50 per cent of the cases and an alternate or secondary position in the remainder.

The consultation says:

> The CRA can assess a taxpayer using the GAAR to deny a tax benefit obtained as a result of an avoidance transaction. As with any tax dispute, the taxpayer generally has the burden of refuting the factual assumptions made by the CRA that support the assessment. However, case law has developed which has imposed on the CRA the burden of establishing that the avoidance transactions frustrate the object, spirit and purpose (misuse or abuse) of the provisions of the Act. The process of applying the GAAR and the current judicial approach are resource intensive for the government. It requires detailed analyses of the impugned transactions and a case for the application of the GAAR being presented to a committee that includes representatives of the CRA and the Departments of Justice and Finance (the GAAR Committee).

A number of major changes are proposed to be made to the GAAR. First, there is a concern that, despite its broad definition, a "tax benefit" has not been found in every appropriate case. Further, the CRA is concerned that the GAAR fails to prevent abusive tax avoidance when a tax benefit is achieved in the context of a transaction with a primarily non-tax purpose. As a result, a transaction with significant tax planning objectives may be exempt from the GAAR, even where that transaction results in abusive tax avoidance.

With a view to appropriately limiting the circumstances in which tax benefits may be achieved in cases that are not subject to the misuse or abuse analysis under the GAAR, the government has identified for consideration the following possible solutions:

- providing an interpretive rule to specify what is not a "*bona fide*" purpose;
- extending the definition of "transaction" to include a choice; and
- lowering the threshold under the purpose test.

The GAAR is not intended to deny the tax benefits that result from transactions that are carried out within the object, spirit, and purpose of the provisions of the Act. The consultation notes, however, "it can be difficult to ascertain the object, spirit and purpose of a provision of the Act, or the existence and relevance of a general scheme in the Act read as a whole, in order to determine whether abusive tax avoidance has occurred. Moreover, the courts have looked to the Crown to make persuasive submissions on the object, spirit, and purpose of provisions and where the existence of abusive tax avoidance is uncertain, the courts have given the benefit of the doubt to the taxpayer."

The Government is considering the following possible solutions to these issues:

- the inclusion of preambles and purpose statements in income tax legislation;
- greater emphasis on purpose statements in extrinsic aids;
- greater emphasis on the "abuse of the Act read as a whole" portion of the existing legislation;
- the inclusion of an interpretive rule for assessing certainty, predictability, and fairness; and

- changing the judicially established onus under the misuse or abuse exception such that the taxpayer would be required to demonstrate, in particular circumstances, that it can reasonably be concluded that the tax benefit would be consistent with the object, spirit, and purpose of the provisions relied upon by the taxpayer.

The consultation says, also, the GAAR does not sufficiently take into consideration the economic substance of transactions. The government intends to add an explicit economic substance rule to the GAAR, so that it applies "more appropriately".

Last, to deter taxpayers from entering into potentially abusive arrangements, the Government is also considering the following measures:

- introducing a penalty based on a percentage of the tax benefit;
- increasing the interest rate on taxes in dispute under a GAAR assessment; and
- extending the reassessment period for GAAR assessments.

Input is being sought on the proposals discussed in the consultation by September 30, 2022.

FOCUS ON CURRENT CASES

This is a regular monthly feature examining recent cases of special interest, coordinated by Tony Schweitzer of Dentons Canada LLP. The contributors to this feature are from Dentons Canada LLP, Montreal, Toronto, Calgary, and Vancouver.

Coopers Park Real Estate Development Corporation v. The Queen, 2022 DTC 1068 (Tax Court of Canada) — Third Party Documents Considered by CRA and Documents Considered by GAAR Committee in Assessing Unrelated Taxpayer Resulting in Subsequent Decision To Assess Taxpayer Subject to Discovery

Background

The Minister of National Revenue (the "Minister") assessed the 2007, 2008, and 2009 taxation years of the Appellant to apply the general anti-avoidance rule (the "GAAR") in section 245 of the *Income Tax Act* ("ITA") to deny loss carryforwards, investment tax credit carryforwards, and scientific research and experimental development pool deductions claimed by the Appellant for those years.

The Appellant conducted examinations for discovery of the Respondent on January 18, 19, and 20, 2021. The Respondent refused to provide answers to certain questions (the "Disputed Refusals"). Specifically, they refused to produce the third-party documents of unrelated taxpayers (the "Third Party Documents") and the documents produced during the GAAR Committee meetings during a similar case involving an unrelated taxpayer (the "GAAR Committee Documents").

The Appellant brought a motion for an order requiring the Respondent to provide answers to questions on examinations for discovery.

Issue and Decision

The issue before the Tax Court was whether the Disputed Refusals fall under subsection 105(2) of the *Tax Court of Canada Rules* (the "Rules"), allowing a party to obtain production of a document that is not otherwise required to be produced at the examination.

The Tax Court addressed the question of whether the scope of discovery in a GAAR case differs from the scope of discovery in a non-GAAR case. The principal difference with a GAAR appeal is that the Minister is required to identify

the "object, spirit or purpose of the provisions that are claimed to have been frustrated or defeated" (the "policy"), which is the Minister's interpretation of the law. Questions exploring the Respondent's legal position are permissible but questions that seek the Respondent's legal arguments are not.

The Tax Court cited *Madison Pacific Properties Inc. v. R.*, 2019 DTC 5012 (FCA) ("*Madison*"). In *Madison*, the Federal Court of Appeal reviewed the principles and upheld the Tax Court judge's approach to disclosure. The principles provide for broader disclosure in a GAAR appeal than might be appropriate in non-GAAR cases. The Tax Court concluded that unlike in non-GAAR appeals, draft documents prepared by the Minister considered by officials in the context of a taxpayer's audit should be disclosed because they "inform the Minister's mental process leading up to an assessment and reflect the Minister's understanding of the policy at issue".

Subsection 105(2) of the Rules imposes three conditions on a party's right to obtain production of a document. First, a person must admit on an examination that he or she has possession or control of or power over the document. Second, the document must relate to a matter in issue in the proceeding. Third, the document must not be privileged.

In *Superior Plus Corp. v. R.*, 2015 DTC 1124 (TCC) ("*Superior Plus*"), affirmed 2015 DTC 5118 (FCA), the Tax Court noted that the Appellant is entitled to know the case that it must meet in its appeal and "information pertaining to the policy of the Act, even where it is not taxpayer specific, can be relevant on discovery". In *Superior Plus*, the Tax Court judge found that "the motion record shows that the Refused Documents were either prepared directly in the context of the audit of the Appellant or were considered by the CRA officials who were charged with the audit or who were consulted regarding the application of the GAAR".

The Respondent stated that the Third Party Documents were not relevant because beyond reading them, there was no use of them in the audit of the Appellant and they did not inform the basis of the assessment in any manner.

