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Tax Notes

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COMMON REPORTING STANDARDS IN CANADIAN TAX

- –Ron Choudhury, Miller Thomson LLP

The Organisation for Economic Cooperation and Development has developed certain common reporting standards with respect to accounts held in financial institutions. Its member countries have been engaged in adopting the common reporting standards ("CRS") into their domestic legislation as a means of combatting tax evasion through reporting and compliance. Canada implemented the CRS by enacting the reporting requirements into the *Income Tax Act* (Canada) (the "Tax Act"). The rules came into force as of July 2017 and are now being actively used by Canadian financial institutions to seek information about accounts opened or held by Canadians.

This article provides a brief summary of the CRS rules and discusses their impact on account holders with Canadian financial institutions. The due diligence requirements themselves are not discussed here as such requirements are likely to be addressed by Canadian financial institutions through detailed forms provided to clients. This article focuses on the types of accounts that may need reporting, specific exemptions from reporting, and the impact on account holders.

WHO REPORTS?

Part XIX of the Tax Act implements the CRS. Pursuant to subsection 271(1) of the Tax Act (the operative provision in Part XIX), a reporting financial institution must report certain information to the Canada Revenue Agency with respect to each of its reportable accounts. Most Canadian financial institutions will be reporting financial institutions. Government entities, retirement and pension funds, international organizations, and qualified credit card issuers comprise a narrow group of organizations that are not financial institutions.

REPORTABLE ACCOUNTS

A "reportable account" is defined in subsection 270(1) of the Tax Act to mean an account held by one or more reportable persons or by a passive non-financial entity ("NFE"), if one or more controlling persons of the passive NFE is a reportable person. In addition and pursuant to paragraph (b) of this definition, a "reportable account" may be an account that has been identified as meeting the conditions in paragraph (a) (as described immediately above) in accordance with due diligence procedures described in sections 272 to 277.

A number of defined terms in Part XIX of the Tax Act are used within the definition of reportable account. They are as follows:

- "Reportable person" means a reportable jurisdiction person other than listed corporations and corporations related to such corporations, governmental entities, international organizations, central banks, and financial institutions.
- "Reportable jurisdiction person" means, *inter alia*, a natural person or entity that is resident in a reportable jurisdiction under the tax laws of that jurisdiction.
- "Reportable jurisdiction" means a jurisdiction other than Canada or the USA.
- "Passive NFE" is defined, *inter alia*, as a non-financial entity that is not an active NFE. Active NFE contains an extensive definition in subsection 270(1) that is not repeated here.

- "Controlling persons" means, in respect of an entity, the natural persons who exercise control over the entity and includes, in the case of a trust, its settlors, trustees, protectors, and beneficiaries. In any other case, a controlling person is a person in equivalent or similar positions to those described above.

Subsection 271(1) also requires information in respect of custodial accounts and depository accounts. A custodial account is an account (other than an insurance contract or annuity contract) that holds one or more financial assets for the benefit of another person. A depository account is any commercial, chequing, savings, time, or thrift account, or an account evidenced by certain certificates issued by a financial institution in the ordinary course of its banking business. An amount held by an insurance company under a guaranteed investment contract is also a depository account. Each term is defined in subsection 270(1) of the Tax Act.

Section 272 of the Tax Act provides that an account may be treated as a reportable account if it is identified as such under certain due diligence procedures identified in sections 273 to 277. Section 273 contains due diligence rules for pre-existing individual accounts while section 274 contains due diligence rules for new individual accounts. Sections 275 and 276 contain the parallel rules for entity accounts.

INDIVIDUAL ACCOUNTS

The due diligence requirements for individuals have been divided into requirements for lower value and high value accounts. A lower value account is defined as a pre-existing individual account with an aggregate balance or value as of June 30, 2017, not exceeding US$1 million. Each pre-existing account must be reviewed before 2019 in the case of a high value account or before 2020 if the account is a lower value account. The due diligence requirements are significant and are designed to determine the residence of the account holder for tax purposes and confirm the reasonableness of any self-certification by the account holder.

ENTITY ACCOUNTS

In the case of pre-existing entity accounts, no due diligence is required for such accounts with an aggregate account balance or value that does not exceed US$250,000 on June 30, 2017. However, a financial institution may elect otherwise, either with respect to all pre-existing entity accounts or with respect to clearly identified groups of accounts. Reportable accounts in this context are accounts held by entities that are reportable persons or passive NFEs with one or more controlling persons that are reportable persons. A pre-existing entity account must be reviewed by 2020, if the account has an aggregate balance or value exceeding US$250,000 on June 30, 2017, or by the end of the calendar year following the year in which the aggregate account balance exceeds US$250,000 on December 31.

No restrictions are provided on the due diligence requirements for new entity accounts.

SPECIAL RULES

Section 277 of the Tax Act contains certain special rules with respect to the due diligence requirements under the CRS. Subsection 277(1) states that a financial institution may not rely on self-certification or documentary evidence if it has knowledge or has reason to know that the self-certification or documentary evidence is incorrect or unreliable. Subsection 277(2) states that a financial institution may presume that an individual beneficiary (other than the owner) of a cash value insurance contract or an annuity contract receiving a death benefit is not a reportable person and may therefore treat the financial account as a non-reportable account unless it has actual knowledge or reason to know that the beneficiary is a reportable person.

