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Wolters Kluwer

TAXATION OF NON-RESIDENT TRUSTS

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The following overview is a preview of new content available now on IntelliConnect. Topic pages provide readers with a concise overview of a particular subject. They succinctly explain the rules, provide helpful tips, flag potential issues, and provide references to key research sources. Additional topic pages can be found under the "CCH AnswerConnect Preview" tab when a topic page appears in your search results on IntelliConnect.

Overview

Subsection 94(3) provides that a trust is deemed to be resident in Canada throughout the particular taxation year if there is either a "resident contributor" to the trust or a "resident beneficiary" under the trust at a "specified time" in the year (either the end of the year or the time immediately before the trust ceases to exist). An exception is made for an "exempt foreign trust". Paragraphs 94(3)(*a*) – (*g*) deem the trust to be resident in Canada for the purposes of several provisions of the *Income Tax Act*, including the requirement to pay Part I tax on income under section 2.

Definitions for the following terms are provided in this topic page:

- resident contributor
- resident beneficiary
- successor beneficiary
- exempt person
- connected contributor
- non-resident time
- exempt foreign trust
- infirm beneficiary

Definitions

Resident Contributor

Subsection 94(1) provides that a "resident contributor" is basically a person (other than an "exempt person") who is a resident of Canada who has made a contribution to the trust.

Subsection 94(1) provides that the definition of "contributor" includes persons who have ceased to exist.

Resident Beneficiary

Subsection 94(1) defines the term “resident beneficiary”. The resident beneficiary test is two-fold. First, the “beneficiary” under the trust (other than a “successor beneficiary” or “exempt person”) must be resident in Canada, and second, there must be a “connected contributor” to the trust.

Successor Beneficiary

Subsection 94(1) defines a “successor beneficiary” as a person who is a beneficiary under a trust solely because that person can receive a distribution upon the death of a contributor who is alive or upon the death of someone related to that contributor, including an uncle, aunt, niece, or nephew, or who would have been related to the contributor of the trust if every individual who was alive before that time were alive at that time.

Exempt Person

Subsection 94(1) defines “exempt persons” to include Her Majesty in Right of Canada or a province, a person who is exempt from tax under subsection 149(1), as well as certain trusts and corporations resident in Canada which are established pursuant to legislation in order to manage pension funds or workers’ compensation. A mutual fund trust or a mutual fund corporation can also be an exempt person, but beneficiaries may be subject to income tax pursuant to the provisions of sections 94.1 and 94.2, if applicable.

Connected Contributor

Subsection 94(1) defines a “connected contributor” to a trust to be any person who has made a contribution to the trust, other than a person whose contributions to the trust were made at that person’s “non-resident time”.

Non-Resident Time

Subsection 94(1) defines the “non-resident time” of a contributor to be the period which commences 60 months before the contributor made the contribution to the trust and which ends 60 months after the contributor made the contribution to the trust, i.e., a total of 10 years — five either side of the contribution — if the contributor was non-resident throughout that period.

Example

If A has been a non-resident of Canada for 60 months and makes a contribution to the trust at that time and remains a non-resident for a further 60 months, then that contribution would have been made during A’s “non-resident time”. However, if A makes a contribution to the trust having been a non-resident for 60 months, but subsequently establishes residence in Canada within 60 months after making the contribution, the trust will be deemed resident in Canada from the time of the contribution.

The 60-month period of the non-resident time is reduced to 18 months if the contributor has ceased to exist (e.g., has died or has been wound up).

Exempt Foreign Trust

The definition of “exempt foreign trust” under subsection 94(1) provides an extensive list of non-resident trusts which will not be subject to the deemed residency rules in section 94.

Infirm Beneficiary

“Beneficiary” in subsection 94(1) includes trusts which have an infirm beneficiary or which are created as a consequence of the breakdown of a marriage or common-law partnership.

Specifically, where there is a non-resident beneficiary who because of physical or mental infirmity is dependent on the contributor to the trust or a person related to such contributor, then such a trust is an “exempt foreign trust” provided that each contribution is for the maintenance of such a beneficiary. A non-resident trust created as a consequence of a breakdown of a marriage or common-law partnership for the maintenance of a non-resident beneficiary who is a child of both of those individuals (a “child beneficiary”) or who is one of those individuals (an “adult beneficiary”) is an

exempt foreign trust. A child beneficiary must be under 21 years of age (or, if studying at an educational institution outside Canada, under 31 years of age) and each contribution must be for the maintenance of a child beneficiary or in the case of an adult beneficiary must qualify as a "support amount".

Other Exempt Foreign Trusts

Other types of exempt foreign trusts include the following:

- Paragraph (*c*): agencies of the UN, trusts which are created pursuant to certain international agreements, trusts which administer a university, and trusts which have received gifts from Her Majesty in Right of Canada.
- Paragraph (*d*): a trust created for charitable purposes where there are at least 20 persons who are contributors to the trust and who deal with at least 19 other contributors on an arm's length basis, provided that such trust is generally exempt from income tax under the laws of the country in which it is resident.
- Paragraph (*e*): trusts which administer employee- or retirement-related benefits, including trusts governed by an employee profit sharing plan, a retirement compensation arrangement, or a foreign retirement arrangement, as well as those trusts which are operated for the purposes of pension-related benefits in respect of qualifying services rendered in that country.
- Paragraph (*h*): trusts whose beneficiaries hold "fixed interests" in the trust. Generally, a distribution to the holder of a fixed interest does not depend on the exercise of significant discretionary powers. In addition to the "fixed interests" requirement, one of the following must be applicable:

- There are at least 150 beneficiaries whose interests each have a total fair market value of at least $500;
- All the fixed interests are listed on a designated stock exchange and in the 30 days prior to the time in question interests in the trust were traded on the exchange on at least 10 days;
- Each fixed interest was issued in exchange for consideration that was not less than 90% of the interest's proportionate share of the net asset value of the trust's property or was acquired for fair market value; or
- The trust is a Roth IRA or is similar to a Roth IRA.

These are generally referred to as commercial foreign trusts and unitholders may be subject to Canadian tax under section 94.2.

Finally, certain trusts may be prescribed to be exempt foreign trusts. No trusts have been prescribed at this time.

Deeming and Application Rules

Subsection 94(2) provides various deeming and application rules, particularly in terms of what constitutes a transfer or contribution of property to a trust.

Consequences of Being a Deemed Resident Trust

Paragraph 94(3)(*a*) provides that a trust meeting the conditions noted above is deemed to be resident in Canada. It should be noted that under section 4.3 of the *Income Tax Conventions Interpretation Act (Canada)*, a trust which is deemed to be resident in Canada under subsection 94(3) is also deemed to be resident in Canada under the relevant tax treaty and not a resident of the other contracting state.

More specifically, under paragraph 94(3)(*a*) such a trust is also deemed resident for the purposes of the following:

- Computation of income;
- Various designations, elections, and distributions in respect of trusts (subsections 104(13.1) to (28) and 107(2.1));
- Computation of the adjusted cost base of an interest in the trust (subparagraph 53(2)(*h*)(ii));
- Definition of non-resident entity (subsection 94.1(2));
- Non-resident's taxable income (section 115);
- Certain loss provisions (subsection 111(9));

- Determining obligations under sections 233.3 (reporting ownership of "specified foreign property") and 233.4 (reporting ownership of foreign affiliates);
- Determining the trust's rights and obligations under Division I (returns, assessments, payment, and appeals) and Division J (appeals to the Tax Court of Canada and the Federal Court of Appeal);
- Determining the trust's liability for tax under Part I and Part XIII in respect of amounts paid or credited to the trust and in respect of certain amounts paid or credited by the trust under Part XIII; and
- Determining whether a foreign affiliate of a taxpayer is a controlled foreign affiliate of the taxpayer.

Rules for Determining Foreign Taxes

Paragraph 94(3)(*b*) sets out the rules for the determination of foreign taxes (and related income) of a deemed resident trust. A trust's foreign tax paid for these purposes does not include taxes paid on Canadian-source income (other than dividends or interest).

Bump in Cost Base of Certain Assets

Paragraph 94(3)(*c*) provides that upon becoming subject to subsection 94(3), the cost base of certain assets of a non-resident trust are bumped up to their fair market value immediately prior to the year in which the trust is deemed to be a resident of Canada. Subparagraphs 128.1(1)(*b*)(i) to (iv) exclude the trust's taxable Canadian property, its property relating to a business in Canada, as well as its excluded rights or interest from this treatment.

Liability Extended for Taxes Payable

Paragraph 94(3)(*d*) provides that if the trust fails to pay the applicable income tax, each resident contributor and each resident beneficiary is jointly and severally, or solidarily, liable with the trust for the trust's tax, subject to a limited exclusion for an electing contributor noted below. The liability of these parties is generally limited to a "recovery limit" if certain conditions are met in subsections 94(7) and 94(8).