Reliance is not the test for relevance. As noted in *Superior Plus*, consideration of the documents in the context of the audit of the Appellant is sufficient to make them relevant for the purposes of discovery. The Tax Court inferred from the facts that the Third Party Documents were considered by Mr. Simms because he read them and they were in the Appellant's audit file.

The GAAR Committee Documents involve a similar case with an unrelated taxpayer and in that case the GAAR Committee recommended the application of the GAAR as a principal position. Given the similarities in that case to the current case, the current case was not taken to the GAAR Committee.

The Tax Court found that the CRA relied on the GAAR Committee's analysis of the similar case in deciding to assess the Appellant under the GAAR. The approach adopted by the CRA negated the need for a GAAR Committee assessment of the Appellant's transactions. If the GAAR Committee had considered the Appellant's case, the Appellant would have been entitled to discovery of all non-privileged documents considered by the GAAR Committee in deciding to assess the Appellant under the GAAR.

The GAAR Committee Documents are relevant for the purposes of discovery because the documents considered by the GAAR Committee in making the first decision in the similar case are in effect the basis of the CRA's subsequent decision to assess the Appellant under the GAAR.

Conclusion

In summary, the Tax Court allowed the motion and ordered the Respondent to provide to the Appellant the Third Party Documents, subject to redaction of information identifying third parties, and the GAAR Committee Documents, subject to the redaction of information identifying third parties and subject to any claim of solicitor-client privilege.

The important takeaway from this case is that disclosure can be ordered for all non-privileged documents considered by the GAAR Committee in a previous decision to assess under the GAAR an unrelated taxpayer when that decision directly results in a subsequent decision to assess a taxpayer under the GAAR.

Further, third party documents involving unrelated taxpayers, even if not used in the assessment of the taxpayer, will be subject to discovery if considered by the CRA.

— *Raman Khera*

Murray Stroud v. The Queen, 2022 GTC 24 (Tax Court of Canada) — Reasonable Expectation of Profit Requires More Than Luck and Hope for ITCs Under *Excise Tax Act*

Background

Mr. Murray Stroud (the "Appellant") operated a horse farm since the 1990s where he bred and raced horses and lost money every year doing so. He claimed approximately $30,000 in investment tax credits ("ITCs") in computing his net tax for GST purposes under Part IX of the *Excise Tax Act* (the "ETA") for his 2017 taxation year. The Minister reassessed the Appellant to deny the ITCs on the basis that the Appellant did not have a reasonable expectation of profit and thus had not paid the GST in question in "the course of a commercial activity."

Issue and Decision

The issue considered by the Court was whether or not the Appellant had a reasonable expectation of profit ("REOP") in carrying out his horse breeding and racing activities. The Court looked solely to the 1978 Supreme Court of Canada case *Moldowan v. The Queen*, 77 DTC 5213 (*"Moldowan"*), in considering whether the Appellant had an REOP, and in particular the following factors enumerated in Moldowan:

> . . . whether a taxpayer has a reasonable expectation of profit is an objective determination to be made from all of the facts. The following criteria should be considered: the profit and loss experience in past years, the taxpayer's training, the taxpayer's intended course of action, the capability of the venture as capitalized to show a profit after charging capital cost allowance. The list is not intended to be exhaustive. (p. 485)

In addressing the first factor (profit and loss experience in past years), the Court looked to the Appellant's net income/losses over the previous nine years. It concluded that, notwithstanding that the Appellant had realized a profit in some of his breeding and racing activities, he had nonetheless realized a net loss in every year from his breeding and racing activities in aggregate. The Court noted that the Appellant had failed to demonstrate that any of the losses might have been due to extraordinary expenses like interest or fraud. The court further noted that the Appellant had never prepared any financial statements or profit and loss statements with a view to diagnosing and treating the underlying financial issues at the farm. On both examination and cross-examination, the Appellant could not provide details of his profits or expenses. From this, the court drew two inferences weighing against the Appellant's position that he had a reasonable expectation of profit from the farm:

(1) He was unable to objectively discern the root cause(s) of the farm's lack of profitability; and

(2) He was unable to objectively assess the effect of any efforts he made to stem the rising tide of farm losses.

Regarding the second factor (training), the Court further noted that the Appellant was trained as a lawyer with no training in business, or horse breeding and racing.

Regarding the third factor (intended course of action), when asked how he intended to make his operations profitable, the Appellant described that he had relocated his operations and entered into a new expense arrangement with the horse trainers. However, the Appellant failed to submit any evidence regarding how the new location or arrangements were anticipated to change the financial results of his operations. In testimony, the Appellant stated that he "hoped" the farm would become successful and that he "was positive he could make it work", but that "there's I guess a certain amount of luck, but there's a lot of bad luck too."

Regarding the fourth factor (capability of the venture as capitalized to show a profit), the Court noted that it was unable to draw any conclusions given the Appellant's failure to provide any detailed financial information.

Conclusion

The Court concluded that the Appellant did not have an REOP, focusing in particular on the Appellant's lack of financial data that would have been necessary for him to diagnose the cause of the losses in order to make the changes necessary to make the operation profitable.

> . . . unless he had the tools to diagnose the underlying cause or causes of his farm losses, the Appellant could not reasonably expect to stem those losses. The Appellant's expectation of profit must have been "reasonable". A mere hope or desire for profit is insufficient to meet the "reasonable expectation of profit" test.
>
> A review of the farm's financial statements, or similar records, would have been necessary for the Appellant to (a) understand why the business continued to lose money and (b) take the steps necessary to make the business profitable. It was impossible for the Appellant to diagnose and treat the problem without the appropriate financial tools. (paras 32, 33)

— *Ron Dueck*

Jeffrey C. Chan v. The Queen, 2022 DTC 1065 (Tax Court of Canada) — Registered Owner of Foreign Bank Account Not Liable for Penalties for Failure To File T1135 If Reasonable Grounds for Believing They Were Not Beneficial Owner

Background

From 2013 to 2015, Jeffrey Chan (the "Appellant") was the registered owner of a foreign bank account at the Bank of China. In filing his Canadian income tax returns, the Appellant did not file a form T1135 (*Foreign Income Verification Statement*) reporting the income earned in the foreign bank account. The Minister reassessed the Appellant penalties under paragraph 162(7)(*a*) of the *Income Tax Act* (the "ITA") for failure to file T1135s, together with penalties under paragraph 162(10)(*a*) on the basis that such failure was made knowingly or under circumstances amounting to gross negligence.

The Appellant took the position that he was not required to file form T1135s on the basis that his father was the sole beneficial owner of the Bank of China accounts.

The Appellant testified that:

(1) He had accompanied his father on a trip to China in 2013 at his father's request and expense in order to open up the Bank of China account;

(2) His father had originally intended for the account to be opened as a joint account between himself and the Appellant, but they were advised by the Bank of China that their policy was to require all accounts to be in only one person's name, and that they did not permit powers of attorney over an account;

(3) His father decided the account should be opened in the Appellant's name;

(4) His father was the sole funder of the account;

(5) The Bank of China subsequently began permitting powers of attorney in 2014, whereupon the Appellant executed a power of attorney in favour of his father;

(6) The Appellant performed most of the online transactions involving the account, but always under the direction of his father; and

(7) The Appellant's father was stated to have held the bank card and PIN to the account, together with the bank statements.

