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Tax Notes

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THE TAXATION OF EMPLOYEE STOCK OPTIONS AND PROPOSED CHANGES

- –Joseph Frankovic, Toronto

BACKGROUND ON THE TAXATION OF EMPLOYEE STOCK OPTIONS

Under the *Income Tax Act* (the “Act”), employee stock option benefits are treated differently than other forms of remuneration from employment. Most forms of remuneration, including non-cash remuneration, are fully included in the employee’s income from employment in the year in which the cash or property is received. In the case of non-cash compensation, the fair market value of the property is included in income.

On the other hand, the receipt of an employee stock option does not generate an income inclusion or other taxable event for the recipient employee (the rationale relates to issues with valuation and liquidity, particularly in the case of options in shares of private corporations). The recognition of the stock option benefit is deferred and included in income in the year in which it is exercised (subsection 7(1)), or, in the case of options issued by Canadian-controlled private corporations (“CCPCs”), the year in which the shares are disposed of (subsection 7(1) with reference to subsection 7(1.1)). More significantly, owing to a deduction of one-half of the benefit allowed in computing taxable income under either paragraph 110(1)(d) or (d.1), typically only one-half of the stock option benefit is subject to taxation.[1]In other words, employee stock option benefits are taxed preferentially, at the same rate as capital gains and with a built-in deferral, even though they are considered employment income and not capital gains. The preferential taxation of stock option benefits is a tax expenditure—in this case, government spending for the benefit of certain employees through the tax system.

Many countries tax employee stock options preferentially, but Canada has one of the most generous stock option tax regimes in the world.[2] Under the Act, the one-half taxation rule can apply regardless of the amount of the stock option benefit, the size of the employer corporation, and generally without regard to the holding period of the shares. Furthermore, the one-half taxation rule can still apply if the underlying shares decline in value before the option is exercised and the option exercise price is reduced accordingly (subsection 110(1.7)). The downside, from the employer’s perspective, is that a deduction is not allowed in respect of the stock option benefit in computing the employer’s income (paragraph 7(3)(b)).

In the United States, statutory “qualified stock options” are taxed preferentially but they carry significant monetary and trading restrictions. As a result, most employee stock options in the United States are issued as “non-qualified stock options”, the benefits from which are fully included as employment income.[3] In other words, most employee stock options benefits do not receive a tax preference under the US tax system. In states such as California and New York (apparent “brain drain” destinations for certain Canadian individuals), the highest income earners are typically taxed at a rate of around 50% on employee stock option benefits, compared to a rate of about 24% to 27% in Canada, depending on the province. However, unlike Canada, the corporate employer is allowed a corresponding deduction in computing its income.

Proponents of the employee stock option tax preference often contend that stock options motivate employees and improve their performance and align their interests with shareholders, such that their use should be encouraged under the tax system. Stock options are therefore viewed as valuable tools to attract and retain highly-skilled workers.[4]

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On the other hand, many tax policy experts argue against a tax preference for recipients of employee stock options.[5] They argue that there is no reason why the government should subsidize a decision to issue stock options if it is sound from a business perspective (that is, without tax considerations).[6] On the flip side, if firms choose the stock option route that is not worth the risk from a business perspective but may be worth the risk after accounting for the tax considerations, the tax preference subsidizes a bad business decision.[7]

Tax policy experts at the Organisation for Economic Co-operation and Development (the "OECD") have provided a detailed study on the taxation of employee stock options, which is available on the OECD website.[8] The authors concluded that, as a benchmark, an efficient tax treatment of employee stock options would provide no tax preference to either increase or decrease the number of employee stock options and would be neutral with respect to the choice between granting stock options and paying salary. The benchmark would therefore tax stock option benefits in full and allow a deduction for the employer. The authors also conclude that the fact stock options may have desirable characteristics is not sufficient to justify preferential tax treatment. They do, however, concede that a tax preference may be warranted for certain start-up firms that wish to attract talented employees but cannot afford to pay large cash salaries. These firms may lack collateral or a proven track record that prevents them from raising cash to cover their employment costs, and potential employees may balk at accepting stock options in the absence of a tax break.