Electing Contributor

Subsection 94(16) provides an alternative tax treatment for an "electing contributor". Under this alternative, instead of being jointly and severally liable for all of the trust's tax obligations, the electing contributor will include a proportionate share of the trust's income (net of losses carried over from other years and deducted in computing the trust's taxable income), generally equal to the proportion that is the amount of the contributor's contributions to the trust divided by the amount of all contributions received by the trust from resident contributors or connected contributors.

Non-Resident Portion ("Electing Trust") Election

Paragraph 94(3)(*f*) provides that a trust may elect to be treated as though the "non-resident portion" of its property is held in a separate trust with the result that such portion is not subject to section 94 and only the resident portion of a deemed resident trust is subject to section 94. Generally, the "non-resident portion" of the trust property is property contributed by non-residents of Canada. The property contributed to the trust by residents of Canada is considered to form the resident portion of the trust property. If a non-resident contributor to a trust subsequently becomes a resident of Canada, then the formerly non-resident portion of the trust property will form part of the resident portion of the trust property.

Electing Trust Not Subject to Section 94 Tax

Paragraph 94(3)(*f*) provides that upon such election, the property forming the non-resident portion is not subject to section 94. Paragraph 94(3)(*f*) deems "a non-resident portion trust" to have been created and to continue until the trust ceases to be resident in Canada because there is neither a resident contributor nor a resident beneficiary, because the trust becomes an exempt foreign trust, because the trust ceases to exist, or because the trust becomes resident in Canada under common law. The trustees and beneficiaries of the electing trust are deemed to be the trustees and beneficiaries of the non-resident portion trust.

Electing Trust Rights Deemed To Be the Same

Subparagraph 94(3)(*f*)(iii) provides that the terms and the rights and obligations of the beneficiaries under the electing trust are deemed to be the same in respect of the non-resident portion trust. Subparagraph 94(3)(*f*)(viii) provides that the electing trust is deemed to be affiliated with the non-resident portion trust and both trusts are deemed not to deal with each other at arm's length.

Tax Liability of Electing Trust Extends to Other Trust

Clause 94(3)(*f*)(ix)(A) provides that both trusts are jointly and severally, or solidarily, liable in respect of rights and obligations under Divisions I and J of the *Income Tax Act* (the "Act"). The deemed disposition and reacquisition rules in subparagraph
94(3)(*f*)(x) apply where the non-resident portion trust ceases to exist.

How To File the Election

The definition of "electing trust" in subsection 94(1) provides that the election has to be filed for the first taxation year throughout which the trust is deemed to be resident in Canada under subsection 94(3) and holds property meeting the definition of a non-resident portion. The election is filed with the trust's income tax return for the relevant taxation year.

Caution

It appears that there is no mechanism for late filing or for revoking the election. Failure to make the election will result in the entire corpus of the trust being subject to tax in Canada — even where there is ostensibly a non-resident portion that would otherwise not be taxed in Canada.

CURRENT ITEMS OF INTEREST

Canada Ratifies MLI

On August 29, 2019, Canada deposited its instrument of ratification with the Depositary of the Multilateral Instrument ("MLI"). The MLI will enter into force in Canada on December 1, 2019, and will apply to certain tax treaties as early as January 1, 2020. Article 35 of the MLI contains the coming into force provisions. For tax withheld at source, the MLI applies as of the first day of the calendar year following the year in which the latest of the dates that the MLI comes into force in a contracting jurisdiction. In other words, for tax withheld at source, the MLI applies as of January 1, 2020, to any tax treaty that Canada has with a jurisdiction where the MLI came into force in 2019 or earlier. Generally, for all other taxes levied, the MLI applies to taxable periods beginning on or after the expiration of the period that is six months after the latest of the dates that the MLI comes into force in a contracting jurisdiction. That said, Article 35 contains many other provisions for the coming into force of the other various aspects of the MLI. A complete list of the coming into force dates for all jurisdictions can be found at: http://www.oecd.org/ctp/treaties/beps-mli-signatories-and-parties.pdf.

Government Amends Child Benefit Rules

The government has released a legislative proposal to amend the definition of a "shared-custody parent" under section 122.6 of the *Income Tax Act* in response to Federal Court of Appeal decisions in *Lavrinenko v. Canada* (2019 DTC 5038) and *Morrissey v. Canada* (2019 DTC 5039). The Canada Child Benefit is split between shared-custody parents. Regulation 6301(1) requires that the child reside with each parent on an equal or near equal basis, which the CRA generally interprets as being between 40% and 60% of the time. However, in *Morrissey* the Court found that any percentage of time that cannot be rounded off to 50% would not qualify as "equal or near equal". Based on this interpretation, many parents with joint custody may no longer qualify for child benefits.

In response, the government proposes to amend the definition of a shared-custody parent. Among other existing conditions, the child will only be required to reside with the parent for at least 40% of the time in a given month, or on an approximately equal basis.

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.

Federal Court Allows Implicit Waiver of Normal Reassessment Period

***Kerry (Canada) Inc. v. Attorney General of Canada*, 2019 DTC 5041 (Federal Court)**

In this decision, the Federal Court granted the taxpayer's application for judicial review of a decision of the Minister of National Revenue denying the taxpayer's request to reassess its 2002 and 2003 taxation years. In reaching this decision, the Court concluded that the Minister had failed to consider the taxpayer's clear intention to waive the normal reassessment periods for 2002 and 2003 given a Canadian Competent Authority process that was underway. Accordingly, the Court referred the matter back to the Minister for redetermination.

The case involved certain transactions involving three related companies during the taxpayer's 2001, 2002, and 2003 taxation years. The taxpayer, Kerry (Canada) Inc. ("Kerry Canada"), sold products to a related US company and paid royalties to a related Irish company. On February 6, 2007, the CRA issued Notices of Reassessment to Kerry Canada for each of the relevant years, increasing income attributed to sales to the related US company and disallowing deductions from income for royalties paid to the related Irish company in each taxation year. In 2006, Kerry Canada had filed with the CRA a waiver of the normal reassessment period for its 2001 taxation year pursuant to subsection 152(4) of the *Income Tax Act* (the "Act"), so the reassessment of the taxpayer's 2001 taxation year was not in issue in this case. However, no similar formal waivers were filed by the taxpayer for its 2002 or 2003 taxation years.

On May 3, 2007, Kerry Canada filed Notices of Objection ("Part I Objections") in respect of the reassessments, arguing that the CRA had erred in adjusting the sale price to the US company and disallowing deductions of royalties paid to the Irish company. Kerry Canada requested that the Part I Objections be held in abeyance pending a decision by the Canadian Competent Authority ("CCA"). The taxpayer subsequently filed two requests for assistance with the CCA, each of which referred to the Part I Objections and informed the CCA of Kerry Canada's request that the Part I Objections be held in abeyance pending resolution of the two issues.

On September 28, 2010, the CCA issued its first decision, regarding the sale price to the US company, and reversed the CRA's income adjustment related to the sale price to the US company in its entirety for each of the relevant years. On June 12, 2012, the CRA issued Notices of Reassessment ("Second Reassessments") for each of 2001, 2002, and 2003 reflecting the first CCA decision. The Second Reassessments were not objected to by the taxpayer.

On September 5, 2013, the CCA issued its second decision, regarding the royalties paid to the Irish company, and reversed the CRA's income adjustment related to royalty payments to the Irish company entirely for taxation years 2001, 2002, and 2003. In November 2013, Kerry Canada was informed that the CRA was unable to process the second CCA decision for 2002 and 2003 as those years were statue-barred under the Act since the Second Reassessments closed the Part I Objections filed in 2007 and no new Notices of Objection were filed following the Second Reassessments.

In a letter dated December 31, 2013, Kerry Canada requested that the CRA implement the second CCA decision. A second letter dated May 26, 2014, was sent to the CRA and requested that the CRA treat the first CCA request as a waiver pursuant to paragraph 152(4)(*c*) of the Act. The CRA denied Kerry Canada's request in a letter dated October 27, 2014.