The Appellant testified that the account had been set up by his father to deal with certain family legal issues in China, as well as to hold low-risk equity investments (the Appellant testified that he himself invested in more risky stocks domestically in Canada). However, the CRA auditor testified that the account had been funded by unreported Canadian business income, rental income, and investment income earned by the father from 2007 to 2016. The Appellant stated that he had no knowledge of his father's unreported income.

By way of a letter from his lawyer in 2017, the father told the auditor that he was the sole beneficial owner of the account. The auditor had concluded in his report that in fact the father was the sole beneficial owner of the account, and that all funds in the account had originated from the father. The father died intestate in 2018, at which time the account held approximately C$2 million. The Appellant testified that his view was that the account had passed to his mother, whereas the father's lawyer's letter indicated that the father intended the account to pass to his son, the Appellant, on his passing.

The Appellant filed T1135s reporting the foreign account for his 2016 to 2019 taxation years, however in doing so specifying that he was a nominee for his father and father's estate.

The Appellant and his father were both professional accountants practicing in Canada. The father ran his own firm, while the Appellant worked at another firm.

Issue and Decision

Relying on the 2007 Supreme Court of Canada decision in *Pecore v. Pecore* (2007 SCC 17), the Appellant took the position that his father's express intention that the Appellant act as his nominee for no consideration in respect of the account resulted in a rebuttable presumption that the Appellant held registered title to the account as trustee. The Court noted that such presumption could be rebutted on the civil standard of a balance of probabilities. The Crown argued that, following *Cassan v. The Queen* (2017 DTC 1105 (TCC)), a presumption of resulting trust does not apply where the Crown has pleaded assumptions of fact assumed to be true (although rebuttable on the basis of a balance of probabilities). The Court agreed with the Crown on this point, finding that the presumption of resulting trust could thus not apply to shift the burden of proof to the Crown in this case.

The Appellant took a secondary position that even if there was no trust, the Appellant had reasonable grounds for believing that he was not the beneficial owner of the account.

Conclusion

On the evidence that the account was solely funded and controlled by the father, the Court concluded that the father was the sole beneficial owner of the account — with the result that the reassessed penalties should be vacated. The Court further stated that even if this finding was incorrect, the Appellant did have reasonable grounds for believing this to be the case, such that the penalties should in any event be vacated.

— *Ron Dueck*

Canada (Attorney General) v. Collins Family Trust, 2022 DTC 5069 (Supreme Court of Canada) — Equitable Remedy of Rescission Not Available for Plan Leading to Undesirable Tax Consequences

Background

With the help of their tax advisors, Collins devised a plan to protect certain corporate assets held in a British Columbia operating company ("Opco") from potential creditors. Moreover, the plan aimed to minimize any tax liability in the process of protecting these corporate assets.

In summary, the plan involved the following set of transactions:

(a) The creation of a holding company ("Holdco") which would purchase shares in the Opco;

(b) The creation of a family trust by which the Holdco would become a beneficiary of the Trust; and

(c) A loan would be made by Holdco in favour of the Trust to be used to purchase the shares of Opco and ultimately funds would flow to the Trust via dividends. Those funds would then be used to repay the initial loan.

The plan was conceived by Collins and their tax professionals to take advantage of the attribution rules in subsection 75(2) of the *Income Tax Act* ("ITA") and the inter-corporate dividend deduction in subsection 112(1). As such, Opco's dividend payments to the trust would be attributed to Holdco which in turn would claim a deduction by virtue of section 112 with no tax implications.

The expected result at the time the planning was conceived was that the income provided by the dividends could be allocated to Holdco without any tax implications as per subsection 75(2). This was supported by an administrative policy and practice allowed by the CRA and acknowledged by many tax professionals throughout the tax community.

In 2008 and 2009, Opco paid funds to the trust through a series of dividends, and, as previously planned, Holdco declared the funds as income by virtue of subsection 75(2) and proceeded to deduct that income in its tax return by way of subsection 112(1).

However, a few years later, in *Sommerer v. The Queen*, 2011 DTC 1162 (affirmed by the Federal Court of Appeal in July 2012 (2012 DTC 5126)), the Tax Court of Canada held that the term "person" found in subparagraph 75(2)(*a*)(i) of the ITA had to be the settlor of the trust. This meant that the attribution rule did not apply where the property in question was sold to a trust, as opposed to gifted to, or settled on, the trust. Hence, the attribution rule could not apply in the present circumstances and the end result was contrary to the CRA's position found in Interpretation Bulletin IT-369.

As a result of *Sommerer*, the Minister of National Revenue (the "Minister") proceeded to issue reassessments to the Collins Family Trust for its 2008 and 2009 taxation years on the basis that the dividends paid by Opco to the trust were to be included as income for the trust and could not be attributable to Holdco as previously thought.

British Columbia Supreme Court ("BCSC")

The Minister argued that in the present circumstances, the equitable remedy of rescission required Collins to rely on different considerations than those relevant to the rectification doctrine, as set out in *Canada (Attorney General) v. Fairmont Hotels Inc.* ("*Fairmont*"), 2016 DTC 5135 (SCC), and *Jean Coutu Group (PCJ) Inc. v. Canada (Attorney General)* ("*Jean Coutu*"), 2016 DTC 5134 (SCC). The Minister added that this distinction had been clearly addressed by the Court in *Pitt v Holt* [2013] UKSC 26, [2013] 2 A.C ("*Pitt v. Holt*") which precluded Collins from obtaining the equitable remedy of rescission.

In *Pitt v Holt*, it was held that when a case relies on the rectification doctrine it must not be confused with the remedy from rescission since the latter rests on a different test. In *Pitt v. Holt*, it was determined that rescission was a possible remedy when the facts of a given case presented an important mistake such that it would be unconscionable, unjust, or unfair to leave the particular transaction unaltered or not annulled. The British Columbia Court of Appeal, in *Re Pallen Trust* ("*Pallen Trust*"), 2015 DTC 5061, had followed and applied *Pitt v. Holt*.

The BCSC held that it was bound by *Pallen Trust* in view of the doctrine of *stare decisis* and the fact that the facts under consideration in that case were virtually identical with those in this case. The BCSC further saw a distinction with *Fairmont* and *Jean Coutu* that did not preclude an order of rescission. The Chambers judge agreed that *Pallen Trust*, *Fairmont*, and *Jean Coutu* did provide different remedies and different tests, but both were based on equitable remedies. As such, the BCSC granted the order of rescission in favour of Collins in regards to the declaration and payment of dividends to the discretionary trust on the basis of mistakes derived from tax planning.