Subsection 277(3) contains rules for determining the aggregate value or balance of a financial account. These rules require the aggregation of all financial accounts maintained by a financial institution or related entity but only to the extent that the institution's computerized systems link the accounts by reference to a data element (e.g., TIN) and allow account balances or values to be aggregated. In addition, each holder of a jointly held financial account must be attributed the entire balance or value of such account.

REPORTING REQUIREMENTS

Reporting financial institutions are required to report each reportable account maintained by the institution at any time in the preceding calendar year and after June 30, 2017. The report (in the form of an information return) must be filed prior to May 2 of the relevant calendar year. In addition, the financial institution must retain all records obtained or created for the purpose of complying with Part XIX of the Tax Act, including self-certification and documentary evidence. The records must be retained for at least six years from certain specified dates.

Section 280 contains an anti-avoidance provision stating that if a person enters into an arrangement or engages in a practice, the primary purpose of which can reasonably be considered to be the avoidance of an obligation under Part XIX, the person shall be subject to that obligation.

IMPLICATIONS FOR ACCOUNT HOLDERS

As may be evident to most, tax administrators across the world are increasingly sharing information about individuals and entities in an effort to combat tax evasion (and in some instances, money laundering). The CRS is another instance of the extensive information being gathered by tax administrators around the world and being shared with other jurisdictions. The obvious concern with such laws is privacy and the extent to which personal information may be shared by tax administrations like the Canada Revenue Agency with non-Canadian organizations. However, and quite apart from any privacy concerns, the use of CRS also leads to some tax issues.

Financial institutions are the intermediaries in CRS. In an effort to please tax administrators and provide the information sought, some Canadian financial institutions have been known to be over-zealous in seeking information. There seems to be a lack of understanding among these institutions about the process and the requirements. Given that the financial institutions have no incentive to determine the exact scope of the information sought and do not wish to fall afoul of tax authorities, excessive and unrequired information is being procured and provided.

Individuals and entities subject to CRS are also being required to provide personal information that would not previously be provided to financial institutions and taxing authorities. While the requirement for such information is necessary to combat tax evasion, the privacy concerns raised previously and the lack of policies or guidance with respect to the use, dissemination, and sharing of such information will be concerning to all parties. To that extent, CRS may compromise the personal information of many individuals and entities in order to apprehend the few that may be engaging in tax evasion. Tax authorities like the Canada Revenue Agency must develop robust policies and practices for the use and dissemination of such information.

Nevertheless, CRS is now part of the Tax Act and is here to stay. Individuals and entities must carefully consider the implications of providing personal information prior to opening accounts with financial institutions. Most such institutions can be expected to aggressively seek such information without regard to the impact of obtaining or providing the same. Accordingly, it is incumbent upon the persons impacted to consider the potential consequences of providing such information. While combatting tax evasion is a laudable goal, most individuals and entities with accounts at financial institutions are not engaged in tax evasion and would not wish their personal information shared with one or more tax authorities.

CURRENT ITEMS OF INTEREST

TAX RELIEF FOR LIVESTOCK PRODUCERS

On February 26, 2018, Agriculture and Agri-Food Canada published its list of designated regions in which livestock producers are eligible for the livestock tax deferral provision in 2017. Livestock farmers in these regions can defer a portion of their proceeds from selling their breeding livestock in 2017 until 2018 under subsection 80.3(4). On June 25, 2019, a Canada Gazette publication (SOR/2019-247) officially amended Reg. 7305.01(1) by adding these prescribed regions for 2017.

ONTARIO COURT OF APPEAL FINDS GREENHOUSE GAS ACT CONSTITUTIONAL

On June 28, 2019, the Ontario Court of Appeal released its decision in *Reference re Greenhouse Gas Pollution Pricing Act*, 2019 ONCA 544. By a four-to-one verdict (Strathy CJO for the majority and Huscroft JA in dissent), the Court of Appeal concluded the federal *Greenhouse Gas Pollution Pricing Act* was within the constitutional powers of Parliament. The Ontario government has indicated it will seek leave to appeal the decision to the Supreme Court of Canada.

PRESCRIBED INTEREST RATES FOR Q3

The CRA has published the prescribed interest rates for the third calendar quarter of 2019. These rates apply to amounts owed to the CRA and amounts that the CRA owes to corporate and individual taxpayers. The only change from the second quarter is the rate applicable to pertinent loans or indebtedness, which is 5.67% in Q3 (up from 5.63% in Q2).

PROGRESS OF LEGISLATION

On June 21, 2019, the following bills received Royal Assent:

- C-82, *Multilateral Instrument in Respect of Tax Conventions Act* (S.C. 2019, c. 12)
- C-97, *Budget Implementation Act, 2019, No. 1* (S.C. 2019, c. 29)

GOVERNMENT RELEASES EMPLOYEE STOCK OPTION LEGISLATION

In Budget 2019, the federal government announced that it intends to cap the $^1/_2$ deduction for employee stock option benefits at $100,000. The Liberal government's 2015 election platform included a promise to cap the stock option deduction, but it abandoned this proposal in the months following the election. The 2019 Budget surprisingly resurrected this tax promise, and on July 17, 2019, the government released draft legislation for consultation.