Before the Court, Kerry Canada advanced two arguments in support of its position that the Minister's decision was unreasonable. Firstly, Kerry Canada maintained that it had provided valid waivers in respect of the limitation periods for 2002 and 2003 pursuant to subparagraph 152(4)(*a*)(ii) or paragraph 152(4)(*c*) of the Act. Secondly, Kerry Canada maintained that the Minister could have and should have applied the Part I Objections to the Second Reassessments. Walker J at the Federal Court ("FC") agreed that the primary issue of whether the Minister unreasonably concluded that Kerry Canada did not provide valid waivers falls within the competence of the FC; however, with regard to the second argument, the FC was not in a position to consider this issue as it is exclusively reserved for the Tax Court of Canada pursuant to the *Tax Court of Canada Act* and the Act. In reaching this conclusion, Walker J referred to *Addison & Leyen Ltd*. (2007 DTC 5365) and cited the statement therein by the Supreme Court of Canada that "judicial review should not be used to develop a new form of incidental litigation designed to circumvent the system of tax appeals established by Parliament and the jurisdiction of the Tax Court. Judicial review should remain a remedy of last resort in this context."

Both parties agreed that the first issue must be reviewed against the standard of reasonableness and that the Court

should interfere only if the decision lacks justification, transparency, or intelligibility, and falls outside the range of possible, acceptable outcomes which are defensible on the facts of the case and in law.

In support of the valid waiver position, Kerry Canada advanced two arguments. Firstly, that the statements regarding abeyance contained in the Part I Objections and in the second CCA request gave rise to valid waivers. Secondly, that the Minister failed to provide adequate reasons in her decision to deny the implementation of the second CCA decision.

With regard to Kerry Canada's first argument, Walker J considered various factors such as the taxpayer's written documentation, intention, the course of conduct of both parties with regard to the years in question, and the ongoing CCA process. She noted that "it is also important to bear in mind that the CCA is part of the CRA and that the Appeals Division of the CRA was aware of the two issues before the CCA from the outset."

Even though in the documentation Kerry Canada made no explicit statements that it wished to be reassessed whether the CCA decision concluded within or outside of the limitation period for reassessment, it was noted that the statements in the Part I Objections and the second CCA request expressed a clear intention that the three taxation years be reassessed in accordance with the two CCA decisions. Walker J found as follows:

> [T]he absence of an explicit reference to the normal and extended reassessment periods under the ITA was not fatal to Kerry Canada's position. A waiver of the protection of the statutory limitation periods was implicit in its requests for abeyance. The documentation contained the information necessary to alert the CRA to Kerry Canada's intention that the years in question be reassessed whenever the issues before the CCA were resolved.

The Court also referred to the CRA's Audit Manual that recognized implied waivers and to Information Circular IC 71-17R5 that further supported the taxpayer's position. Walker J noted the CRA's statements in the information circular that a waiver is not required for the CRA to implement a CCA decision for a statute-barred year if the relevant Notices of Objection are held in abeyance. While the Part I Objections may no longer have been effective once the Second Reassessments were issued, the taxpayer clearly requested in the two CCA requests that the Part I Objections be held in abeyance.

In addition, the CRA had been aware since 2007 of the abeyance requests and the ongoing CCA process. The Court emphasized that the conduct and knowledge of the taxpayer and the CRA are critical in determining whether waivers were provided and found that in this case the parties each understood the taxpayer's intention that the Part I Objections would function as effective waivers. Even though Kerry Canada did not file second Notices of Objection to the Second Reassessments, that should not negate its intention to be reassessed to implement the results of the CCA process.

With regard to Kerry Canada's second argument, that the CRA decision was sparse and unintelligible, Kerry Canada submitted that the decision contained no elaboration of the underlying reasons for the decision and noted that there was also no accompanying report or document explaining the basis for the Minister's decision. The Court found that the reasons provided no basis for the taxpayer to understand the CRA's reasoning and were inadequate, and that the CRA had failed to consider all of the circumstances of the taxpayer's request and the subsequent conduct of the parties.

Walker J referred to *Mitchell* (2002 DTC 7502), a Federal Court of Appeal judgment confirming that waivers need not be in prescribed form to be effective, and cited its statement that the Canada Revenue Agency "does not have an option as to whether or not to accept a waiver. A waiver is a privilege which a taxpayer has, and, if sent, [the Canada Revenue Agency] cannot disregard it." The Second Reassessments could not override the taxpayer's express request to hold the Part I Objections in abeyance, and the taxpayer's intention to keep the taxation years open for reassessment.

This case illustrates that the CRA must consider all of the surrounding circumstances and a taxpayer's intention in deciding whether there has been a valid waiver of the normal reassessment period. If a taxpayer has clearly indicated an intention to keep the years open, the CRA cannot simply negate that intention by operation of the reassessment process. In addition, in denying a taxpayer's request to keep taxation years open, the CRA must provide clear reasons to allow the taxpayer to understand the reasoning behind the decision. In reaching its conclusion, the CRA must consider all of the circumstances of the taxpayer's request and the subsequent conduct of the parties involved.

— Jaclyn Wang, Summer Student

Federal Court Considers Legal and Factual Basis of a Reassessment in the Context of a Pension Plan Revocation Notice

***Mammone v. The Queen*, 2019 DTC 5033 (Federal Court of Appeal)**

This case is an appeal from a judgment of the Tax Court which had dismissed an appeal by the taxpayer. The Federal Court of Appeal reversed the Tax Court's judgment, holding that a pension plan revocation notice sent in 2017 by the Minister of National Revenue in effect sought to do away with a limitation period that protected the taxpayer from reassessment.

The taxpayer had been employed as a mechanic from 1981 to 2009, and had been a member of the pension plan Ontario Municipal Employees Retirement System ("OMERS"). In his year of retirement, the taxpayer established a new pension plan of which he was the sole member. The plan was registered under the *Income Tax Act* (the "Act") effective on January 1, 2009. On June 23, 2009, the commuted value of $640,080.91 of the taxpayer's OMERS pension was transferred to the new plan.

On November 14, 2013, the Minister sent a notice of an intention to revoke the registration of the new pension plan retroactive to January 1, 2009, on the basis that the plan did not satisfy registration requirements. Twenty-eight days later, on December 12, 2013, the Minister provided notice of revocation. On the same day, the Minister reassessed the taxpayer's 2009 taxation year, including the amount transferred to the new plan in the taxpayer's income (on the basis that there had been a transfer to an unregistered plan). The notice of reassessment was sent on the last day before expiry of the limitation period for the taxpayer's 2009 taxation year. The reassessment ultimately led to an appeal by the taxpayer to the Tax Court, which was filed in July 2016.

In 2017, the Minister concluded that the notice of revocation sent in 2013 had been ineffective because it was sent two days earlier than was permitted by the Act. The Minister therefore sent a second notice of revocation on June 26, 2017, stating that the second notice superseded the first one and was being issued to correct a timing error. The second revocation notice was relied on by the Minister for the purposes of the reassessment issued on December 12, 2013.

The Tax Court determined that the reassessment should not be vacated on the basis that the commuted value of the OMERS pension plan was transferred to a non-registered pension plan. The question before the Federal Court of Appeal was whether the Minister impermissibly relied on a new factual basis for the reassessment, and whether that basis related to facts arising after the 2009 limitation period had expired.

At the Federal Court of Appeal, Woods JA stated that the legal basis underlying the reassessment was that the amount transferred to the new pension plan was required to be included in the taxpayer's income because the new pension plan was never registered. On this point, the Federal Court of Appeal agreed with the Tax Court that the legal basis did not change over time, given the retroactive nature of the revocation. However, as confirmed by the Federal Court of Appeal, the factual basis underlying the reassessment did change. When the notice of reassessment was issued on December 12, 2013, the reassessment was based on the revocation notice sent on the same day. This basis was abandoned in 2017 because the notice was of no effect, such that the Minister relied on a new notice of revocation.

Procedurally, the revocation of a pension plan's registration by the Minister involves a two-step process under the Act. First, the Minister gives notice to the plan administrator of a proposal to revoke the registration, and second, the Minister provides notice to the plan administrator of the actual revocation. The notice of revocation must be provided after a period of thirty days from the mailing of the notice of intent to revoke. Once the revocation notice has been provided, the registration of the pension plan is revoked as of the date specified, unless the Court orders otherwise. Such revocations can be made on a retroactive basis, but if made retroactively, the applicable limitation periods need to be taken into account in considering consequential assessments that are made. In this regard, the courts have developed jurisprudence that prevents the Minister from avoiding a limitation period by raising a new basis of assessment after the limitation period has expired.

In its reasons for judgment, the Federal Court of Appeal stated that pursuant to the legislative scheme, a revocation notice is a necessary step which must be taken to revoke a pension plan's registration. Without the notice, the new pension plan would be a "registered pension plan" under the Act, and therefore would qualify for a tax-free transfer of funds between plans. Accordingly, the revocation notice was a factual element that was necessary in order to support the legal basis of the income inclusion. In this case, the revocation notice was sent in 2017, which was long after the limitation period had expired. Thus, there was no factual basis on which the reassessment was based at the time that it was issued or at the time that the limitation period expired.