British Columbia Court of Appeal ("BCCA")

The BCCA dismissed the Minister's appeal and upheld the BCSC's decision.

Summarily, contrary to the BCSC, the BCCA was of the opinion that *Pallen Trust* was a binding precedent in consideration of the facts and law of this case, and that neither *Fairmont* nor *Jean Coutu* undermined the *Pallen Trust* decision which allows for the remedy of rescission in particular cases such as the one at bar.

It further added that it was highly unlikely that other remedies, such as a remission order pursuant to section 23 of the *Financial Administration Act* or a negligence claim against the tax professionals, would realistically have been successful.

Supreme Court of Canada

Before the Supreme Court of Canada, the Crown argued that the principle in *Fairmont* remained operative in this case: "Taxpayers should be taxed on what they actually did and not what they could have done". What a taxpayer did freely and voluntarily may not be corrected or annulled retroactively in order to avoid an unintended tax consequence (per *Shell Canada Ltd. v. Canada*, 99 DTC 5669 (SCC), at para. 45). Moreover, the Crown argued that retroactive tax planning as a result of an error or a mistake should not be treated the same way as circumstances relating to unfair situations.

Contrary to the Crown's pleadings, Collins sought to convince the Supreme Court that the BCCA's reasoning did not constitute an error in law and its analysis, based on *Pitt v. Holt*, was applicable in Canadian tax law as it was readily applicable in other common law jurisdictions such as the United Kingdom.

The majority concluded however, that the Court of Appeal's reasoning based on *Pitt v. Holt* could not counter the principle in Canadian tax law that retroactive tax planning may not allow any equitable remedy as was determined in *Fairmont* and in *Jean Coutu*. The underlying reasoning in *Pitt v. Holt* that equity may grant relief to counter a tax mistake is irreconcilable with *Fairmont* and *Jean Coutu*. The majority rejected the possibility of an unconscionable or otherwise unfair situation arising in the ordinary application of a tax statute to a set of transactions that were freely undertaken. According to the facts, the "unfairness" for which Collins was seeking relief was none other than a direct result of the ordinary operation of the ITA applied to their transactions. It follows that the prohibition against retroactive tax planning, as stated in *Fairmont* and *Jean Coutu*, should be applied broadly, precluding any equitable remedy for which it might be achieved, including rescission.

Arising from *Fairmont*, in deciding the appeal, the majority wrote:

> (a) Tax consequences do not flow from contracting parties' motivations or objectives. Rather, they flow from the freely chosen legal relationships, as established by their transactions (*Jean Coutu*, at para. 41; *Fairmont Hotels*, at para. 24).

(b) While a taxpayer should not be denied a sought-after fiscal objective which they should achieve on the ordinary operation of a tax statute, this proposition also cuts the other way: taxpayers should not be judicially accorded a benefit denied by that same ordinary statutory operation, based solely on what they would have done had they known better (*Fairmont Hotels*, at para. 23, citing *Shell Canada*, at para. 45; *Jean Coutu*, at para. 41).

(c) The proper inquiry is no more into the "windfall" for the public treasury when a taxpayer loses a benefit than it is into the "windfall" for a taxpayer when it secures a benefit. The inquiry, rather, is into what the taxpayer agreed to do (*Fairmont Hotels*, at para. 24).

(d) A court may not modify an instrument merely because a party discovered that its operation generates an adverse and unplanned tax liability (*Fairmont Hotels*, at para. 3; *Jean Coutu*, at para. 41).

The majority also added that the Minister is always bound to apply the ITA, as interpreted by a court of law (as it was in *Sommerer*), unless and until such time that the interpretation is found to be incorrect by a higher court.

The Crown's appeal was allowed.

Justice Côté dissented, arguing that the BCCA did not err in law and that *Fairmont* had only dealt with the legal particulars under the rectification test and not the legal requisite to apply equitable remedy. She saw no convincing argument that *Pitt v. Holt* was incompatible with Canadian tax law principles.

Conclusion

The majority's decision does not allow any widening of the equitable remedy in situations that would counter the principles in *Fairmont* and *Jean Coutu*. It has also widened the gap between Canadian tax principles and those in other common law jurisdictions, such as those from the *Pitt v. Holt* decision of the Supreme Court of the United Kingdom.

— *Marc R. Lesage*

Veilleux v. The Queen, 2022 DTC 1049 (Tax Court of Canada) — Section 160 Applies on the Payment of Dividends From a Corporation to Its Only Two Shareholder/Directors

Background

The Minister assessed Daniel Veilleux ("Veilleux") pursuant to section 160 of the *Income Tax Act* (the "ITA"), holding Veilleux liable for the $23,733.28 tax debt of 9135-0280 Québec Inc. ("9135"), which was a corporation that operated a store interior design business. During the relevant periods, Veilleux and Pietro Felice Carile ("Carile") were the sole shareholders (each holding 50% of the shares), directors, and officers of 9135.

Section 160 of the ITA provides that a transferee of property is liable for the outstanding tax debts of the transferor of such property if: (i) the fair market value of the transferred property exceeds the fair market value of the consideration given by the transferee in return for such property; and (ii) the transferee is one of the persons specified in paragraphs 160(1)(*a*) to (*c*) of the ITA. Paragraphs 160(1)(*a*) and (*b*) are not relevant to this case. Paragraph 160(1)(*c*) is met if the transferee does not deal at arm's length with the transferor.

If section 160 applies, the transferee is liable for the lesser of: (i) the value of the transferred property less the value of the consideration given by the transferee in return for such property; and (ii) the transferor's tax debt as of the year of transfer.

During its taxation years ending November 30, 2011 and 2013, 9135 paid Veilleux dividends of $80,000 and $25,000 respectively. The Minister assessed Veilleux as being liable for the tax debt of 9135 on the basis that Veilleux and 9135 did not deal at arm's length with each other and that 9135 transferred property (the dividends) to Veilleux for no consideration at a time when it had an outstanding tax debt. Veilleux acknowledged these facts except for the assertion that he and 9135 did not deal at arm's length with each other.

The amount assessed of $23,733.28 is the lesser of the amount of dividends paid to Veilleux and 9135's outstanding tax debt during the relevant taxation years.

Issues and Tax Court Decision

The sole issue before the Tax Court was whether Veilleux (as transferee) and 9135 (as transferor) dealt with each other at arm's length during the relevant period. Answering this question in the negative would result in the application of section 160.

Subsection 251(1) of the ITA sets out the rules for determining whether an arm's length relationship exists. Only paragraphs 251(1)(*a*) and (*c*) were relevant to this case. After finding that paragraph 251(1)(*a*) did not apply because Veilleux held only 50% (i.e., not more than 50%) of the shares of 9135 (and thus did not have *de jure* control of 9135), the Tax Court found it necessary to analyze paragraph 251(1)(*c*), which stated that "it is a question of fact" whether unrelated persons are dealing with each other at arm's length.