PROPOSED CHANGES

The current federal government seems to agree, to a large extent, with the OECD study and the critics of the stock option preference. In the 2019 Federal Budget, the Department of Finance announced that it would be restricting the one-half taxation rule for employee stock options. The budget proposal indicated that the current one-half rule could apply in respect of benefits arising from up to $200,000 of shares—the value determined at the time of the grant—for each year in which the options vest. Options reflecting shares worth more than the $200,000 amount would not qualify for the one-half deduction and the option benefits would therefore be fully included in income. A major exception, where the current one-half tax rule would continue to apply, would be to stock options granted by CCPCs and other small start-up corporations to be prescribed under the Regulations to the Act.

The main rationale for the government's decision to restrict the stock option preference is one of fairness. The 2019 Budget papers note that the current treatment disproportionately benefits high-income earners and therefore makes the income tax system less progressive. Interestingly, the Budget papers further indicate that the restriction will move toward aligning Canada's employee stock option tax treatment with that of the United States. This latter point is interesting as it is rare that a Canadian government does away with a tax preference in order to align itself with the United States. More commonly, governments of all stripes and at all levels rationalize a *reduction* of our taxes in order to be more competitive with the United States (in this context, "competitive" always means lower taxes). Ironically, in the 2000 Federal Budget (released by a previous Liberal government), the introduction of a deferral for benefits in respect of options on publicly-traded shares (a tax break) was rationalized as assisting "corporations in attracting and retaining high-calibre workers and [making] our tax treatment of employee stock options more competitive with the United States."[9]

On June 17, 2019, the Department of Finance released draft legislation reflecting the 2019 budget tax proposals. The draft legislation is scheduled to apply to options issued after 2019. Whether it will be passed into law remains to be seen, and likely depends on the results of the upcoming October federal election. If the current governing Liberal party wins the election, one would expect the proposals to be implemented. If another party wins, we will have to wait and see.

Under the draft legislation, the one-half deduction under paragraph 110(1)(d) for employees is not allowed for stock option benefits deemed to be received under subsection 7(1) in respect of "non-qualified securities" under an agreement for each "vesting year" of those securities. This new restriction does not apply to benefits under options granted to employees by CCPCs, and other employers who meet prescribed conditions,[10] who are not "specified persons" (subsection 110(0.1)) and whose issued securities therefore

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cannot constitute “non-qualified securities” (see subsection 110(1.3)). In other words, such options will remain eligible for the one-half deduction. Interestingly, the exception for options issued by a CCPC applies regardless of the size or capitalization of the CCPC.[11]

Generally, when dealing with one option agreement, subsection 110(1.31) provides that non-qualified securities for a vesting year under the agreement mean those securities whose fair market value (“FMV”) at the time the agreement was entered into (the “relevant time”) exceeds $200,000. For example, if the FMV of the securities at the relevant time in 2020 was $300,000, and the vesting year was 2021, one-third ($100,000 / $300,000) of the securities would be non-qualified securities regardless of their value in 2021 or when they were acquired. The other two-thirds would remain eligible for the one-half deduction under paragraph 110(1)(d).[12]

Although the $200,000 amount is determined as of the relevant time, the determination of whether the securities are non-qualified securities is made in respect of each vesting year. For example, if the FMV of the securities under an agreement at the relevant time was $500,000, and half of the securities had a vesting year of 2021 and the other half had a vesting year of 2022, one-fifth of the securities vesting in each of 2021 and 2022 would be non-qualified securities ($250,000 - $200,000 / $250,000),[13] while any benefit from the remaining securities would remain eligible for the one-half deduction.

An ordering rule in subsection 110(1.31) applies where securities under more than one agreement have the same vesting year, and the aggregate FMV of the securities at their respective relevant times exceeds $200,000. In such case, the FMV of securities under earlier agreements are counted before those under later agreements in order to determine which securities exceed the $200,000 limit and are therefore deemed to be non-qualified securities.[14]

The $200,000 limitation per vesting applies to securities that may be issued to an employee by the employer and those that may be issued by specified persons who do not deal at arm’s length with the employer. Therefore, the limit cannot be circumvented by having stock options issued to one employee by multiple non-arm’s length parties.