This case serves as a reminder of the importance that limitation periods play in providing finality to disputes. In issuing the second revocation notice and relying on it for purposes of the prior reassessment, the Minister was in effect seeking

to do away with the limitation period, which would defeat the purpose of the limitation period. The Court held that the taxpayer was entitled to rely on the expiry of the normal reassessment period to finalise his tax payable for the 2009 taxation year, with no income inclusion relating to the transfer of funds between pension plans.

— *Jaspreet Kaur*

When Does a CRA Civil Audit Become a Criminal Investigation Under Which a Taxpayer Receives Charter Protection?

***The Queen v. Mariani*, 2019 DTC 5032 (Ontario Court of Justice)**

This case was an application to the Ontario Court of Justice regarding whether a CRA auditor had violated the taxpayers' Charter rights in obtaining evidence under compulsion pursuant to section 231.1 of the *Income Tax Act* (the "Act"). The Applicants were Mr. Mariani and Mariani Metal Fabricators Limited ("Mariani Metal Fabricators"). Both were charged with four counts of willfully evading taxes pursuant to paragraph 239(1)(*d*) of the Act. The Applicants argued that the CRA auditor, Mrs. Voth, had impermissibly used her audit powers to gather evidence for a criminal investigation, breaching their section 8 rights against unreasonable search and seizure under the *Canadian Charter of Rights and Freedoms* (the "Charter").

The CRA's audit powers come mainly from two provisions under the Act: sections 231.1 and 231.2. Pursuant to these provisions, a person authorized by the Minister of National Revenue has the power to enter a taxpayer's place of business or record keeping, to require a taxpayer and third parties to answer questions, and to require a taxpayer and third parties to provide information upon request.

In *Jarvis* (2002 DTC 7547), the Supreme Court of Canada decided that, where the predominant purpose of an inquiry is the determination of criminal liability and the inquiry engages the adversarial relationship between the taxpayer and the state, federal tax officials cannot use their powers under sections 231.1 and 231.2. The *Jarvis* decision recognized that sections 231.1 and 231.2 of the Act raise competing interests. On one hand, for a system of taxation that relies on taxpayer forthrightness to be effective, it is necessary to have "adequate investigation, but also the existence of effective penalties" (*Jarvis*, para 55). On the other hand, the "principle against self-incrimination [is] an elemental canon of the Canadian criminal justice system" and is protected by section 7 of the Charter (*Jarvis*, para 67). Moreover, section 8 of the Charter guarantees that all have the right to be secure against unreasonable search and seizure. The Court in *Jarvis*, recognizing that there could come a point in an investigation at which privacy interests outweighed the public tax system interest, decided that CRA officers could use their audit powers only while pursuing civil remedies. To help courts determine when a civil audit becomes a criminal investigation, the Supreme Court of Canada provided a list of factors:

(a) Did the authorities have reasonable grounds to lay charges? Does it appear from the record that a decision to proceed with a criminal investigation could have been made?

(b) Was the general conduct of the authorities such that it was consistent with the pursuit of a criminal investigation?

(c) Had the auditor transferred his or her files and materials to the investigators?

(d) Was the conduct of the auditor such that he or she was effectively acting as an agent for the investigators?

(e) Does it appear that the investigators intended to use the auditor as their agent in the collection of evidence?

(f) Is the evidence sought relevant to taxpayer liability generally? Or, as is the case with evidence as to the taxpayer's *mens rea*, is the evidence relevant only to the taxpayer's criminal liability?

(g) Are there any other circumstances or factors that can lead the trial judge to the conclusion that the compliance audit had in reality become a criminal investigation?

In *Mariani*, the Court had to consider the *Jarvis* factors to determine whether the evidence obtained by the CRA pursuant to its section 231.1 and 231.2 powers was admissible in a prosecution under section 239 of the Act.

The CRA's audit of the Applicants began in April 2013. Mrs. Voth reviewed the information that the CRA had on Mariani Metal Fabricators' file, notifying Mariani Metal Fabricators and Mr. Mariani of the audit at the same time. Through her review, Mrs. Voth noticed that $2,000,000 in payments that had originally been debited from the shareholder's account had subsequently been reversed and declared as business expenses of Mariani Metal Fabricators. The majority of these payments went to a company called Capoferro.

Digging deeper, Mrs. Voth conducted a Google "street view" search of the new house that Mr. Mariani had moved into in March 2013. She noticed that a construction trailer displaying the name Capoferro was on the property. Mrs. Voth

researched Capoferro's business and discovered that it designed homes in the Greater Toronto Area ("GTA"), the location of Mr. Mariani's new residence. Mrs. Voth became suspicious that Mariani Metal Fabricators was paying for the construction of Mr. Mariani's personal residence.

Mrs. Voth decided to meet with Mr. Mariani and other persons from Mariani Metal Fabricators, interviewing Mr. Mariani and others at the company's place of business on July 8, 2013. She made an interview plan, but it was unclear how closely she stuck to it. She asked questions about the bookkeeping practices of the company and its history, but did not alert anyone at the company about her suspicions that Mariani Metal Fabricators was paying for Mr. Mariani's personal expenses. The day after the interviews, without advising Mr. Mariani, Mrs. Voth drove past Mr. Mariani's residence.

On July 9, 2013, Mrs. Voth sent a letter to Mariani Metal Fabricators to ask for documents. She received documents from the company on July 23, 2013, including invoices from Capoferro to Mariani Metal Fabricators. The invoices stated that they were for work on the "Bow Project", and did not contain a description of the type of work that Capoferro had done. Mrs. Voth researched the "Bow Project" and discovered that it related to a large building project in Calgary. Her suspicions increased at this point, given that Capoferro's business was designing and building homes in the GTA, but she testified that, without additional documentation, she was still not in a position to refer the file to the CRA's investigation team.

From August to October 2013, Mrs. Voth went on leave, but upon her return began to consider imposing civil penalties on the company. In November 2013, Mrs. Voth asked Mariani Metal Fabricators for additional documents. The company's bookkeeper stated that there was nothing more to provide.

Mrs. Voth and her supervisor had a confrontational meeting with Mr. Mariani on December 12, 2013. It was at this meeting that Mr. Mariani learned of the CRA's intention to impose civil fines on the company. Mr. Mariani stated that he had proof that he had personally paid for his home renovations, but (although the Court indicated it was not sure why) neither Mrs. Voth nor her supervisor felt that such information was relevant to their audit.

After the meeting, Mrs. Voth and her supervisor visited Capoferro's office and spoke with one of the company's employees, who confirmed that Capoferro did work only in the GTA. A few days later, Mrs. Voth sent a formal request to Capoferro to provide the CRA with documents relating to Mr. Mariani and Mariani Metal Fabricators. Capoferro reluctantly provided a set of invoices to the CRA. These invoices looked different than the ones that Mr. Mariani had earlier provided, which Mrs. Voth thought indicated that the earlier invoices may have been altered.

On February 5, 2014, shortly after receiving Capoferro's invoices, Mrs. Voth referred the file to the CRA's criminal investigations department. She stated that she did so at this point because of the evidence that some invoices had been altered. The CRA investigations team obtained warrants and searched the offices of Mariani Metal Fabricators, Mr. Mariani's residence, and the offices of the company's accounting firm. They seized numerous documents, hard drives, and other electronic materials. Subsequently, Mr. Mariani and Mariani Metal Fabricators applied to Court, arguing that their Charter rights had been breached.

The Court decided that the predominant purpose of Mrs. Voth's actions related to civil tax liability, not criminal liability. As such, Mrs. Voth's use of sections 231.1 and 231.2 to obtain evidence did not breach the Charter rights of the accused. The Court offered the following analysis in support of its decision.

On factor (a), whether the authorities had reasonable grounds to lay a charge, and whether it appeared from the record that a decision to proceed with a criminal investigation could have been made, the Court was unable to conclude that charges could have been laid prior to February 2014. The Court emphasized that this factor plays a "limited role" on the overall assessment of predominant purpose. In the Court's view, the possibility should be left open in these situations for the CRA to pursue administrative penalties instead of criminal sanctions. Although reasonable grounds existed to refer this matter to criminal investigations by July 23, 2013, the Court stated that it was not unreasonable for Mrs. Voth to wait for additional documents that might reveal an innocent explanation in respect of her suspicions. The Court added that after July 23, 2013, Mrs. Voth obtained significant additional information, and even after the matter was referred to criminal investigations, charges were not laid for many months.

The Court's comments may suggest that there needs to be significant evidence of wrongdoing before factor (a) will support that a CRA audit has become a criminal investigation. Given the importance of the principle against self-incrimination in Canadian law, one might ask whether requiring a taxpayer to fully disclose all information relating to an audit until after there is substantial inculpatory evidence may leave the engagement of Charter protections too late.