In analyzing whether Veilleux and 9135 were non-arm's length as "a question of fact", the Tax Court cited *Canada v. McLarty* (2008 DTC 6354 (SCC)) for the tests used to determine whether two parties are non-arm's length "in fact":

(a) a common mind that directs the bargaining for both parties;

(b) parties to a transaction acting in concert without separate interests; and

(c) *de facto* control.

The Crown argued that 9135 disregarded its own interests and instead acted in concert and without separate interests from its shareholders (Veilleux and Carile) because Veilleux and Carile, in their roles as directors, acted in concert without separate interests from each other and because they, also in their roles as directors, declared the dividends in question without considering the interests or financial situation of 9135 (i.e., the debts of 9135, including the outstanding tax debt).

Veilleux argued that he was dealing at arm's length with 9135 because he and Carile had different personal financial interests (i.e., Carile needed more money from 9135 than Veilleux) and that accordingly, they did not act in concert and without separate interests, in their roles as directors, when deciding to declare the dividends.

The Tax Court held that even if Veilleux and Carile were found to have had different personal financial interests (i.e., one needing more money from the company than the other), this would not answer the question of whether the two acted in concert to declare the dividends and if they acted without separate interests, acting both in their capacity as directors and shareholders of 9135.

The Tax Court went on to say that the fact that both director/shareholders wanted "less salary and more dividends" (as was advised by their accountant) was enough for them to "act in concert with a common economic interest" when they decided to declare the dividends. In other words, the Tax Court found that the amount of money each director/shareholder wanted/needed (for personal reasons) was not relevant, but how the money was withdrawn from the company (i.e., in the form of dividends versus salary) was relevant.

In this case, the two director/shareholders were following the advice of their accountant, who told them that they were receiving "too much salary, not enough dividends". Based on this advice, the two director/shareholders wanted the same thing, more dividends. Accordingly, they did not negotiate how their remuneration would be split between salary and dividends (i.e., this was not a case where one person wanted more dividends and the other wanted less dividends and they negotiated the split). The Tax Court noted that this case lacked the "long and laborious negotiations" that are sometimes found in other cases with a different outcome.

Accordingly, the Tax Court found that Veilleux and 9135 were two unrelated persons who did not deal with each other at arm's length because Veilleux and Carile, as the only two director/shareholders of 9135, did not have competing or conflicting interests and that they acted in concert and without separate interests in deciding to withdraw money from 9135 in the form of dividends.

Conclusion

The Tax Court held that Veilleux and 9135 did not deal with each other at arm's length during the relevant period and as such, section 160 of the ITA applied so that Veilleux was liable for the $23,733.28 outstanding tax debt of 9135.

— *Francis Chang*

Triassi v. The Queen, 2022 DTC 1060 (Tax Court of Canada) — Rental Losses Are Not Deductible Where There Is No Source of Income in Respect of the Losses From a Business or Property; Subsection 44(1) Does Not Apply to Rental Property

Background

Giacomo Triassi ("Triassi") was the sole shareholder and administrator of a corporation called G.A.T. Knitting Inc., which was incorporated in 1995 and was voluntarily dissolved in 2007. The company's GST and QST registrations were terminated on September 1, 2007.

On April 6, 2000, Triassi acquired a one-storey brick building in Montréal (the "De Beauharnois Property") for $150,000.

In 2008, Triassi entered into two one-year lease agreements with Sylvain Larose. One lease was for one part of the De Beauharnois Property for a monthly rent of $2,300 plus taxes. The other lease was for one of the garages of the De Beauharnois Property for a monthly rent of $300 including taxes. According to Triassi, Sylvain Larose paid rent for three months in cash, which was not declared for tax purposes. The leased property was to be used for storage and parking purposes.

On October 8, 2008, Triassi entered into a one-year lease agreement with G.A.T. Knitting Inc. for one part of the De Beauharnois Property, that was not leased to Larose, for a monthly rent of $3,500 including taxes. However, G.A.T. Knitting Inc. never paid rent because it was dissolved a year earlier. The leased property was to be used for storing Triassi's knitting machines. According to Triassi, he used only 15% of the building for the storage of his knitting machines.

On January 26, 2009, there was a fire at the De Beauharnois Property which terminated the two leases with Sylvain Larose. Triassi renovated the De Beauharnois Property in 2009 and 2010 and then sold it in July 2010 for $450,000. The De Beauharnois Property was not leased from the date of the fire through to the date of its sale.

On April 13, 2010, Triassi purchased immovable property located in the city of Île-Perrot (the "Île-Perrot Property") for $155,000. The Île-Perrot Property needed major renovations, which were completed in 2010. According to Triassi, the Île-Perrot Property was rented in 2010 for a monthly rent of $300 per month, paid in cash. Triassi asserted that there was no formal lease signed and that the rent was not declared for tax purposes. Triassi also used the Île-Perrot Property to store his car during the winter.

In 2011, the Île-Perrot Property was put up for rent but it was not rented. In 2012, Triassi sold the Île-Perrot Property at apparently no profit, due to the substantial renovation costs.

On September 19, 2013, the Minister reassessed Triassi in respect of his 2009, 2010, and 2011 taxation years. In doing so the Minister:

- (i) denied net rental losses of $43,868, $23,287, and $40,379 for 2009, 2010, and 2011, respectively;
- (ii) included interest income of $1,822 for 2010 (which was added to Triassi's income by a February 2011 notice of reassessment); and
- (iii) included a taxable capital gain of $150,000 for 2010.

On October 12, 2018, the Minister reassessed Triassi again in respect of his 2009 and 2010 taxation years, allowing a net rental loss of $20,589 for 2009 and reducing the taxable capital gain to $100,000 for 2010. These reassessments were based on an out-of-court settlement, duly signed by Triassi, with the Québec Revenue Agency.

By affidavit dated November 12, 2020, Triassi solemnly affirmed that he was misled by the lawyers who represented him in this case and that he signed the settlement against his own interests.

Issues and Tax Court Decision

At the outset of its analysis, the Tax Court pointed out that the issue of whether 2009 was statute-barred was not under appeal because Triassi did not raise it in his amended notice of appeal. Moreover, the inclusion of interest income in Triassi's 2009 taxation year was also not under appeal because Triassi did not contest it. Accordingly, the two issues before the Tax Court were in respect of the denied rental losses and included taxable capital gain.

The first issue was whether Triassi was entitled to deduct losses from his rental activities. The Tax Court stated that the answer to this question depends on whether Triassi had a source of income from a business or property.

In its analysis, the Tax Court referred to the test developed by the Supreme Court of Canada in *Stewart v. R.*, 2002 DTC 6969, to determine "if a taxpayer has a source of income from a business or property". The test in *Stewart* provides for a two-stage approach, which is set out as follows:

(i) Is the activity of the taxpayer undertaken in pursuit of profit, or is it a personal endeavour?

(ii) If it is not a personal endeavour, is the source of the income a business or property?