Employee stock options granted on or after January 1, 2020, will be subject to the new rules. The cap is equal to $200,000 per vesting year. However, rather than being based on the stock option benefit, the cap is based on the fair market value of the securities underlying the option at the time it is granted (at least based on the examples in the technical backgrounder). The cap will not apply to employees of a CCPC. The proposed rules will also not apply to start-up companies, and the government is consulting the public on the matter of what rules should be used to determine whether a company is a start-up. Comments should be submitted by September 16, 2019.

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.

ALLEGATIONS OF WRONGFUL CONDUCT BY CRA OFFICIALS EXCLUDED FROM SCOPE OF APPEAL

***Brooks v Her Majesty The Queen*, 2019 DTC 1044 (Tax Court of Canada)**

This is a decision on a motion brought by the Minister in the Tax Court to strike certain paragraphs in the taxpayer's Notice of Appeal. The question raised by the motion was the extent to which the Tax Court has jurisdiction to provide relief in respect of improper conduct by CRA officials or violations of the *Canadian Charter of Rights and Freedoms* (the "Charter"). As discussed below, the Tax Court confirmed that while it may consider Charter-related questions when evaluating the admissibility of evidence at trial, the Court's power in connection with the disposition of an appeal is limited by statute to issuing a decision to dismiss, vary, or vacate the Minister's assessment. The Court has no jurisdiction to award damages or grant other remedies in relation to either CRA misconduct or Charter violations alleged by the taxpayer.

The taxpayer, Mr. Brooks, filed an appeal in the Tax Court to dispute the Minister's reassessment that was issued beyond the normal reassessment period to assess income tax and penalties attributable to unreported business income. The taxpayer's Notice of Appeal contained allegations with respect to the conduct of CRA personnel and contested the admissibility of certain evidence on the basis that it was gathered in violation of his rights against self-incrimination and unreasonable search and seizure under sections 7 and 8 of the Charter. The Notice of Appeal also asserted that, as a consequence of the Charter violations, the taxpayer was entitled to relief pursuant to section 24 of the Charter.

The Crown brought its motion to strike those paragraphs in the taxpayer's Notice of Appeal that were relevant to the taxpayer's allegations concerning the conduct of CRA personnel and violation of the taxpayer's Charter rights.

The Tax Court first addressed the paragraphs that described CRA misconduct. The Court reaffirmed the principle that the conduct of CRA personnel is not normally relevant to the determination of the correctness of an assessment, which is the question in a tax appeal. In the taxpayer's Notice of Appeal for this case, it was alleged that the conduct of the CRA officials violated his sections 7 and 8 Charter rights. However, unless the taxpayer is able to establish that the Charter claim had a reasonable chance of success at trial (which is the question the Court considered next), the Minister was entitled to have the paragraphs addressing the conduct of the CRA officials struck from the taxpayer's Notice of Appeal. To the extent that a taxpayer is seeking legal recourse in respect of the improper conduct of CRA officials, the appropriate avenue is to seek relief through proceedings in another court, such as an action in tort for damages or judicial review.

The Tax Court then considered the paragraphs that were relevant to the taxpayer's position that evidence collected by the CRA should be excluded due to violations of the taxpayer's rights under sections 7 and 8 of the Charter. The Tax Court found that the conduct of CRA personnel during an audit (rather than a criminal investigation) cannot lead to a violation of the taxpayer's sections 7 and 8 Charter rights. Canadian jurisprudence has made an important distinction between the rights of the taxpayer during a tax audit versus a tax-related criminal investigation. A taxpayer may have its Charter rights violated if the Minister is using its compulsion powers to collect information when it is a criminal investigation disguised as an audit. However, to date, the Canadian courts have not held that those Charter rights can be breached where the predominant purpose of the inquiry is the determination of the liability for tax, even if it began as a tax-related criminal investigation. Consequently, the Tax Court held that there is no possible Charter rights violation here since the appeal in the Tax Court did not engage potential criminal liability and, therefore, the paragraphs in the taxpayer's Notice of Appeal relevant to the alleged Charter violations should also be struck.

The question of whether the Tax Court may grant remedies for Charter rights violations under section 24 of the Charter was moot since the Court struck the paragraphs from the Notice of Appeal that purported to support a Charter breach. The Tax Court still felt compelled to address this issue, as *obiter*, since the taxpayer raised the issue as part of its case in the motion. The taxpayer asserted that the Supreme Court of Canada's decision in *R. v. Conway* (2010 SCC 22), a non-tax case, supported the proposition that specialized tribunals such as the Tax Court have the power to grant remedies pursuant to section 24 of the Charter independently from the tribunal's powers granted by its enabling legislation. The Tax Court disagreed with the taxpayer and concluded that the *Conway* decision did not expand the scope of remedies that a specialized tribunal may grant for Charter violations beyond those allowed under the enabling legislation. Consequently, the Tax Court has power to remediate Charter violations, but only through the remedies provided by its constituting statute. It may only dismiss, vary, or vacate the Minister's tax assessment. In rare occurrences, the Tax Court remediated a Charter rights violation by ruling that evidence was inadmissible. For example, documents seized under an invalidly issued search warrant, or pursuant to a provision of an act that was found to be unconstitutional, may not be admitted as evidence in an appeal of a tax assessment. However, the Tax Court likely does not have the power to vacate or vary an otherwise correct reassessment on the basis of a Charter breach.