On factor (b), whether the general conduct of the authorities was consistent with pursuit of a criminal investigation, the Court found that all of Mrs. Voth's actions were "very typical" of an audit. In response to the Applicants' arguments that a number of Mrs. Voth's actions were "covert in nature and could be viewed as taking on the flavour of a criminal investigation", the Court cited the proposition that "covertness, surreptition, and subterfuge designed to inculpate the

taxpayer are acceptable conduct in the regulatory enforcement of the [Act].” Taxpayers are expected to be forthright and honest carrying out their responsibilities under the Act. However, with respect, one might ask whether it is desirable to allow the CRA to abide by such a low standard of conduct in carrying out its functions of the Act.

On factors (c), (d), and (e), whether the auditor transferred the file to investigators or whether the auditor was acting as an agent of the investigator, the Court accepted that Mrs. Voth was being truthful in stating the predominant focus of her investigation was not criminal liability. The Court stated there was no evidence that anyone from the CRA’s investigations team knew about the file prior to its referral in February 2014. The Court also rejected the suggestion that Mrs. Voth intended to act as an agent for the CRA’s investigation team. The Court stated that “there was no benefit to [Mrs. Voth] continuing down the audit path because grounds clearly existed by July 23, 2013 to support obtaining search warrants for the remaining documents”. With respect to the Court’s comments on these factors, one might ask whether this logic could be used in CRA audits generally to justify not referring a matter to criminal investigations. Further, it is respectfully suggested that having reasonable grounds to obtain a search warrant should not be used as justification for opting to obtain the desired information without a search warrant.

On factor (f), the Court found that Mrs. Voth’s investigation did not focus on the Applicants’ *mens rea*, but rather on whether Mr. Mariani was claiming personal expenses as business expenses and, if so, what amount of taxes was really owed so that civil penalties could be imposed. However, one might ask whether some of the evidence that Mrs. Voth collected could have been used in combination with other evidence to establish the *mens rea* of the Applicants. Further, one might ask whether a CRA auditor should have to directly look for evidence of *mens rea* for this factor to support that an audit has become an investigation. Regardless of the answers to the above questions, the Court did not consider Mrs. Voth’s actions to have breached the Applicants’ Charter rights.

The Court did find, however, that CRA investigators had breached the Applicants’ section 8 Charter rights when searching Mr. Mariani’s residence and Mariani Metal Fabricators’ place of business. Although the CRA investigators had a warrant to search the data storage units in each location, the warrant did not permit the CRA investigators to perform the thorough search of the data storage units that they carried out. The Court therefore had to decide whether this breach of the Applicants’ Charter rights was serious enough to justify excluding the evidence at trial.

Applying the test in *Grant* (2009 SCC 32), the Court held that the Charter breach was not sufficiently severe to justify excluding the evidence under subsection 24(2) of the Charter. The *Grant* test involves analyzing three factors to determine whether admitting the evidence would “bring the administration of justice into disrepute”:

(1) the seriousness of the Charter-infringing state conduct,

(2) the impact on the Charter interests of the accused, and

(3) society’s interest in an adjudication of the case on its merits.

Considering the excessive search by the CRA officers, the Court concluded that the breach was at the “lower end of the continuum”, that the “impact of the Charter breach . . . was minimal”, and that there was a “strong societal interest in having these allegations tried on their merits”. The Court therefore decided not to exclude the evidence. The Court noted that “the CRA investigators honestly believed that the warrant permitted the search of the computers” and that “the CRA investigators appeared to have been acting in good faith and were not negligent in their conduct”. The Court’s holding indicates that a Charter breach of the taxpayer’s rights during a CRA investigation may not be fatal to having the evidence obtained by the breach admitted at trial.

As the above comments make clear, the *Mariani* reasons for judgment suggest that there may be considerable latitude for CRA auditors to use sections 231.1 and 231.2 of the Act in an audit even where there is likely sufficient evidence for a matter to be referred to the CRA’s criminal investigations team. The decision also shows that evidence obtained through a Charter breach in a CRA investigation may be admissible at trial. Whether this case represents a positive development, affirming CRA use of powers necessary to uphold the tax system, or a negative development, compromising the privacy rights of taxpayers, is a fair question. Based upon this decision, the CRA may have very broad authority to use its powers to ensure effective operation of the tax system.

— *Colton Dennis, Summer Student*

Federal Court of Appeal Rejects Taxpayer's Attempt To Claim Interest Deductions Pursuant to Subsection 16(1) and Paragraph 20(1)(*c*) of the *Income Tax Act*

***Plains Midstream Canada ULC v. The Queen*, 2019 DTC 5040 (Federal Court of Appeal)**

In this case, the Federal Court of Appeal ("FCA") was asked to consider the appeal of a decision of Hogan J of the Tax Court of Canada, *Plains Midstream Canada ULC* (2017 DTC 1125) ("*Plains*"). In *Plains*, the Tax Court dismissed the taxpayer's appeal of the Minister of National Revenue's denial of the taxpayer's interest deductions claimed for its 1995 and 1996 taxation years under paragraph 20(1)(*c*), pursuant to subsection 16(1) of the *Income Tax Act* (the "Act"). As discussed below, the FCA upheld the Tax Court's ruling on the basis that the amounts deducted by the taxpayer were not considered interest under subsection 16(1) of the Act.

In February of 1981, Dome Petroleum Limited ("Dome Petroleum") and its subsidiary, Dome Canada Limited ("Dome Canada"), entered into an agreement with the Arctic Petroleum Corporation of Japan ("APCJ"). APCJ provided a $400 million loan to Dome Petroleum and Dome Canada to fund exploration of oil and gas in the Beaufort Sea. The loan was not repayable until 2030. The agreement also imposed obligations on Dome Petroleum and Dome Canada "with regard to drilling, development and oil production activities in the Beaufort Sea". Dome Petroleum and Dome Canada were jointly and severally liable for the $400 million as well as for other obligations owing to APCJ. However, APCJ could look to Dome Petroleum first for the performance of the obligations as well as the repayment of the loan. In the event that either Dome Petroleum or Dome Canada became insolvent, APCJ could demand immediate repayment of the $400 million.

In March of 1981, Dome Petroleum and Dome Canada entered into a separate agreement whereby liability for the repayment of $225 million of the loan would be allocated to Dome Canada and liability for the repayment of the remaining $175 million would be allocated to Dome Petroleum.

In 1987, Dome Petroleum required debt relief due to financial troubles. Amoco Canada Petroleum Company ("Amoco") entered into an agreement for the purchase of Dome Petroleum by way of a Plan of Arrangement pursuant to the *Canada Business Corporations Act*. The Plan of Arrangement required the consent of both APCJ and Dome Canada.

Dome Canada was renamed Encor Energy Corporation ("Encor"). With the approval of Amoco, Dome Petroleum sold its shares in Encor for approximately $398 million to pay its creditors. While Encor would become an entity independent of Dome Petroleum following the sale of Dome Petroleum's Encor shares, both Encor and Dome Petroleum remained jointly and severally liable to APCJ. If either Dome Petroleum or Encor became insolvent, APCJ would still be entitled to look to Dome Petroleum first for the immediate repayment of the $400 million loan.

In order to eliminate the risk of having to immediately repay the $400 million loan in the event that Encor became insolvent, Amoco assumed Encor's joint and several obligations to APCJ as well as its liability to repay $225 million of the $400 million loan. In exchange, Amoco received $17.5 million from Encor and full subrogation of Encor's rights under the original agreement of February of 1981 with APCJ. Encor also agreed to vote in favour of the Plan of Arrangement and cooperate with Amoco in renegotiation of the original agreement with APCJ.

The taxpayer, Plains Midstream Canada ULC, is the successor to Amoco. The taxpayer sought to claim an interest deduction of $207.5 million, being the difference between the $225 million portion of the $400 million loan that Amoco assumed and the $17.5 million paid by Encor to Amoco. The taxpayer sought an annual interest deduction for the taxation years of 1995 and 1996 of $4,788,456 which equaled the total interest deduction amount of $207.5 million divided by 43 years, the period during which the loan was outstanding and payable by the taxpayer.

The Minister reassessed the taxpayer's income for its 1995 and 1996 taxation years by denying the interest deductions. The taxpayer appealed the reassessment to the Tax Court. Shortly before trial, the taxpayer changed its position and sought an annual deduction of $1,043,700, representing 5.964% of the $17.5 million paid by Encor to Amoco. The taxpayer did not adduce any evidence explaining why this interest rate was chosen, nor did it present evidence demonstrating the relevant prevailing interest rates.