The Supreme Court of Canada in *Stewart* stated that the first question could also be restated as follows: Does the taxpayer intend to carry on an activity for profit and is there evidence to support that intention? Further, the Supreme Court of Canada stated that answering this question "requires the taxpayer to establish that his or her predominant intention is to make a profit from the activity and that the activity has been carried out in accordance with objective standards of business-like behaviour."

In applying the facts of this case to the test in *Stewart*, the Tax Court held that there was a personal element with respect to Triassi's rental activities because Triassi used the De Beauharnois Property for storage of his knitting machines and the Île-Perrot Property to store his personal car during the winter. Accordingly, and as stated in *Stewart*, a further analysis was required to determine whether Triassi had:

- an intention to make a profit from the rental activities and if there is evidence in support of that intention; and
- carried out his rental activities in accordance with objective standards of business-like behaviour.

The Tax Court held that there was not enough evidence to support Triassi's stated intention of trying to make a profit and that Triassi did not carry out his rental activities in accordance with objective standards of business-like behaviour. Notably, Triassi claimed his rental losses but did not report the rental income derived from his rental activities for tax purposes.

The second issue was the capital gains issue and whether the replacement property rollover, as provided for in subsection 44(1) of the *Income Tax Act* ("ITA"), applied.

Subsection 44(1) of the ITA applies when a taxpayer disposes of "former business property" and then acquires, within a certain period of time, another capital property that replaces the former business property (i.e., the "replacement property"). If applicable, subsection 44(1) allows a taxpayer to defer a capital gain realized on the disposition of the former business property.

The Tax Court held that subsection 44(1) did not apply because the definition of a "former business property" in subsection 248(1) of the ITA specifically excludes a rental property and because, for the purposes of subsection 44(1), a "former business property" cannot be replaced with a rental property. Further, the Tax Court held that the Île-Perrot Property could not qualify as a "replacement property" because Triassi did not carry on any business in the property in 2010.

Conclusion

The Tax Court dismissed the appeal and held that Triassi's rental losses were not deductible for tax purposes because he did not have, in respect of the rental losses, a source of income from a business or property. Further, the Tax Court held that the replacement property rollover that is provided in subsection 44(1) of the ITA does not apply to rental property.

— *Francis Chang*

St. Benedict Catholic Secondary School Trust v. The Queen, 2022 DTC 5083 (Federal Court of Appeal) — Discretionary CCA Deductions Are Akin to Elections Which the ITA Does Not Provide a Right To Amend

Background

The St. Benedict Catholic Secondary School Trust (the "Trust") held a Class 13 leasehold interest in a secondary school building and surrounding land (the "Leasehold Property").

In its 1997 to 2003 taxation years, the Trust claimed a total of approximately $5.7 million in CCA deductions in respect of the Leasehold Property, resulting in non-capital losses ("NCLs") in each of the forgoing taxation years. In filing its tax returns for its 2014 to 2016 taxation years, the Trust sought to deduct approximately $5.7 million of these NCLs in computing its taxable income. In 2017, the Minister reassessed the Trust's 2014 to 2016 taxation years (the "Reassessments") to deny the claimed NCLs in their entirety on the basis that the loss carry-forward period had expired.

In objecting to the Reassessments, the Trust dropped its position that it had an available NCL carry-forward balance and instead took the position that its disposition of the Leasehold Property in 2017 for $1 gave rise to a terminal loss of $2.7 million which it sought to carry back to its 2014 to 2016 taxation years. In calculating its terminal loss, the Trust sought to reverse the CCA deductions it had claimed in its 1997 to 2003 taxation years, thereby resulting in a greater terminal loss than would have otherwise resulted based on the CCA it had claimed in its previous filings.

Issue

The issue in this case was whether the Trust was entitled to adjust its previous CCA claims downwards to increase the amount of the terminal loss for its 2017 taxation year.

Tax Court Decision

The Tax Court held that the CCA regime confers on taxpayers the discretion to fix the amount of CCA they wish to claim in any particular taxation year, up to the statutory maximum, which discretion entails both risks and rewards. In this case, the taxpayer had claimed the maximum amount of CCA in its 1997 to 2003 taxation years on the expectation that it would be able to avail itself of the resulting NCL carry-forward balance within the carry-forward period.

The Trust cited *Clibetre Exploration Ltd. v. R.*, 2003 DTC 5073 (FCA), as support for its ability to reverse its prior CCA claims. In *Clibetre*, the taxpayer had originally filed prior tax returns on the basis that certain expenses were deductible as ordinary expenses, but later sought to have the expenses recognized as Canadian exploration expenses ("CEEs"). However, the Tax Court found that this matter of characterization was not equivalent, as whether an expense is a CEE is not a matter of taxpayer discretion but rather a mixed question of fact and law. If the expenses fall within the definition of CEE they are added to the taxpayer's CEE pool and deducted on a discretionary basis. As such, the Court found that Clibetre stands for the proposition that neither a taxpayer nor the Minister is bound by a mistake made regarding the proper tax treatment of expenses.

In contrast, the Tax Court found there was no dispute regarding the proper characterization of the taxpayer's CCA claims. Rather, the Court found that when it turned out that the Trust was unable to use its NCL carry-forward balance within the carry-forward period, it sought to reverse its earlier discretionary claims. The Court dismissed the Trust's appeal on the basis that it amounted to retroactive tax-planning.

Federal Court of Appeal Decision

In considering the Trust's appeal, the Federal Court of Appeal performed a textual, contextual, and purposive analysis of the calculation of "E" in the definition of "undepreciated capital cost" ("UCC") in subsection 13(21) of the ITA, as relevant to the calculation of a terminal loss under subsection 20(16).

The Court found that the text was unambiguous:

> The amount to be used for E in the formula to determine UCC of the Class 13 property of the Trust is the total amount deducted under paragraph 20(1)(*a*) of the Act in respect of the Class 13 property in computing the Trust's income, which will include the amounts deducted for its 1997 to 2003 taxation years.

The Court agreed that the Trust had the absolute discretion to determine the amount it wished to deduct under paragraph 20(1)(*a*) of the ITA in respect of its Class 13 property. However, the Court concluded that "Once the amounts for each year were chosen and the Trust filed its tax returns, which included the amounts so deducted, those amounts became the total depreciation allowed for those years, as defined in subsection 13(21) of the Act."

The Trust argued that, read in context, the language used in "E" of the definition of UCC and in the definition of total depreciation accommodates changes to amounts claimed as CCA and that if the amount claimed as CCA is changed, the revised amounts will then become the total depreciation allowed. However, the Court found that this contextual claim rested on the premise that a taxpayer has the right under the Act to amend a tax return that had been previously filed to change the amount of CCA that was claimed for a particular year. The Court rejected this premise, noting that, as set out by the FCA in *Armstrong v. Canada (Attorney General)*, 2006 DTC 6310, an amended income tax return submitted to the Minister is merely a request that the Minister reassess the particular taxpayer for that year, and that the CRA's position in Information Circular 84-1 (which sets out the administrative policy of the Minister with respect to when an amendment to CCA claimed in a prior year would be accepted by the Minister) is an administrative practice that is not binding on the Court.