In summary, this decision highlights that taxpayer allegations of breach of protections under the Charter in the Tax Court will usually not be allowed to form part of the taxpayer's appeal of the Minister's reassessment. Furthermore, a taxpayer will need to seek recourse in a forum other than the Tax Court if it wants to complain about the conduct of CRA personnel.

—Pierre-Gabriel Grégoire, Summer Student

MINISTER REQUIRED TO RECONSIDER REFUSAL TO APPLY STATUTE-BARRED TAX CREDITS TO OTHER TAX LIABILITIES

***Forbes Painting and Decorating Ltd. v. AG of Canada*, 2019 DTC 5014 (Federal Court)**

The taxpayer applied for judicial review of a decision of the Minister of National Revenue in which the Minister denied the taxpayer's request to re-appropriate statute-barred tax credits. In the application, the taxpayer asked that the Minister be ordered to set off the tax credit amounts against the taxpayer's current corporate income tax and source deduction arrears.

The taxpayer, Forbes, is a corporation which carried on a painting business in the City of Edmonton. Its two director-shareholders swore in affidavits that they did not realize that the corporation had to file income tax returns for years in which it failed to make a profit. As a result, the corporation did not file returns for its 2006 or 2007 taxation years, as it was required to do under paragraph 150(1)(a) of the *Income Tax Act* (the "Act").

When the Canada Revenue Agency reached out to Forbes, it did not respond. So, the CRA issued notional assessments of Forbes for 2006 and 2007 pursuant to subsection 152(7). The CRA then issued garnishment notices (Requirements to Pay) under subsection 224(1), and in November 2011 it collected $12,795.03 relating to Forbes' 2006 tax year and $76,754.73 relating to Forbes' 2007 tax year.

In 2012, Forbes hired an accountant to file its outstanding tax returns for 2006 and 2007. In these returns, Forbes reported income but with a net tax owing that was less than the garnished amounts. In August 2015, Forbes applied to re-appropriate this difference, which represented the statute-barred credit ("SBC") amounts, and have the difference applied against an outstanding payroll balance pursuant to subsection 221.2(2) of the Act. (The SBC amounts could not simply be refunded because the returns had not been filed within three years, as required in subsection 164(1).)

The CRA advised Forbes that the SBCs owing from 2006 and 2007 could not be re-appropriated because Forbes' account was not compliant.

So Forbes filed its tax returns to become compliant and applied again in May 2017. In this second request, Forbes cited three factors as extraordinary circumstances why the Minister should re-appropriate the SBCs:

(1) its shareholders were new to the corporate structure and unfamiliar with the filing deadlines;
(2) its shareholders were under the impression that corporate returns did not have to be filed if the corporation was in a loss position for that year; and
(3) the funds withheld caused financial strain to Forbes by preventing it from making its required payroll remittances, resulting in interest and penalties owing on the payroll account.

This second request was denied. The CRA wrote that there were no extraordinary circumstances that had prevented Forbes from filing its returns within the three years from its tax year-ends, and that Forbes had not demonstrated that it took any action to resolve non-compliance within what the delegate perceived to be a reasonable time.

Following this denial, Forbes made a second-level review request in August 2017. This request cited the same three factors as stated in the May 2017 request, but also referred to the decision in *Cybernius Medical Ltd.* (2018 DTC 5012 (FC)) in which the Court found that it was unreasonable for the Minister not to exercise her discretion to ensure the collection of a payroll source debt by using an existing SBC.

In a January 2018 letter, a delegate of the Minister upheld the original decision not to re-appropriate, saying: “We do not take into consideration the results of court cases, nor do we compare the situation of this corporation to the situation of other corporations …” The CRA then listed the factors it considers when deciding to exercise its discretion:

> … whether the taxpayer has demonstrated that extraordinary circumstances prevented the filing of the corporate returns within three years from their tax year-end, the actions the taxpayer took to demonstrate that they attempted to resolve their non-compliance within a reasonable time, and the taxpayer’s compliance history.

Forbes argued that the Minister’s decision was unreasonable: the Minister should have used an existing tax credit to ensure collection of current corporate income tax and source deduction arrears; she did not provide clear and supportable justification to deny Forbes’ request given that the sum of money was large for Forbes; and her decision, in the context of Forbes’ financial situation, constituted punishment for failing to meet the Minister’s unclear expectations.

The Minister’s position was that the three extraordinary factors cited by Forbes were inapplicable. The Minister maintained that nothing had indicated that Forbes was at financial risk because of the SBCs not being re-appropriated.

However, the Court found for Forbes. The Court cited *Pomeroy’s Masonry* (2017 DTC 5126 (FC)) for the principle that the ability of a corporate taxpayer to continue as a going concern, if raised in a request for reappropriation under subsection 221.2(2), is a factor that should be weighed by the Minister when assessing the reappropriation of SBCs, and that the Minister should also have regard to whether denial of the request might possibly result in the Minister’s inability to collect outstanding tax arrears from a taxpayer.