The taxpayer conceded that the annual deduction of $1,043,700 claimed did not constitute interest payable to either APCJ or to Encor. The taxpayer argued that the fact the amount claimed did not constitute interest payable was not relevant in determining that the amount was interest under subsection 16(1) of the Act. The taxpayer argued that "the amount claimed as a deduction in economic substance is interest".

The taxpayer took the position that paragraph 16(1)(*a*) of the Act allowed it to characterize the $207.5 million as interest, since the $207.5 million reflected the time value of investing $17.5 million at 5.964% over 43 years. The taxpayer argued that had it not assumed Encor's liability to repay $225 million of the total $400 million loan to APCJ,

but instead invested the $17.5 million received by Encor with the promise to pay Encor the proceeds of that investment when Encor's $225 million portion of the loan became due to APCJ, the $207.5 million differential would constitute interest.

The Tax Court dismissed the taxpayer's appeal based on an interpretation of subsection 16(1) of the Act.

Referring to principles of statutory interpretation articulated in the Supreme Court of Canada decision *Canada Trustco Mortgage Co*. (2005 DTC 5523) ("*Canada Trustco*"), the Tax Court (*per* Hogan J) concluded that Parliament's intention when drafting subsection 16(1) was that both parties receive symmetrical treatment, in that the amount is interest for both parties. The Tax Court found that "the determination that an amount was interest had to be reasonable in light of the relevant circumstances surrounding the transaction at issue".

The Tax Court found that the interpretation of subsection 16(1) did not support the taxpayer's position that it could claim amounts as interest deductions while those amounts did not constitute interest amounts payable to either APCJ or Encor. The taxpayer suggested an application of subsection 16(1) that would result in asymmetrical tax treatment. Therefore, the Tax Court found that it was not reasonable to regard the amounts deducted by the taxpayer as interest.

The Tax Court rejected the taxpayer's claim that the $400 million repayable to APCJ constituted "compensation for the use of money". The Tax Court pointed out that Amoco had received more than merely the $17.5 million from Encor for assuming Encor's liability to repay APCJ $225 million of the total loan. Amoco received other consideration for assuming both Encor's liabilities and obligations to APCJ, including full subrogation of Encor's rights under the original agreement as well as Encor's consent to the Plan of Arrangement.

The Tax Court found that the taxpayer's claim that its deductions were in "economic substance" interest failed to consider this other consideration received by Encor in exchange for assuming Encor's liabilities and obligations to APCJ. The Tax Court concluded that the entire $400 million "constituted the repayment of capital owed to APCJ".

The FCA was asked to consider whether the Tax Court judge erred in finding that the $207.5 million did not constitute interest under subsection 16(1) of the Act. The FCA was also asked to determine the appropriate standard of review to be applied.

The FCA upheld the decision of the Tax Court and dismissed the taxpayer's appeal.

On the issue of the applicable standard of review, the taxpayer argued that since the appeal turned entirely on the Tax Court's "erroneous interpretation of subsection 16(1)", the standard of correctness alone applied (see *Housen v. Nikolaisen*, [2002] 2 S.C.R 235 ("*Housen*")).

The Minister argued that the words "reasonably regarded" in subsection 16(1) required an "objective review of the relevant facts and circumstances", and that the Tax Court's finding that it was not reasonable to regard the amounts deducted by the taxpayer as interest was subject to the palpable and overriding error standard (see *Housen*).

The FCA (*per* Nadon JA) agreed with the Minister, and stated as follows:

> Thus, in my view, the issue before us in this appeal is whether the Judge erred in finding that no portion of the $207.5 million differential could be regarded as interest under subsection 16(1). This raises both questions of law and questions of mixed fact and law. Hence, we must first determine, on the standard of correctness, whether the Judge properly interpreted subsection 16(1) and second, whether, on the palpable and overriding error standard, his application of the provision to the relevant facts warrants intervention on our part.

The taxpayer submitted that it was reasonable to find that the $207.5 million was interest under subsection 16(1) from Amoco's perspective, since repaying APCJ directly had the same economic effect as if Amoco paid Encor the time value of $17.5 million invested over 43 years, such that Encor could repay APCJ $225 million when the loan became due. In the taxpayer's view, the fact that the $225 million was repayable to APCJ and not to Encor since Amoco assumed Encor's liability did not affect the "economics" of the loan transaction.

The taxpayer argued that the Tax Court failed to consider the above reasoning, and "required symmetry when symmetry was not required" in applying subsection 16(1). Citing *Antosko* (94 DTC 6314 (SCC)) and *RCI Environment Inc*. (2009 DTC 5105 (FCA)), the taxpayer argued that symmetry would be required only if the "contracts or arrangements at issue were restricted to two parties". The taxpayer added that "subsection 16(1) applies to each individual party based on the economic effect to that party of the terms of the legal agreements it is a party to, and not based on the circumstances of another party to the agreement".

The FCA disagreed with the taxpayer, stating that the taxpayer's arguments flew "in the face of commercial and legal reality". The FCA found that the Tax Court did not err in concluding that the $207.5 million did not constitute interest under subsection 16(1) and therefore could not be deducted under paragraph 20(1)(*c*) of the Act.

Citing *Canada Trustco*, the FCA stated that the ordinary meaning of the words used by Parliament must be given a dominant role in interpreting a provision where the words of the statute are "clear and unequivocal". Based on an interpretation of subsection 16(1) of the Act, the FCA found that the amount claimed as interest by a party must also be reasonably regarded as interest by the recipient of that amount. The FCA upheld the Tax Court's finding that symmetry was required for the application of subsection 16(1).

After finding that the Tax Court did not err in its interpretation of subsection 16(1), the FCA determined that the Tax Court did not make a palpable and overriding error in finding that the $207.5 million could not reasonably be regarded as interest.

The FCA found the Tax Court's determination that the $207.5 million was not interest under subsection 16(1) "unassailable", as it was not interest from the perspective of either APCJ or Encor. The FCA agreed with the Tax Court's finding that the taxpayer failed to include the consideration that Amoco received from Encor in addition to the $17.5 million when it characterized the deductions as interest. The FCA also agreed with the Tax Court's finding that the taxpayer failed to adduce satisfactory evidence of its accounting treatment showing that the $207.5 million interest reflected the time value of investing $17.5 million over 43 years.

This case illustrates that the application of subsection 16(1) of the Act must result in symmetrical tax treatment. An amount will be considered interest under subsection 16(1) and thus deductible under paragraph 20(1)(*c*) only if it can reasonably be regarded as interest to both the party deducting the interest amount and the party receiving the interest payment. The taxpayer was unsuccessful in claiming interest deductions for its 1995 and 1996 taxation years, as the amounts deducted were not interest payments received by another party. A subsection 16(1) issue is that of mixed law and fact. The FCA in this case found, in applying the correctness standard, that the Tax Court judge did not err in his interpretation that the application of subsection 16(1) required symmetrical tax treatment. The FCA also found that the Tax Court judge, in applying subsection 16(1) to the relevant facts and circumstances, did not make a palpable and overriding error in finding that the amounts deducted by the taxpayer could not reasonably be considered as interest.

— *Nishant Jain, Summer Student*

RECENT CASES

Section 237.1 compliance order varied to require taxpayer to deliver requested tax records to Minister

In the course of a lengthy dispute and ensuing litigation between the taxpayers and the Canada Revenue Agency ("CRA"), a Compliance Order was issued under section 237.1 of the *Income Tax Act* (the "Act") requiring that the taxpayers provide certain documents to the Minister in connection with an audit. A dispute arose between the taxpayers and the Minister as to the obligations of the taxpayers under that order, with the taxpayers taking the position that the Minister was required to attend at their offices for the purpose of reviewing the documents. The Minister applied to the Federal Court seeking an order requiring the taxpayers to deliver the particular documents to the Minister at her place of business.

The application was allowed and an order issued as requested. The Federal Court held that the issue for determination was whether, when a taxpayer is required "to provide" documents to the CRA, such documents must simply be made available by the taxpayer, or whether the taxpayer must physically deliver them to the auditors. It noted that the term "provide" is not defined in section 237.1 of the Act and that such word could include various appropriate methods of "providing" information and documents to the CRA depending on the circumstances. The Court reviewed the history and circumstances of the litigation and noted that there had been a history of non-cooperation by the respondents, such that the Minister had been attempting for over five years to carry out an audit, which the respondents had resisted "at every turn". The Court reviewed the circumstances of the Minister's audit in light of factors set out in the jurisprudence with respect to section 237.1. The Court noted that, in particular, the factors of the unknown state of the records and the taxpayers' lengthy tax history, as well as the Minister's entitlement to determine the scope, manner, course, and direction of an audit led it to conclude that the Minister was entitled to delivery of the records sought. In addition, past orders of the Federal Court had held that "to provide" may mean the delivery of taxpayer documents to the CRA. The applicant Minister's motion was therefore granted, and the respondents were ordered to provide the requested material by delivery via courier pick-up, at the Minister's expense.