“Vesting year” of a security to be issued under an agreement is defined in subsection 110(0.1). If the agreement specifies the calendar year in which the employee’s right to acquire the security first becomes exercisable (otherwise than as a consequence of an event that is not reasonably foreseeable at the time the agreement is entered into), that calendar year is the vesting year. If the agreement does not specify the calendar year in which the employee’s right to acquire the security first becomes exercisable, the vesting year is the first calendar year in which “the right to acquire the security can reasonably be expected to be exercised”, which, depending on the facts, may be difficult to determine. In its explanatory notes to the provision, the Department of Finance provides the example where the right becomes exercisable in a year as a consequence of the attainment of certain goals based on sales, hours, or performance.

Another ordering rule in subsection 110(1.41) applies where an employee exercises a right under an agreement to acquire shares, where some of the shares under the agreement are not qualified securities and others are qualified. The employee is deemed to acquire the qualified securities before the non-qualified securities, which could be beneficial if the former are eligible for the one-half deduction under paragraph 110(1)(d).[15]

The benefit relating to non-qualified securities, although not eligible for the one-half deduction for the employee, may be deductible for the employer in computing taxable income under paragraph 110(1)(e). The deduction for the employer is allowed only if, among other things, the employee otherwise would have been eligible for the deduction under paragraph 110(1)(d). Owing to the deduction for employers, the additional tax revenues resulting from the full taxation for the employees may be largely, if not completely, offset by the tax savings for employers.[16] But, as noted, these changes were meant to address a perceived tax unfairness relating to employee stock options, and not necessarily to increase tax revenues. It is also interesting that the employer’s deduction does not reduce its income under Division B of the Act, but rather reduces its taxable income under Division C. Deductions under Division B are typically justified under a “technical” tax

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regime in measuring income, whereas deductions under Division C are typically of a special category such as that of a tax expenditure.

Subsection 110(1.9) provides that where securities to be issued or sold are non-qualified securities under subsection 110(1.31) (see above), the "specified person" must notify the employee in writing that they are non-qualified securities on the day that the agreement is entered into and file a prescribed form with the CRA for the taxation year that includes that day. The "specified person" for this purpose is the employer, or non-arm's length entity, that sells or issues the securities under the agreement (which can include either securities of that specified person or of a non-arm's length specified person). A specified person is defined to exclude a CCPC, or a corporation or mutual fund trust that meets prescribed conditions. As noted earlier, we await the release of the prescribed conditions.

Lastly, subsection 110(1.4) allows an employer to designate one or more securities of the employer or a non-arm's length entity (that could otherwise be qualified) to be issued under an agreement as non-qualified securities. The designated securities are then deemed to be non-qualified securities for the purposes of the rules discussed above.

CURRENT ITEMS OF INTEREST

GOVERNMENT CONSULTS ON DRAFT LEGISLATION

On July 30, 2019, the government released draft income tax legislation affecting the following areas:

- Accelerated investment incentive for resource expenditures;
- Accelerated investment incentive for depreciable property;
- Change in use rules for multi-unit residential properties;
- Registered plans: permitting additional types of annuities;
- Registered disability savings plan: cessation of eligibility for the disability tax credit;
- Contributions to a specified multi-employer plan for older members;
- Pensionable service under an individual pension plan;
- Mutual funds: allocation to redeemers methodology;
- Electronic delivery of requirements for information;
- Accelerated capital cost allowance for zero-emission vehicles;
- Character conversion transactions;
- Transfer pricing measures;
- Foreign affiliate dumping; and
- Cross-border share lending arrangements.

The government is accepting comments on these proposals, which should be submitted by October 7, 2019. Most of the proposals in the draft legislation are from Budget 2019.

LIVESTOCK DEFERRAL FOR 2019

On July 22, 2019, Agriculture and Agri-Food Canada published its initial list of designated regions in which livestock producers are eligible for the livestock tax deferral provision in 2019. These regions in British Columbia, Alberta, Saskatchewan, Manitoba, and Quebec have been affected by drought, flooding, or excess moisture. Livestock farmers in these regions can defer a portion of their proceeds from selling their breeding livestock in 2019 until 2020. This deduction is provided by subsection 80.3(2) of the *Income Tax Act*, and the regions will eventually be prescribed in Regulation 7305.01(1).

CRA UPDATES FOLIOS

The CRA has made changes to the following income tax folios:

- S1-F3-C2, *Principal Residence*;

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- S3-F2-C1, *Capital Dividends*; and
- S4-F7-C1, *Amalgamations of Canadian Corporations*.

A description of the changes can be found in the Chapter History section of each folio.