The Court found that Forbes was clearly suffering from financial hardship. The two shareholders said so in their affidavits. Their accountant, in the cover letter submitting the second request, stated that the corporation had borrowed from friends and family to cover payroll debt and that the CRA’s refusal to re-appropriate the SBCs “jeopardized the ability of the Company to continue as a going concern”. In the corporation’s reconsideration request, it was noted that the company had incurred payroll penalties, and that the matter had caused considerable emotional stress to the shareholders. And because there was “no indication that the Minister considered this hardship in her delegate’s decision”, the decision was thereby unreasonable.

Moreover, the Court found that the Minister fettered her discretion. Forbes’ financial hardship clearly constituted an “other” circumstance beyond those examples set out in the T2 Statute-barred Credits Guide. The Court stated that the Minister focused only on whether there were extraordinary circumstances which prevented the filing of the corporate returns within three years from their tax year-ends, rather than also considering Forbes’ financial hardship.

Forbes asked for an order in the nature of *mandamus*, an order of the Court directing the Minister to make a particular decision. But *mandamus* is an extraordinary remedy, and courts will not issue *mandamus* to compel a decision-maker to make a particular decision when the decision-making power is discretionary in nature. So the Court determined that it was neither appropriate nor required in this case: there were no unusual or exceptional circumstances which required that the Court issue a mandatory order requiring the Minister to re-appropriate the SBCs to Forbes’ existing or future tax liabilities. Rather, the matter was returned to another delegate of the Minister for redetermination in accordance with the reasons for judgment.

—*Hilary Smith*

SUBSECTION 256(2.1) APPLIED TO PREVENT MULTIPLICATION OF SMALL BUSINESS DEDUCTION

***Jencal Holdings Ltd. v. The Queen*, 2019 DTC 1019 (Tax Court of Canada)**

The principal issue in this case was whether the corporate taxpayer, a Candian-controlled private corporation (“CCPC”), was required to share its annual business limit with another CCPC with which the taxpayer was deemed not to be associated pursuant to an election filed under subsection 256(2) of the *Income Tax Act* (Canada) (the “Act”). The Tax Court found that the taxpayer had failed to establish that the reduction of taxes was not one of the main reasons for its separate existence, and concluded that subsection 256(2.1) applied to deem the two corporations to be associated with each other, thereby thwarting the taxpayer's attempt to multiply the small business deduction.

At the centre of the case was a global tire business carried on by a partnership (KT Partnership) through its direct and indirect subsidiaries. KT Partnership was owned by a CCPC (KT Ltd), which in turn was wholly owned by another CCPC (KT Holdings). Prior to the 2007 reorganization described below, KT Holdings was controlled by the founder of the business through his ownership of a class of voting preferred shares of KT Holdings. The founder also held non-voting common shares of KT Holdings as trustee for a family trust (KT Trust) established for the benefit of his five adult children. Prior to the reorganization, from 2001 to 2007, KT Holdings and KT Ltd were not entitled to claim the small business deduction because their combined taxable capital employed in Canada exceeded the $15 million maximum threshold in subsection 125(5.1) for claiming the deduction.

In 2007, the KT group undertook a reorganization in connection with 21-year deemed disposition planning in respect of KT Trust. As part of the reorganization:

(i) KT Trust equally distributed non-voting common shares of KT Holdings among the founder's five children,
(ii) each child then transferred the non-voting common shares of KT Holdings to a newly-formed holding company in exchange for shares of the holding company, and
(iii) four of the five children then froze their respective holding company shares in favour of four new family trusts of which they were the sole trustee and which were established for the benefit of their respective children and grandchildren.

Although not specifically mentioned in the decision, it appears that at some stage of the reorganization the non-voting common shares of KT Holdings were exchanged for voting non-participating shares and non-voting participating shares of KT Holdings.

As a result of the reorganization, each child held freeze shares and voting non-participating common shares of the relevant holding company, and the corresponding family trust held voting participating common shares of the relevant holding company. Each holding company in turn owned 20% of a single class of voting, non-participating common shares of KT Holdings and 100% of the shares of one of five separate classes of non-voting participating common shares of KT Holdings. The taxpayer in the case before the Tax Court was the holding company for one of the five children.

Following the reorganization, each holding company was associated with KT Holdings. Subsection 256(2) (as it read prior to the 2016 amendments) provided that where two corporations are not otherwise associated with each other and each is associated with the same third corporation, the two corporations shall be deemed to be associated with each other for the purposes of the Act, except that the third corporation shall, where it so elects, be deemed not to be associated with either of the two other corporations for the purposes of section 125. KT Holdings made the aforesaid election in the relevant taxation years. As a result, it was deemed not to be associated with the taxpayer or any of the other holding companies for the purposes of section 125, but was otherwise associated with the taxpayer and each of the other holding companies for all other purposes under the Act. As a consequence of the deemed non-association of the taxpayer with KT Holdings and each of the other holding companies, the taxpayer was not required to share its $500,000 business limit with KT Holdings or any of the other holding companies.