The Court went further and found that a taxpayer's exercise of discretion regarding how much CCA it wishes to claim in a year is "akin to an election", and that the FCA held in *Canada v. Nassau Walnut Investments Inc*. (1996), [1997] 2 F.C. 279, [1998] 1 C.T.C. 33 (C.A.), that taxpayers are not generally permitted to change an election absent a specific provision in the ITA permitting such a change. In this case, there is no provision in the ITA providing for such a change.

The Court further confirmed its agreement with the Tax Court regarding the application of *Clibetre*: the case dealt with the correct characterization of an expense, which was not at issue in the present case.

Considering the purposive interpretation, the Court noted:

> Parliament chose to only allow taxpayers to carry non-capital losses forward for a defined period of time (seven years for the loses incurred from 1997 to 2003). This limitation applies whether the expenses claimed (which resulted in the loss) are discretionary or mandatory. If the Trust is permitted to revise its earlier claims for CCA, this would defeat the purpose chosen by Parliament of having non-capital losses only available for a particular period of time. Having chosen to claim the amounts of CCA as it did in each of the years, the Trust must accept the consequences that flow from having made those choices. The Trust is attempting to revive non-capital losses that it cannot otherwise claim by converting these non-capital losses into a terminal loss in 2017.

The Court dismissed the Trust's appeal.

Conclusion

The case highlights the need for taxpayers to carefully weigh the risks and benefits of maximizing discretionary CCA deductions.

— *Ron Dueck*

RECENT CASES

Appellant's Material Earnings From Playing Texas Hold'em Poker Games Not Taxable as He Was Not Considered as "Carrying On A Business"

This case revolves around the appropriate treatment for income tax purposes of amounts earned by the Appellant from playing No-limit Texas Hold'em poker games in taxation years 2010, 2011, and 2012. For instance, in 2010, the Appellant won the Main Event of the World Series of Poker cashing in over $4 million, while being named World Poker Champion. The Appellant played "in person" tournaments, online tournaments, and private games ("cash games"). The CRA considered the earnings from the Appellant's poker playing to be business income that should be added to his taxable income for income tax purposes. The Appellant argued that because poker was a game of chance, the earnings from playing it cannot be taxable income as there could not be any business being carried on.

The appeal was allowed. The Court concluded that the evidence showed chance was a very important element in the game of poker, and that, overall, the Appellant's poker playing did not demonstrate the capacity of generating profits. For example, the evidence showed that the Appellant lost money overall with respect to playing in online tournaments. He stopped playing these when the obligation to do so ended with the end of his sponsorship agreement with Pokerstars. The Court also accepted that the Appellant did not use any poker software to follow his opponents as he stated this affected his concentration nor did he use "risk mitigation" tactics such as card counting. The evidence also showed that at the time, the Appellant partied heavily. Furthermore, according to the Court, the expert witnesses' testimony showed that the Appellant's probability of losing money was over 50%. Therefore, on a preponderance of probabilities, the Tax Court found that the Appellant did not act as a serious businessman in his poker activities and that such activities were not exercised in a sufficiently business-like manner to qualify as business income. Accordingly, the Court concluded that the Appellant's poker activities did not amount to "carrying on a business" and allowed the appeal.

Duhamel v. The Queen

2022 DTC 1050

Federal Court of Appeal reiterates CRA's power to reassess amounts disclosed under Voluntary Disclosure Program

The CRA's Voluntary Disclosure Program ("VDP") was introduced to encourage taxpayers to disclose inaccuracies or omissions in past filings voluntarily. The Appellant was accepted into the program in 2015, disclosing previously unreported business income for the 2004 to 2013 taxation years. This meant that he would be expected to pay any additional tax and interest, but could expect to be granted protection against penalties and possible prosecution regarding the amounts included in the disclosure. The CRA's letter accepting the Appellant into the program explicitly stated that "[T]he Canada Revenue Agency reserves the right to open these years for audit or verification in the future." In 2018, the CRA told the Appellant it intended to impose gross negligence penalties for his 2007–2013 taxation years based on unreported loans. The Appellant argued that he had disclosed the loans under the VDP and argued in the Federal Court that he had a reasonable expectation that he would not be assessed penalties once his disclosure to the VDP was accepted. The Federal Court found that it was clear on the face of the acceptance into the VDP that the CRA retained the right to audit (2020 DTC 5030 (FC)).

The Federal Court of Appeal dismissed the Appellant's appeal. The Federal Court's decision was reasonable, and a contrary decision would have put the Appellant in a better position than that of other taxpayers who did not avail themselves of the VDP, who would remain subject to reassessment and its consequences. The Court stated that when a taxpayer makes use of the VDP, the taxpayer can still be audited, and the taxpayer's filings can still be assessed like those of any other taxpayer. Additional tax, interest, and penalties arising from the failure to disclose income may be due.

Grewal v. AG of Canada

2022 DTC 5078

Travel expenses incurred while required to store and repair tools and equipment in Appellant's home garage, deductible expenses for ITA purposes

The Appellant, a construction foreman for Wetherell Contracting Ltd., had claimed as a deduction in computing his employment income motor vehicle expenses totalling $9,853, representing 90% of the total expenses of $10,948 that he incurred using his personal vehicle. The Minister had only allowed a deduction for motor vehicle expenses totalling $7,175 and disallowed the remaining motor vehicle expenses on the basis that they were personal expenses and therefore were not deductible under paragraph 8(1)(*h*.1) of the *Income Tax Act* (the "Act"). The Appellant had reduced his total claim to $9,306 and the total amount of motor vehicle expenses remaining in issue in this appeal was $1,642.

The appeal was allowed. In determining whether motor vehicle expenses totalling $1,642 incurred by the Appellant while travelling from his house to various worksites of his employer and vice versa are properly deductible under paragraph 8(1)(*h*.1) of the Act, the court observed that the expenses of travelling from an employee's house to his or her place of work and vice versa are personal expenses. These expenses are not deductible under paragraph 8(1)(*h*.1) of the Act because they are not incurred in the course of the employee's duties. On the basis of evidence adduced, the court, on a balance of probabilities, held that the Appellant was ordinarily required to carry on his employment duties in different places, namely in his garage located at his house (where he repaired and maintained his employer's tools and equipment and stored them as well as materials), and at various worksites, where he supervised his crew and constructed homes. Notably, the Court added that "Surely, Mr. Mason could face negative consequences if he left tools, equipment and materials at a job site and those tools, equipment and materials were stolen, or his crew regularly was to work with broken tools or no tools at all." The court further held that the motor vehicle expenses incurred by the Appellant while travelling from his house to various worksites of his employer and vice versa were expenses incurred for travelling in the course of his employment with his employer's organization. In holding so, the court concluded that the motor vehicle expenses totalling $1,642 incurred by the Appellant while travelling from his house to various worksites of his employer and vice versa were properly deductible under paragraph 8(1)(*h*.1) of the Act and allowed the appeal.