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.

TAX COURT REJECTS MINISTER'S ATTEMPT TO USE FAIRNESS AS A BASIS FOR DENYING RRSP DEDUCTION

***Roy v. The Queen*, 2019 DTC 1045 (Tax Court of Canada—Informal Procedure)**

In this case, the Tax Court was asked to consider whether the taxpayer should be denied the ability to carry forward an undeducted RRSP contribution from a prior year if the amount of the contribution far exceeded the taxpayer's cumulative RRSP contribution room when made and the Minister subsequently waived the taxpayer's obligation to pay tax and penalties under Part X.1 of the *Income Tax Act* (Canada) (the "Act") in respect of the over-contribution. As discussed below, the Tax Court confirmed that the Minister's waiver of tax and penalties under Part X.1 in respect of the over-contribution did not prevent the taxpayer from treating the corresponding RRSP contribution the same way as any other RRSP contribution.

In 2006, the individual taxpayer in this case made contributions totalling $43,000 to his RRSP account, which far exceeded his RRSP deduction limit for the year (as defined in subsection 146(1) of the Act). The reported decision does not reveal the circumstances that led the taxpayer to make the excess contribution but, in any event, the subject RRSP contribution was invested in securities that quickly became worthless and therefore could not have been withdrawn from his RRSP thereafter. The RRSP account was eventually closed in 2012.

After the Minister became aware of the over-contribution, the taxpayer was assessed the 1% monthly Part X.1 tax on the excess amount pursuant to subsection 204.1(2.1) of the Act and late-filing penalties for failing to report the over-contribution on Form T1-OVP as required by section 204.3.

The taxpayer applied for and was granted relief by the Minister pursuant to subsection 204.1(4) of the Act from the entirety of the Part X.1 assessment, penalties, and interest in the amount of $39,193.08. Consequently, the taxpayer did not suffer any adverse tax consequences from making the 2006 over-contributions to his RRSP account.

From 2006 to 2012, the taxpayer claimed RRSP deductions in accordance with his RRSP deduction limit for each year, totalling $21,495. The Notice of Assessment for the 2013 taxation year indicated a deduction limit of $3,298 for 2013 and $23,439 of unused RRSP contributions available for 2014. The taxpayer noted that the $23,439 represented approximately the difference between his RRSP contributions in 2006 and the deductions he claimed from 2006 to 2012. At issue in the tax appeal were the Minister's reassessments disallowing $21,439 of the taxpayer's aggregate $23,439 in deductions claimed over the 2013, 2014, and 2015 taxation years.

The Minister's position was based on the notion that the taxpayer's unused RRSP contributions available to be carried forward should be reduced so that they did not reflect "the amount that is no longer available to withdraw" as a result of the loss in value of the RRSP, subject to a $2,000 allowance for over-contributions. The Minister's view was that it would be unfair for the taxpayer to claim deductions in future years in respect of the 2006 contribution while never having paid taxes under Part X.1 on the excess contributions.

The Tax Court (*per* Smith J) rejected the Minister's arguments.

The Court pointed to the fact that the Minister "essentially set-off" the amount of the excess contributions to be carried forward without relying on any statutory provision in the Act. The Court was satisfied that the

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Minister's powers in respect of the over-contribution were limited to the 1% tax and penalty for failure to report excess contributions within 90 days from the end of the taxation year via the T1-OVP form.

The Court also noted that there was no basis for the Minister to arbitrarily eliminate the taxpayer's unused RRSP contributions to be carried forward, since the Minister accepted the taxpayer's relief application. Smith J stated as follows:

> The Minister's decision, as set out in the letter of June 9, 2015, referenced above, can best be described as "water-under-the-bridge". It is conclusive and binding on the Minister and there appears to be no basis for the Respondent's argument in this instance that, having consented to the Appellant's relief application, the Minister may arbitrarily eliminate unused RRSP contributions.

Finally, the Court pointed out two flaws in the Minister's assertion that the waiver of Part X.1 tax disqualifies the taxpayer from claiming deductions in respect of the excess contributions that gave rise to the waived tax. The Court pointed to the fact that the Minister acknowledged that there is no provision in the Act precluding a taxpayer from claiming RRSP deductions with respect to excess contributions, provided they are within the RRSP deduction limit set out in subsection 146(1) of the Act. The Court then reiterated that the Court does not make decisions based on fairness (see *Barel* (2009 DTC 1122 (TCC)) and *Lapierre* (2019 DTC 1021 (TCC))). Citing *Quinco Financial Inc.* ([2014] FCJ No 423 (FCA)), the Court also noted that the Court's role is "not to 'interpret taxation provisions in a tendentious or result-oriented way to enhance the federal treasury'".