In order to take advantage of its separate $500,000 business limit, the taxpayer entered into a series of dividend and loan transactions with KT Holdings. Pursuant to these transactions, KT Holdings transferred funds that were ultimately derived from KT Partnership's profits to the taxpayer as intercorporate dividends and the taxpayer then transferred the funds back to KT Holdings as interest-bearing loans. Since KT Holdings and the taxpayer remained associated for the purposes of the Act (other than section 125), paragraph 129(6)(b) deemed the interest income earned by the taxpayer to be active business income for the purposes of section 125.

The Minister reassessed the taxpayer to deny the small business deduction on the basis of subsection 256(2.1) and the general anti-avoidance rule ("GAAR"). Subsection 256(2.1) is a specific anti-avoidance rule that deems two or more corporations to be associated with each other for the purposes of the Act where it may reasonably be considered that one of the main reasons for the separate existence of those corporations is, among other things, to reduce the amount of taxes that would otherwise be payable under the Act.

With regard to the application of subsection 256(2.1), the Tax Court noted at the outset that there may be more than one main reason for the separate existence of a corporation and that the taxpayer bears the burden of proving that the reduction of tax was not one of the main reasons for its separate existence. The taxpayer in the case adduced no direct evidence from any of the children as to the main reasons for the separate existence of the taxpayer or the other holding companies and the Tax Court found the indirect evidence provided by counsel for the business to be unreliable, and was unconvinced by the taxpayer's alternative explanations provided for the separate existence of the holding companies. Moreover, the documentary evidence adduced by the taxpayer (including, in particular, a planning memo and other tax planning presentations prepared by KPMG) indicated that the reduction of taxes was an important reason for the separate existence of the holding companies. Based on the foregoing, the Tax Court concluded that the taxpayer had failed to establish that the reduction of taxes was not one of the main reasons for its separate existence. Having dismissed the appeal on the basis of subsection 256(2.1), the Tax Court declined to consider the potential application of the GAAR.

In its reasons, the Tax Court did not address whether, and on what basis, the deemed association rule in subsection 256(2.1) took precedence over the deemed non-association rule in subsection 256(2) (as it then read). It was accepted by both parties, and not questioned by the Tax Court, that because KT Holdings made an election under subsection 256(2) and the conditions for making the election were satisfied, subsection 256(2) applied to deem KT Holdings not to be associated with the taxpayer for the purposes of section 125. If, however, subsection 256(2.1) also applied to deem KT Holdings to be associated with the taxpayer for the purposes of the Act, the result would be two statutory deeming rules that created different statutory fictions. In light of this conflict, an argument could perhaps be made, on the basis of the Federal Court of Appeal's decision in *Husky Oil* (2010 DTC 5089), that the deemed non-association rule in subsection 256(2) should trump the deemed association rule in subsection 256(2.1) because the former applies specifically for the purposes of section 125 whereas the latter applies generally for the purposes of the Act. Interestingly, the Canada Revenue Agency touched upon the potential conflict between these two deeming rules in a 2011 technical interpretation (2011-0394471I7), stating without explanation that subsection 256(2) and subsection 256(2.1) are mutually exclusive.

It should also be noted that due to amendments to the Act enacted in 2016, the type of planning undertaken in *Jencal* to multiply the small business deduction has been significantly curtailed. In particular, subsection 256(2) was amended so as to de-associate two corporations that would otherwise be associated by virtue of each such corporation's association with a third corporation, but not to de-associate either such corporation from the third corporation. Subparagraph 125(1)(a)(i) was also amended to render ineligible for the small business deduction income received by a CCPC from an associated CCPC that is deemed under subsection 129(6) to be active business income in circumstances where the associated CCPC has made an election under subsection 256(2).

—*Kabir Jamal*

THE PERILS OF INVESTING IN DUBIOUS RRSP INVESTMENT SCHEMES

***Stewart v. The Queen*, 2019 DTC 1023 (Tax Court Canada)**

In this case, the Tax Court of Canada allowed the taxpayers' appeals of the Minister's reassessments in respect of mortgage investments they had made through their respective self-directed registered retirement savings plans ("RRSPs").

The taxpayers were husband and wife. They were amongst 117 other individuals who were unsophisticated investors who were victims of a fraudulent scheme. The scheme was marketed as an investment opportunity whereby the investors would make contributions to self-directed RRSPs which would use the funds to purchase undivided interests in a $1.8 million mortgage secured by land in Alberta. The interest rate attached to the mortgage was an attractive 12% *per annum*. Investors were told that the underlying property was in the process of being developed into a campground/trailer park to service workers in the Northern

Alberta oil and gas industry and that a $4.8 million development budget was prepared for the property. What the investors did not know was that the promotors acquired the property for only $5,000.

Prior to making their investment, the couple discussed the transaction with a lawyer and an official at the Canadian Western Trust Company. Both individuals informed the taxpayers that it was a good investment that would be a qualified investment for their RRSPs. The husband and wife then proceeded to each open up a self-directed RRSP account with a financial institution, contributed funds to those accounts in the amounts of $37,000 and $42,500, respectively, and directed the RRSP trustee to use the funds to acquire undivided interests in the mortgage.