Canada (MNR) v. Ciciarelli

2019 DTC 5107

Supreme Court of Canada affirms Quebec Court of Appeal's decision that formal demand for documents sent to Alberta by the QRA is not *ultra vires*

This is an appeal from a decision rendered by the Quebec Court of Appeal affirming a previous decision of the Quebec Superior Court. During the audit of a trust, the Agence du Revenu Du Québec ("QRA") issued a formal demand to the National Bank of Canada to produce documents ("the Demand"). In accordance with the *Bank Act*, the Demand was sent to the branch where the account of the client is located, in Alberta. Both the Quebec Superior Court and Quebec Court of Appeal (2018-PTC-QC-12) ruled in favour of the QRA. The decision was appealed to the Supreme Court of Canada ("SCC").

The appeal was dismissed. The issue was whether or not sending the Demand to Alberta rendered the action of the QRA extraterritorial and, therefore, *ultra vires* and invalid. The SCC framed the issue as whether or not subsections 462(1) or (2) of the *Bank Act* applied and, given the answer, did the QRA act extraterritorially in sending the Demand? The appellant argued that subsection 462(1) was applicable and the respondent stated that the Demand had been sent in accordance with subsection 462(2). The question was whether the requirements of the *Bank Act* resulted in the National Bank and its Alberta branch being considered as two distinct entities. The SCC found that subsection 462(1) did not apply, disagreeing with the appellant's position. The purpose of subsection 462(1) is to set out the preconditions for binding customer property held by the bank, either in the form of valuable assets or bank account debt. The text of subsection 462(1) applies to a specific list of documents and affects the assets or debts of the client. The Demand is not included in the enumerated documents in paragraphs 462(1)(*a*) to (*d*) nor does it seek to "bin[d]. . . property belonging to a person and in the possession of a bank", or "money owing to a person by reason of a deposit account in a bank", as stipulated in subsection 462(1). Thus, subsection 462(1) does not apply to the Demand, which is not extraterritorial. Subsection 462(1) only applies in very specific circumstances (not applicable in this case), with the effect of considering National Bank and its branches as separate entities. The appellant contended that the Demand qualified as a "writ or process" document listed in subsection 462(1). The SCC disagreed. Indeed, "writ" and "process" (terms which the appellant argued applied to the Demand) refer to documents issued by courts or as part of court proceedings. A document issued by an administrative agency, in this case the QRA, is not a writ or process. The Court agreed with the respondent that subsection 462(2), a residual provision applicable where 462(1) or (3) did not apply, applied. Subsection 462(2) intends to provide the requirements for notifying a bank when sending documents other than those listed in 462(1) and (3). The Demand is consistent with subsection 462(2)'s concern with practical convenience for the QRA to send the Demand to the Calgary branch of the National Bank, as this is where some of the requested documents are located. Accordingly, the QRA properly sent the Demand to National Bank. This does not change the fact that the National Bank is a single entity operating in Quebec; its branches being treated as distinct only for limited and specific purposes. The wording of subsection 462(2) does not carve out an exception to the Branch Entity Rule because the rule does not operate in the circumstances. The destination of the Demand does not change the party to whom the Demand is made (i.e., the National Bank). It doesn't matter where the letter is sent. Alternatively, the appellant argued that sending the Demand to Alberta amounts to an exercise of coercive power outside of the province. The SCC found that it is a sounder approach to focus on the place where enforcement of the Demand may be sought as the determinative point in characterizing the exercise of the coercive power at issue. In this case, both the consequences of a failure to comply and the potential enforcement of the Demand can only be effected in Quebec. Accordingly, the SCC ruled that sending the Demand to Calgary did not render it extraterritorial or *ultra vires* and the appeal was dismissed.

1068754 Alberta Ltd. v. Quebec

2019 DTC 5108

Orders issued setting out procedure for review of materials for which solicitor-client privilege claimed

In 2016, search warrants were issued in connection with allegations that certain individuals (the respondents) had committed criminal offences under the *Income Tax Act*. In the course of the execution of those warrants electronic materials were seized, and solicitor-client privilege was then claimed over all such materials. The search was then suspended by Court order, pending the identification and isolation of solicitor-client privileged materials. The Canada Revenue Agency ("CRA") applied to the Court for an order permitting its Certified Forensic Analysts to process the electronic documents. Such application was opposed by the respondent and by the Intervenor Law Society of British Columbia, which both took the position that the procedures and order sought by the Crown did not adequately protect the claimed solicitor-client privilege. The respondent instead sought an order providing for the appointment of an

independent referee and an independent computer forensic technician to take possession of, review, and isolate the disputed documents.

An order was issued setting out procedures for the review of materials for which solicitor-client privilege was claimed. The Court held first that the issue for determination was what persons and procedures it should order for the identification, isolation, and storage of solicitor-client privileged materials, so that privilege was "minimally impaired" and remained "as absolute as possible". The Court reviewed the jurisprudence on those issues and, based on that review and on the circumstances of the seizure of the material, it held that the respondents and their counsel were best suited to identify solicitor-client privileged materials and that no independent referee was required. In the Court's view, it was also advisable to appoint an independent technician with expertise in forensic computing to then perform the isolation process. In the Court's view, this would allow for a secure, efficient, and reliable separation of solicitor-client privileged materials. Following that isolation process, the non-privileged materials were to be transferred by the technician to the CRA. Finally, the Court held that once a copy of the seized material had been provided to the independent technician and another filed with the Court, the seized materials were to be deleted in their entirety from the CRA's computer systems and the originals returned to the respondents.

Solicitor-Client Privilege of Things Seized (Re)

2019 DTC 5106

Application for judicial review of denial of taxpayer relief with respect to OETC dismissed

A number of employees worked for a Canadian post-secondary institution at its campus in Qatar and the question of whether such employees were eligible for the overseas employment tax credit ("OETC") arose. One such employee, whose claim for the credit was denied, appealed to the Tax Court of Canada and, in 2016, his appeal was allowed. Thereafter, numerous employees of the institution filed adjustment requests with respect to their tax returns for various years in order to claim the OETC. Those employees sought taxpayer relief pursuant to subsections 152(4) and 152(4.2) of the *Income Tax Act* (the "Act") to allow the OETC to be claimed for taxation years ranging from 2003 to 2010. Such requests were refused and the employees sought judicial review of that denial, arguing that the Minister's delegate had failed to apply the decision of the Tax Court of Canada. Their applications were consolidated for case management purposes.

The application was dismissed. The Federal Court held that the sole issue on the application was whether the decision made to deny taxpayer relief was reasonable and the Court concluded that it was. The Court held that the decision made not to apply, on a retroactive basis, a subsequent judgment of the Tax Court on the question of eligibility for the OETC was consistent with Canada Revenue Agency ("CRA") policy, which provided that the CRA did not perform reassessments or issue refunds in circumstances where the taxpayer's request was based on a successful appeal by another taxpayer. Such policy, which had been found by an appellate Court to be consistent with subsection 152(4.2) of the Act, was adopted by the CRA in connection with both requests made during the taxpayer's normal reassessment period and with requests applicable to statute-barred years. The Federal Court held as well that the judgement demonstrated that the decision maker was aware of the circumstances of the applicants. The Federal Court concluded that while it may have been available for the decision maker to depart from the policy based on the applicants' circumstances, it could not find that the decision not to do so was outside the range of acceptable outcomes based on the facts and the law. The decisions made were reasonable and the application for judicial review of those decisions was therefore dismissed.

Adey v. Canada (AG)

2019 DTC 5105

Appeal from denial of scholarship exemption for fellowship income received dismissed

In 2013, following completion of his doctorate, the taxpayer accepted a research position with Atomic Energy of Canada Limited ("AECL") which provided him with a post-doctoral fellowship in the amount of $56,100. He later filed a T1 adjustment to amend his 2013 tax return to claim the scholarship exemption with respect to such fellowship income. The Minister accepted that $500 of that fellowship qualified as a scholarship exemption, but that the balance did not. The taxpayer appealed from that determination. He argued that while AECL did not provide an educational program, the research conducted at AECL was educational study related to his doctoral program and that the fellowship amount was paid in connection with that program.