The Court concluded that the Minister had no statutory basis to adjust the taxpayer's RRSP deductions, and found as a result that the taxpayer had unused RRSP deductions of $26,737 in 2012. After having deducted $3,298 for the 2012 taxation year, the Court found that the taxpayer had $23,439 left to deduct for future taxation years. The Court allowed the appeal and referred the reassessments for the 2013, 2014, and 2015 taxation years back to the Minister for reconsideration.

This case illustrates that unused RRSP contributions cannot be reduced or eliminated solely on the basis that they represent excess contributions which cannot be withdrawn due to diminishment in RRSP value. The Part X.1 tax on excess RRSP contributions that are not withdrawn and the deductions the taxpayer claims in respect of those contributions are two separate things. The Minister's assertion that it would be unfair for the Court to allow the taxpayer to claim his unused RRSP deductions was not grounded in any provision of the Act. Once the Minister accepted the taxpayer's relief application and waived the Part X.1 tax on the taxpayer's excess contributions, there was nothing that the Minister could do in respect of the fact that the taxpayer made excess contributions to his RRSP and was unable to withdraw such excess.

—Nishant Jain, Summer Student

MINISTER'S ATTEMPT TO PUNISH A "GOOD DEED" THWARTED BY THE TAX COURT?

***Mikhail v. The Queen*, 2019 DTC 1043 (Tax Court of Canada—Informal Procedure)**

If it is not a stretch to characterize a taxpayer's act of filing a T1 adjustment request to include previously unreported income as a "good deed", then the situation that was before the Tax Court in this case might be best described as one in which the Canada Revenue Agency ("CRA") was doing its best to give life to the proverb "no good deed goes unpunished".

This case, decided under the Tax Court's Informal Procedure, involved a pharmacy that was operated by a husband and wife through their corporation, and gift cards and other "in-kind" incentives that were given to the pharmacy by pharmaceutical companies as purchase rebates.

It appears that the pharmacy came to the attention of the CRA as part of an audit program targeting incentives that drug suppliers and manufacturers gave to their pharmaceutical customers. In 2015, the CRA sent a letter to the corporation advising that the CRA was aware of certain incentives the corporation had received and reminding the corporation that the amounts should be treated as business income even though the incentives were not paid in the form of cash. The couple had not been tracking the incentives their pharmacy had been receiving from the drug companies over the years but, after receiving the CRA letter, they contacted their suppliers to obtain data that they used to try to compute the value of the incentives that the pharmacy received during the 2010 to 2013 period.

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The husband and wife instructed their accountant to prepare and file T1 adjustment requests with the CRA for the 2010 to 2013 period to report the incentive amounts in their personal income for those years. While the CRA issued reassessments for the husband and wife to increase their personal tax liabilities in accordance with the T1 adjustment requests, the CRA also decided to reassess the corporation to include the same amounts in the company's income for the 2010 to 2013 period. The Minister took the position that (i) the corporation was the taxpayer that was entitled to receive the incentives from the drug suppliers, and (ii) the husband and wife received a taxable shareholder benefit by appropriating for their personal use the gift cards and other in-kind incentives in their capacity as shareholders and did not receive the property as remuneration for services that they provided to the corporation.

It is well established in the case law that the facts assumed by the Minister in making a reassessment are assumed to be true and that, in a tax appeal, the taxpayer has the initial onus of making out at least a *prima facie* case that the Minister's assumptions are incorrect. In making the decision to reassess both the couple and the corporation, it seems the key assumption the Minister made was that the couple appropriated the rebates for personal use.

At the hearing, the husband testified repeatedly that the rebates were used to buy supplies for the business, not for personal enjoyment. He said they decided to report the amounts personally because he knew they would be unable to show that the incentives were used to pay specific items of expense of the business. He concluded that the easiest route for all involved (including the CRA) would be to report the incentive amounts in the couple's personal income even though reporting the amounts in this way would attract a greater tax liability than if the amounts were included in the corporation's income given the difference in tax rates between individuals and corporations.