The Minister reassessed the taxpayers to include their respective contribution amounts in their income on the basis that the taxpayer received a benefit within the meaning of former subsection 146(8) of the *Income Tax Act* (Canada) (the "Act") equal to the amount that their self-directed RRSPs paid the promoter entity to purchase the mortgage interest. According to the Minister, the taxpayers had participated in an RRSP scheme to obtain tax-free access to their RRSP funds through a collateral arrangement. At trial, the Crown did not provide any evidence of the nature of the alleged collateral arrangement and, therefore, the Tax Court accepted the taxpayers' testimony that they did not have any agreement with the lead promoter or anyone else to gain access to the funds that their RRSPs paid for the mortgage interests. From the Court's perspective, the taxpayers were simply innocent victims of a scam whereby the promotors stole the mortgage proceeds.

As an alternative basis for supporting the reassessment, the Minister asserted that an undivided interest in the mortgage was not a "qualified investment" as defined in subsection 146(1) of the Act and, as such, the value of the investment would have to be included in the annuitant's income by virtue of former subsection 146(10). Even though paragraph 4900(1)(j) of the *Income Tax Regulations* prescribes a debt fully secured by a mortgage over real property in Canada to be a qualified investment for purposes of subsection 146(1), the Minister argued that, in the circumstances, the investments that the taxpayers' RRSPs acquired should not be considered to be a mortgage at all. The Court did not agree with the Minister and held that the RRSP contribution made to the property was, in fact, a loan secured by a mortgage on the Alberta land. The Court observed that the term 'mortgage' is not defined in the Act, and the *Land Titles Act*(Alberta) defined the term as "a charge on land created merely for securing a debt or loan"; this is the type of interest that the taxpayers' RRSPs acquired when they purchased the undivided interest in the mortgage. Therefore, the investment by the RRSPs in the Alberta mortgage was a qualified investment.

As a further basis for supporting the reassessment, the Minister sought to rely on former paragraph 146(9)(b) of the Act, which applies when an RRSP acquires property for consideration in excess of its fair market value, and requires the difference in value to be included in the annuitant's income. The Court rejected this further alternative argument and held that the consideration the taxpayers' RRSPs paid for the mortgage interests reflected the fair market value of the acquired property. Based on the evidence, the Court concluded that the sale of the mortgage interests occurred in the ordinary course of the promoters' businesses of selling interests in mortgages and the taxpayers dealt at arm's length with the vendor. The fact that the taxpayers paid a price similar to the price paid by 117 other individuals who each acquired an undivided interest in one of three mortgages over the same property was evidence that the parties negotiated the price in a market not exposed to any undue stress and composed of willing arm's length buyers and sellers. The Court concluded that former paragraph 146(9)(b) did not apply in a situation where a taxpayer directs his/her RRSP to make an investment with an arm's length party for what the taxpayer believes is a fair market value consideration, even if the circumstances surrounding the investment are suspect.

This case is a bittersweet victory for the taxpayers as they lost their savings even though the Court decided in their favour. In light of this case, one may question whether going after the taxpayer in these situations was an effective strategy adopted by the Minister. Instead of bringing a case against taxpayers who acted in a *bona fide* manner, it may be a better use of the Canada Revenue Agency's resources to go after promoters of such schemes in an effort to try and prevent these frauds from occurring in the first place.

—*Jaspreet Kaur*

RECENT CASES

ADVANCES TO CORPORATION OF WHICH TAXPAYER NOT A SHAREHOLDER MADE TO GENERATE INCOME FOR TAXPAYER; TAXPAYER THUS ENTITLED TO ABIL DEDUCTION CLAIMED

The taxpayer's mother, DD, was the sole shareholder of Les Cantines Nutrec Inc. (the "Corporation"). A property owned by DD and her two daughters was rented to the Corporation, and the taxpayer regularly received a portion of such rent annually. The Minister refused the taxpayer an ABIL deduction related to certain advances made by her to the Corporation (the "Advances") on the grounds that: (a) she was not a shareholder of the Corporation; (b) the Advances were interest-free and undocumented; and (c) they were not made by her to earn income. The Minister admitted at the hearing, however, that the Advances became unrecoverable when the Corporation subsequently ceased carrying on business. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was allowed. The taxpayer admittedly failed to show that she had received or reported for tax purposes any interest on the Advances. However, the Advances were made to finance the Corporation's business, although priority was given by the Corporation to repaying the capital portion of the Advances. Conversely, the taxpayer was able to show that there was an adequate connection between the Advances and the income eventually received by her from the Corporation. However, it is well established that it is not necessary that there be a direct connection between the debt owing to the taxpayer and the income which he/she hopes to derive from the advances leading to that debt (see *The Queen v. Byram*, 99 DTC 5117 (FCA)). The foregoing analysis led to the conclusion that the Advances in the present proceedings were made by the taxpayer to earn income from the Corporation in the form of an increased salary from the Corporation for her, together with the eventual payment to her of interest on the Advances. The taxpayer was thus entitled to the ABIL deduction claimed.