The appeal was dismissed. The Tax Court of Canada held that the assumptions of fact on which the reassessment was made were, for the most part, agreed to by the parties. The issue for determination was whether, as required by the *Income Tax Act*, the appellant had received the fellowship amount in connection with his enrolment in an educational program in respect of which he could claim an education tax credit. The Court noted that, under the relevant statutory provisions, a fellowship is not considered to be received in connection with the taxpayer's enrolment in an educational program except to the extent that the fellowship is intended to support the taxpayer's enrolment in that program. The Court reviewed both the appellant's educational history in light of the requirements for claiming an education tax credit and the terms of the offer made to the appellant by AECL. Based on that review, the Court concluded that, while the doctoral program completed by the appellant would qualify for the education tax credit, the fellowship was not, as required, paid or received in connection with that qualifying program. Consequently, the statutory requirements for the claimed exemption had not been met, and the appeal was dismissed.

Ismail v. The Queen

2019 DTC 1119

Appeal from denial of third party claim to holdback amounts dismissed

The corporate taxpayer entered into an agreement with Saskatchewan Power ("SaskPower") to act as general contractor in a construction project. Invoices were rendered and progress payments made, less a 10% builders' lien holdback. The corporate taxpayer then entered into a Factoring Agreement under which its accounts receivable were assigned to a third party. That third party eventually sought payment of the holdback amounts from SaskPower, and the Minister of National Revenue claimed priority over such amounts. The amounts were paid into Court and an application made for a determination of the respective rights of the parties. On that application, the Chambers judge held that the subcontractors had priority over both the third party and the Minister, and that the disputed amounts should be paid to the subcontractors on a *pro rata* basis. The Minister of National Revenue did not pursue an appeal, but the third party appealed from the decision of the Chambers judge to the Saskatchewan Court of Appeal.

The appeal was dismissed. The Saskatchewan Court of Appeal held that the sole issue in the appeal was whether the assignment by the company to the third party defeated the claim of the subcontractors which arose under subsection 70(2) of the *Builders' Lien Act* (the "BLA"). In the appellate Court's view, the outcome of the appeal turned on the interpretation of that provision, which stated that no assignment was valid as against a lien arising under the BLA. The Court reviewed the wording of the provision as well as its purpose and intent before concluding that it was in complete keeping with the specifics of the lien and holdback features of the BLA's statutory scheme to interpret the provision as encompassing absolute assignments of holdback monies. The Court noted that subsection 70(2) did not prevent the assignment by a contractor of its accounts receivable; it stated simply that such assignment is not effective against lien claimants. It remained open to a factor to purchase the accounts receivable, but required it to be aware that such accounts receivable may be subject to the overarching rights of lien claimants. As well, in the Court's view, the contrary interpretation argued for by the appellant, that absolute assignments should be excluded from the scope of the provision, would frustrate rather than promote the legislative purposes of the statute and would also run counter to the specific statutory regime designed to achieve those objectives. The Court concluded, therefore, that all dimensions of the modern principle of statutory interpretation led to the conclusion that subsection 70(2) was properly understood to encompass absolute assignments. The appeal was therefore dismissed.

Liquid Prairie v. Mainline Industrial

2019 DTC 5104

Application for judicial review of administrative decision denying interest relief dismissed

The matter covered in this case spans a period of some 35 years. As early as 1984 the Applicants subscribed to limited partnerships promoted and marketed by the Overseas Credit and Guaranty Corporation ("OCGC"). OCGC claimed the partnerships were an opportunity to invest in a luxury yacht chartering business with attractive tax advantages and with limited personal risk. This business, known as "Fantaseas", turned out to be a sham. Some 600 investors were involved in a reassessment process that began in 1986 and resulted in reassesssments disallowing all losses, interest, and professional fees claimed by the Applicants. Various settlement proposals were offered from 1994 to 2004. Approximately 300 investors settled and the others appealed the assessments in 1991. Following disposition of the Tax Court appeals in January 2014, numerous Applicants requested relief under subsection 220(3.1) of the *Income Tax Act* (the "Act"), citing, as their main reason, delay by the Canada Revenue Agency (the "CRA"). The matter was reviewed

twice with some interest relief being granted. This case relates to an application for judicial review of a third review where the Applicants claimed they should receive further interest relief based on expanded detailed arguments. In 2018, the Delegate denied the Applicants' requests for further relief from arrears interest, which resulted in this Application for judicial review.

The Applications were dismissed. For the third review, the Applicants claimed they should receive interest relief because: (i) the first level review only considered delay; (ii) of the overall delay and other considerations of fairness; (iii) the CRA had repudiated the 1994 settlement; (iv) they were not made aware of balances owing before 1990; (v) the criminal proceedings took priority over the Applicants' interests; and (vi) other taxpayers in other tax schemes had their interest cancelled. In a letter dated April 23, 2018, the Delegate denied the Applicants' requests for further relief from arrears interest. Accordingly, the Applicants filed for judicial review of the decision. The standard of review of such decision is reasonableness. The reasonableness standard tasks the Court with reviewing an administrative decision for "the existence of justification, transparency and intelligibility within the decision-making process" and determining "whether the decision falls within a range of possible, acceptable outcomes which are defensible in respect of the facts and law". The Court agreed with all of the arguments of the Respondent, including accepting that the sheer quantity of the delays did not automatically warrant interest relief. The Federal Court also ruled that the Delegate reasonably considered the length of the delays and recognized that certain time periods were not appropriate for interest relief and others had already been accounted for in the earlier reviews. All in all, the Federal Court found the Delegate's analysis of the Applicants' requests for further interest relief was reasonable. The reasons for the decision are intelligible, transparent, and justifiable, and the decision falls within a range of possible, acceptable outcomes defensible in respect of the facts and law. Furthermore, the Court agreed with the Respondents that there were no circumstances beyond the Applicants' control which prevented them from complying with their obligations to pay tax. Finally, the Federal Court ruled that comparisons to the KPMG Untouchables or the GLGI donors are neither factually relevant nor legally permissible. Therefore, the Delegate's decision in this case was reasonable. The Applicants' applications for judicial review were, accordingly, dismissed.

Bailini et al. v. The Queen, CRA, and Canada (AG)

2019 DTC 5103

Application for judicial review of denial of cancellation of tax and interest on TFSA overcontribution allowed

In 2016, the taxpayer made a $10,000 contribution to his tax-free savings account ("TFSA") which was within his allowable contribution limit. Owing to miscommunications and subsequent errors on the part of his financial institution, such contribution was made three times during 2016, putting the taxpayer into an over-contribution position. He became aware of that fact only in July 2017 when he was assessed an overcontribution penalty of $1,784.60. He then withdrew the excess contribution amount and made a request for relief from the tax and penalties resulting from such excess contribution. Such request was refused, both initially and on review, and the taxpayer applied for judicial review of that refusal.

The application was allowed. The Federal Court held that the standard for review of a discretionary decision by the Minister or the Minister's delegate was a deferential, reasonableness standard, and that the decision made did not meet that standard. The Court held that the over-contributions arose due to miscommunications between the applicant and his financial institution and subsequent mistakes made by that financial institution that were outside of the applicant's control. In the Court's view, the decision of the Minister's delegate was unreasonable because it did not fully assess the extent to which the excess contributions resulted from the mistakes of persons other than the applicant. The application was therefore allowed. The decision was set aside and the matter was returned to the Minister for re-determination by a different delegate.

Gekas v. Canada (AG)

2019 DTC 5102

Statutory amendments requiring release of taxpayer information by financial institutions not contravening Charter

Amendments were made to the *Income Tax Act* to implement an intergovernmental agreement made between the Canadian and US governments. Such amendments mandated the release of information by Canadian financial institutions to the Canada Revenue Agency with respect to customers whose account information suggested that they might be "US persons". Two individuals challenged the provisions in the Federal Court, arguing that they were unconstitutional in that they breached the section 8 and 15 *Canadian Charter of Rights and Freedoms* ("Charter") rights of affected persons.

The action was dismissed. The Federal Court held that the plaintiffs had standing to bring the action and that it possessed jurisdiction to hear it. On the substantive question of the alleged breach of Charter rights, the Court held that neither the section 8 nor the section 15 rights of affected individuals were breached. With respect to section 8, the Court held that the individuals had a limited privacy right in their banking records, that the method used to collect the information was minimally invasive, and that the information shared was afforded protection under the Canada–U.S. Tax Treaty. The Court concluded, therefore, that the seizure of banking information contemplated by the impugned provisions was reasonable and did not violate section 8. With respect to the section 15 challenge, the Court held that the impugned provisions did not violate the norm of substantive equality outlined in section 15, nor did they involve the denial to one group of protections that were basic or necessary for full participation in Canadian society. The plaintiffs had not established that the impugned provisions violated Charter rights and their action was therefore dismissed.

Deegan v. Canada (AG)

2019 DTC 5099

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