Based on the reasons for the decision, the Minister did not have any factual basis for challenging the taxpayer's assertion that the incentives were used solely to pay for expenses of the pharmacy business. Instead, it seems the Minister's position throughout was simply based on the fact that the couple made the T1 adjustment requests to include the amounts in their personal income and the taxpayers were unable to produce documents showing a direct connection between the rebates and the specific items of expense that the rebates were used to pay, which, ironically, was the taxpayer's fear when he was trying to decide how to deal with the unreported income.

Ultimately, the Tax Court (*per* Monaghan J) accepted the husband's testimony on how the rebates were spent and his explanation that the decision to include the amount in the couple's personal income was motivated by the desire to resolve the issue in a way that is easier for the CRA to collect taxes. In the result, the Court dismissed the corporation's appeal of the reassessments that included the incentives in the company's income for the 2010 to 2013 period and ordered the Minister to reassess the couple to back out the incentive amounts from their income for the same period.

It is worth noting that the notices of reassessment of the corporation for three of the tax years were issued after the normal reassessment period for those years. Therefore, the Minister had to demonstrate that the taxpayer had made a misrepresentation attributable to neglect, carelessness, or willful default to be able to rely on subparagraph 152(4)(a)(i) to open up the otherwise statute-barred tax years.

The husband argued that the corporation's failure to report the incentives was not attributable to improper conduct by the corporation but was instead attributable to the failure of the drug companies to provide periodic reports that showed the amount of the rebates or in not instructing the recipients on how the amounts should be reported for tax purposes. The Tax Court rejected the husband's attempt to assign blame to the drug companies. It was the corporation's responsibility to maintain an accurate record of the rebates. The corporation should have taken steps to ensure that any amounts received as rebates be properly accounted for and reflected in its records. The taxpayer's failure to maintain its records constituted neglect that led to the misrepresentation of the corporation's income and, therefore, the Minister was entitled to rely on subparagraph 152(4)(a)(i) to reassess beyond the normal reassessment period.

There is nothing particularly surprising about the outcome of this case given the factual circumstances. However, the Crown's approach to dealing with the non-reporting of the incentives seems, in hindsight, to have been a bit heavy-handed.

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When the CRA initiated an audit program to target the drug supplier incentives, one presumes the principal objective underlying the project was to ensure the amount of the incentives did not go untaxed. In circumstances where the business that earned the right to receive the incentive is operated by a corporation and the shareholders are active participants in the business, the CRA has a legitimate concern about ensuring that the income is taxed in the correct hands. Intuitively, it would seem that there are only two scenarios: The first situation is the corporation receiving and applying the incentive amounts for its own use—in which case, the amount is income to the corporation and that is the end of the story. The second situation is the corporation transferring the incentives to the individuals that participate in operating the business for those individuals to use personally—in which case the amount is income for the individual, but there remains an open question as to how the transaction is to be characterized from the perspective of the corporation that earned the right to receive the incentive.

The Tax Court held that the facts supported the first situation. The taxpayer, for administrative convenience, was prepared to accept the tax consequences associated with the second situation even though it yielded more tax than the first situation. The only reason the taxpayers were forced to take the dispute to the Tax Court is that the Minister also chose to characterize the transaction as a shareholder appropriation of the corporation's property—a transaction that would preclude the corporation from claiming an offsetting deduction for the amount of the incentives—instead of a transaction that would support an offsetting deduction in the corporation, such as additional wages in the case of the wife (who was an employee of the corporation) or as additional fee revenue for the husband (who was engaged by the corporation as a non-employee services provider). The Minister's characterization essentially created a situation of double taxation of the same amount and it's unclear why the Minister would choose to pursue such a punitive characterization in light of the fact that the taxpayer's approach already satisfied the program objective of ensuring that the incentive amounts were subject to tax and the fact situation was one in which it was reasonable to treat the transfer of corporate property to the couple as either wages (in the case of the wife) or the payment of fees for services (in the case of the husband).

It is unfortunate the taxpayers were forced to go through a trial and simply restate what they likely already told the CRA personnel many times leading up to the hearing to get the relief that was appropriate in the circumstances. It seems that the CRA had no reason to disbelieve the husband's version of the facts in their dealings with him in the earlier stages of the dispute, and this raises the question of why the CRA and the Minister did not simply accept the taxes on the added personal income and save all the time and resources invested in a trial.