Mason v. The Queen

2022 DTC 1048

Federal Court of Appeal Dismisses Appeal of RFIs

Pursuant to a tax treaty between Canada and Switzerland, the CRA issued Requests for Information ("RFIs") to Swiss tax authorities in relation to foreign investments and foreign income that the Appellants might not have properly reported in Canada. The Federal Court rejected the Appellants' challenge to the RFIs (2021 DTC 5046) and they appealed. They argued that the CRA did not exhaust all domestic avenues, relied on allegations that it knew were false, did not provide full and frank disclosure to the Swiss authorities, illegally sought and obtained solicitor-client privileged information, and illegally disclosed confidential taxpayer information.

The Federal Court of Appeal dismissed the appeals. First, it determined that reasonableness was the correct standard for all five allegations. It then held (1) that the CRA did not need to pursue all avenues, only those that were reasonable, referring to the Appellants' refusal to provide it with information and the Canada-Switzerland treaty's goal of "encourag[ing] the exchange of information to the maximum amount possible"; (2) despite a discrepancy in dates among the RFIs for which it "could have used more accurate language," the CRA did not make false allegations or fail to make full and frank disclosure to the Swiss authorities; (3) the Appellants' claim that the CRA violated confidentiality by demanding information not specified in the treaty's Interpretive Protocol misinterprets the Protocol, which sets a threshold for disclosure, not an upper limit — if the treaty were inconsistent with Canadian law in this respect, it would govern, and in any event it has a confidentiality clause itself; (4) information obtained from the trust account of one of the Appellants' attorneys was based on an RFI directly to the Appellants in question and voluntarily complied with; furthermore, it was gathered by an auditor unconnected with the Appellants' audit and not known by the auditor who drafted the RFIs.

Levett et al. v. AG of Canada and CRA

2022 DTC 5076

FCA Compels CRA To Answer Certain Discovery Questions, Quashes Others

The CRA reassessed the Respondents' reported losses arising from alleged trading in foreign securities contracts on the basis that the trading was a sham. In the Tax Court, the CRA agreed to a number of undertakings at the CRA's nominee's examination for discovery. After some back and forth, the Tax Court ordered the CRA to answer certain residual questions.

On appeal, the Federal Court of Appeal ("FCA") allowed the appeal in part and dismissed it in part. The Court reiterated that the only relevant issue was whether the Respondents' trading was a sham, noting that "a question is relevant for discovery purposes if the answer might assist the asking party in advancing its case or damage the case of the other party." The FCA then divided the questions into two groups: those that related to the CRA's alleged reliance on information derived from audits of other taxpayers, and those that related to its alleged reliance on a report (the "RSD Report") concerning foreign currency transactions by various Canadian partnerships. At the examination for discovery, the nominee confirmed that the CRA had not relied on the information derived from other taxpayers; at the hearing, the Respondents could not provide a reason for requesting the information, under their own definition of "relevance". In consequence the FCA dismissed this group of questions as a fishing expedition. As for the RSD Report, it was relied upon and cited by the auditor who audited the Respondents: consequently, the CRA would be ordered to answer the question (and sub-questions) relating to it.

The Queen v. Thompson et al.

2022 DTC 5077

Tax Court Rejects SR&ED Claim for "Tinkering" Process

The Appellant engaged in the business of remanufacturing used fuel injectors for diesel engines. It claimed scientific research and experimental development tax credits for its 2013 and 2014 taxation years, which the CRA disallowed. To adjust to the transition from mechanical to electronic injectors, the Appellant disassembled three kinds of used injectors, analyzing the components to determine points of failure, rectifying them, and reassembling them.

The Tax Court dismissed the appeal. Under the Federal Court of Appeal's *Northwest Hydraulic* decision, claimed SR&ED expenses must meet five criteria: (1) a technological risk or uncertainty that could not be removed by routine engineering or standard procedures; (2) hypotheses specifically aimed at reducing or eliminating that technological uncertainty; (3) procedures that accord with established and objective principles of scientific method; (4) a resulting technological advance; and (5) a detailed record of hypotheses, tests, and results. The Appellant's activity failed on all five counts. First, "technological uncertainty" is an objective test, not gauged by the subjective knowledge of a small, untrained team without engineers or mechanics. Second, the Appellant's "hypothesis" was the overarching idea that it could repair the injectors, but *Northwest Hydraulic* understands "hypotheses" as discrete conjectures that precede each test and are subject to modification as a result of that test. Third, there was no evidence that the Appellant used established and objective principles of scientific method. Fourth, the Appellant did not make clear how its activity was a scientific advance. Finally, the Appellant did not keep a detailed record of hypotheses, testing, and subsequent modification.

Dave's Diesel Inc. v. The Queen

2022 DTC 1045

Application To Cancel Tax on Excess TFSA Contributions Dismissed

The Applicant had TFSA contribution room of $42,500 available; however, he contributed a total of $52,500 in 2018, which resulted in an over-contribution of $10,000. Subsequently, the Applicant deposited $20,000 and withdrew it the same day. On January 1, 2019, the annual contribution room of $6,000 was recognized and the overcontribution became $4,000. However, on February 19, 2019, the Applicant contributed $6,000. The Applicant was assessed tax under section 207.02 of the *Income Tax Act* (the "Act") because of his excess contribution in 2018. The Applicant requested a cancellation of the tax on the excess TFSA contributions for both the 2018 and 2019 years, which was denied by the Minister. The Applicant had argued that the 2019 excess contribution was an honest mistake, which he rectified immediately upon being notified of it.

The application was dismissed. In determining whether the Minister's decision to deny the Applicant's request for relief of the tax on his excess TFSA contributions for 2019 was reasonable, the Court observed that subsection 207.06(1) of the Act provides that the Minister's discretion may be exercised if the taxpayer establishes to the satisfaction of the Minister's delegate that the tax liability arose as a consequence of a reasonable error and the excess TFSA amounts are removed from the TFSA without delay. The Court noted that the Applicant had contributed $6,000, being the maximum amount allowed for that tax year. Unfortunately, that deposit created a new over contribution of $10,000. This new overcontribution meant that the total amount was not "the same $10,000" as in 2018. The Minister had appropriately noted that the Applicant was notified of their TFSA overcontribution and the resulting tax on July 16, 2019. The Court further found the Applicant's withdrawal of the excess amount on October 29, 2019, to be an unreasonable delay and held that misinterpretation of the TFSA contribution limit could not be considered a reasonable error. In holding so, the Court concluded that the Minister's decision was reasonable and dismissed the application.

Steinbach v. AG of Canada

2022 DTC 5067

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