Dépatie v. The Queen

2019 DTC 1093

APPEAL ALLOWED AND MINISTER ORDERED TO PAY INTEREST ON REFUND AMOUNT

A Notice of Assessment was issued by the Minister in 2012, in which third-party penalties of $2.9 million were levied under section 163.2 of the *Income Tax Act* (the "Act") against the taxpayer. The taxpayer objected to that assessment and paid the amount of $1 million as an "amount in controversy", in an effort to reduce interest charges in the event that his challenge to the assessment was unsuccessful. Following the filing of an appeal to the Tax Court, a settlement was reached, and the Minister agreed to a "Consent to Judgment" allowing the appeal. The Minister then issued a Notice of Reassessment cancelling the original assessment and returning the $1 million amount. The Minister refused to pay interest on such amount, taking the position that subsection 164(3) specifies that the Minister shall pay interest only where amounts were collected in respect of a taxation year. Although the Notice of Reassessment identified the taxation year as being 2012, the Minister took the position that such identification was an error, as the penalties assessed were third-party penalties and were therefore not in respect of a specific taxation year. Consequently, no interest could be paid by the Minister. The taxpayer applied for judicial review of the Minister's decision.

The application was allowed. The Federal Court first determined that it had jurisdiction to hear the application and that the matter was properly before the Federal Court. It noted that as the refund was payable by the Minister and was not an assessed amount, or a nil assessment, there was no right of appeal to the Tax Court of Canada. As well, the Court was satisfied that the reassessment constituted a final decision of the Minister to refuse to pay interest, and that such decision was reviewable on a standard of reasonableness. The Federal Court then reviewed the relevant statutory provisions and the jurisprudence interpreting those provisions before concluding that the only reasonable interpretation of such provisions, in the particular circumstances, was that the inclusion of a taxation year in a reassessment meant that interest must be paid, by operation of subsection 152(8) and paragraph 164(3)(e) of the Act. The Court held that it had not been presented with any compelling evidence or legal authority to demonstrate that a taxation year could not have been associated with the Agency's imposition of a penalty on the taxpayer. It concluded that the current jurisprudence supported a finding that interest must be paid. Subsection 152(8) applied, as did the other provisions of the Act that flowed from it, including subsection 164(3), confirming that the refund must be returned with interest at the prescribed rate. In the Court's view, such was the only reasonable interpretation of the relevant statutory provisions and the Minister's decision to refuse to pay interest was unreasonable. The matter was therefore remitted to the Minister for the calculation and payment of interest on the refund, in accordance with the Court's reasons. Costs were awarded to the applicant.

Glatt v. MNR

2019 DTC 5074

CORPORATE TAXPAYER NOT CARRYING ON A PERSONAL SERVICES BUSINESS FOR ONE OF TWO TAXATION YEARS REASSESSED, AND HENCE ENTITLED TO SBD TREATMENT FOR THAT ONE YEAR

The corporate taxpayer, a CCPC, was controlled by Ms. Singh who was married to Mr. Singh. Mr. Singh controlled Econo, which operated a business wholesaling gasoline products. Ms. Singh was, therefore, a “specified shareholder” of Econo. The taxpayer and Econo were not associated during 2009 and 2010 for purposes of the *Income Tax Act* (the “Act”). The taxpayer entered into a Management Services Agreement with Econo, under which it agreed to provide to Econo financial, administrative, accounting, payroll, billing, and collection services. The Minister determined that the taxpayer was carrying on a “personal services business” (“PSB”) during 2009 and 2010. As a result, for 2009 and 2010, the taxpayer was denied a small business deduction (“SBD”) and was also denied certain expense deductions under paragraph 18(1)(p) of the Act. The taxpayer appealed to the Tax Court of Canada.

The taxpayer’s appeal was allowed in part. Paragraphs (a) and (b) of the definition of “personal services business” in subsection 125(7) of the Act define a “personal services business” being carried on by a corporation to be one where an individual performing services for the corporation is a “specified shareholder” of the corporation, and that individual, but for the existence of the corporation, would reasonably be considered as an officer or employee of the person or partnership to whom or to which the services are being rendered. Paragraph (c) of the definition provides that a corporation will not be considered as carrying on a personal services business if it employs more than five full-time employees. In the present case, Ms. Singh was not an employee of the taxpayer during 2009 and did not perform any services on the taxpayer’s behalf during that year. In addition, the taxpayer had no employees during that year. Accordingly, for 2009 the taxpayer did not meet the PSB criteria set out in paragraph (a). Conversely, during 2010 Ms. Singh was an employee of the taxpayer and was providing services on its behalf. Further, the taxpayer had only five full-time employees during 2010 and, during that same year, the taxpayer and Ms. Singh were not carrying on a services business on their own account, but on Econo’s account. In addition, but for the existence of the taxpayer, Ms. Singh would have reasonably been regarded as an employee of Econo during 2010, as she was during 2009. The foregoing analysis led to the conclusion that the taxpayer was not carrying on a “personal services business” in 2009 but was doing so during 2010. As a result, the taxpayer was entitled to the SBD and expense deductions claimed for 2009 only. The Minister was ordered to reassess accordingly.

Arora Trading Ltd. v. The Queen

2019 DTC 1083