—Jaclyn Wang, Summer Student

CAN SUBPARAGRAPH 152(4)(A)(I) BE USED TO ISSUE A REASSESSMENT BEYOND THE NORMAL REASSESSMENT PERIOD TO REDUCE TAXES PAYABLE AT TAXPAYER REQUEST?

***Revera Long Term Care Inc. v. Canada (MNR)*, 2019 DTC 5025 (Federal Court)**

This case was a judicial review application in the Federal Court concerning the Minister's refusal to use subparagraph 152(4)(a)(i) of the *Income Tax Act* (Canada) (the "Act") to reassess the applicant corporation beyond the normal reassessment period to reduce taxes payable on the basis of a misrepresentation that overstated the taxpayer's income.

The applicant is a taxable entity that operates nursing homes, retirement homes, and acute care facilities. One of the applicant's shareholders is Revera Inc., a subsidiary of a Crown corporation that is tax-exempt by virtue of paragraph 149(1)(d) of the Act.

Around 1999, Revera Inc. became entitled to receive grants from the Ontario and Alberta governments in order to help fund the construction of long-term care facilities. Revera Inc. structured its affairs to allow the applicant to receive the grants on Revera Inc.'s behalf. The aggregate amount of the grants was approximately $9 million annually.

Initially, the applicant filed tax returns that reported the grants in its own income, but later realized that the grants should have been treated as income of tax-exempt Revera Inc. and not subject to tax at all.

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In December 2015, the applicant contacted the Canada Revenue Agency to advise them of the error and was able to get the CRA to make the appropriate adjustments for the 2007, 2008, 2011, 2012, and 2013 taxation years. For 2011–2013, the CRA relied on reassessment waivers that the corporation filed for those years that allowed for the reassessments to be issued beyond the normal reassessment period. In the case of 2008, the corporation reported a loss for that year and, consequently, the CRA was able to adjust the loss balance without having to issue a reassessment for the year.

For 2009 and 2010, statute-barred tax years for which the taxpayer did not file a reassessment waiver, the corporation asked the CRA to reassess on the basis of subparagraph 152(4)(a)(i) of the Act, which grants the Minister discretion to reassess tax years outside the normal period if the taxpayer has made a misrepresentation attributable to neglect, carelessness, or willful default.

The CRA had a different view of subparagraph 152(4)(a)(i). In its opinion, the section could not be applied for a taxpayer's benefit. Its position was supported by an opinion written by a CRA officer with the Legislation Application Section. The officer's opinion was that subparagraph 152(4)(a)(i) could not be interpreted to allow for reassessment beyond the statute-barred years because it was not intended to allow the taxpayer to request that the Minister extend the normal reassessment period to make a favourable adjustment for an otherwise statute-barred year. The officer added that interpreting subparagraph 152(4)(a)(i) as a provision that could be used to provide taxpayer relief would render the notion of the normal reassessment period and the reassessment waiver mechanism meaningless. The CRA responded to the taxpayer's request by advising that it would not process the adjustments to revenue reported for the 2009 and 2010 taxation years because the Act did not allow the Minister to apply subparagraph 152(4)(a)(i) to reduce taxes payable in the taxpayer's circumstances. The taxpayer applied to the Federal Court for judicial review of this decision.

The main issue the Federal Court had to address was this: Was the Minister's decision that she did not have legal authority to reassess the taxpayer's 2009 and 2010 tax returns reasonable?

The taxpayer argued that subparagraph 152(4)(a)(i) of the Act gave the Minister the authority to correct any mistake that was the result of neglect or carelessness, even if the correction of that mistake is for the benefit of the taxpayer. In other words, the Minister had improperly narrowed the discretion given to her by this provision. In support of its argument, the taxpayer pointed out that if Parliament had wanted to restrict the application of subparagraph 152(4)(a)(i) to situations where the taxpayer had underreported tax, Parliament could have used language such as "The Minister may at any time make a reassessment of tax, except that a reassessment of additional tax may be made…" [emphasis in original]. Citing *Aridi* (2013 DTC 1189 (TCC)), the taxpayer argued that the purpose of subparagraph 152(4)(a)(i) was to allow the Minister to reassess the taxpayer "as he or she should have been if not for the misrepresentation." In the taxpayer's view, this purpose encompassed taxpayers who both under-reported and over-reported income.

The Minister, on the other hand, argued that the decision to deny the taxpayer's request was reasonable. One of the Minister's arguments was that the onus was on the Minister to prove carelessness or neglect in order to apply subparagraph 152(4)(a)(i) (see, for example, *Phillip* (2019 DTC 1035 (TCC))). If the taxpayer's interpretation is correct, the Minister could be put in the position of having to prove neglect to make a reassessment that is in the taxpayer's interest. It also raises the question of how the Minister is supposed to exercise her discretion in deciding to grant or not grant a reassessment.

Although not raised by the Minister, another argument is that subsection 152(4.2) arguably loses its meaning under the taxpayer's interpretation of subparagraph 152(4)(a)(i). Subsection 152(4.2) states that:

Notwithstanding subsections (4), (4.1) and (5), for the purpose of determining—at any time after the end of the normal reassessment period, of a taxpayer who is an individual (other than a trust) or a graduated rate estate, in respect of a taxation year—the amount of any refund to which the taxpayer is entitled at that time for the year, or a reduction of an amount payable under this Part by the taxpayer for the year, the Minister may, if the taxpayer makes an application for that determination on or before the day that is 10 calendar years after the end of that taxation year,

(*a*) reassess tax, interest or penalties payable under this Part by the taxpayer in respect of that year; and

(*b*) redetermine the amount, if any deemed by subsection 120(2) or (2.2), 122.5(3), 122.51(2), 122.7(2) or (3), 122.8(4), 122.9(2), 122.91(1), 127.1(1), 127.41(3) or 210.2(3) or (4) to be paid on account of

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> the taxpayer's tax payable under this Part for the year or deemed by subsection 122.61(1) to be an overpayment on account of the taxpayer's liability under this Part for the year.

The Department of Finance Technical Notes that accompanied the introduction of subsection 152(4.2) state that this provision's purpose was to:

> …give the Minister of National Revenue discretion to make a reassessment or a redetermination beyond the normal assessment period when so requested by a taxpayer who is an individual … in order to give the taxpayer a refund, or reduce taxes payable … [F]or example, if after the expiration of the normal reassessment period an individual became aware that a claim for a deduction or credit to which the individual was entitled was *inadvertently* not made … the Minister would have the discretion to reassess the return and give the taxpayer the benefit of the deduction or credit. [Emphasis added.]

The Technical Notes suggest that this provision is meant to capture situations where individual taxpayers overstated their tax payable out of negligence. It is curious, then, that at the time subsection 152(4.2) was introduced, subparagraph 152(4)(a)(i) was already in effect. Why would Parliament introduce subsection 152(4.2) if the Minister already had the power to reassess taxpayers beyond the statutory reassessment period under subparagraph 152(4)(a)(i)? Additionally, the current version of subsection 152(4.2) makes clear that it only applies to individuals, not corporations. If Parliament was specific in limiting the relief of subsection 152(4.2) to individuals, why would subparagraph 152(4)(a)(i) be available for the benefit of corporations?

In the end, the Federal Court decided that the Minister's decision was unreasonable because the Minister's reasons were deficient. The Court stated that it was concerned with the "existence of justification, transparency, and intelligibility within the decision making process". In the Court's view, the opinion of the officer from the CRA's Legislation Application Section, which was the only source of reasons, "lacked any real analysis of whether the Minister's scope of discretion included the legal authority to reassess the statute barred years." In other words, the Minister's reasons were deficient.

Although it decided that the Minister's decision was unreasonable, the Court opted not to exercise its discretion to provide an interpretation of subparagraph 152(4)(a)(i) for the Minister. One of the reasons the Court provided was that neither the taxpayer nor the Minister addressed *Abakhan & Associates Inc.* (2008 DTC 6028), an earlier Federal Court decision that commented on the application of subparagraph 152(4)(a)(i). In that case, a corporation had deliberately overstated its income and requested reassessment beyond the normal reassessment period pursuant to subparagraph 152(4)(a)(i). The Federal Court stated that "[t]here appears to be nothing preventing a company from making such a request and nothing standing in the way of an application for judicial review if the Minister refuses." This remark possibly offers support for the taxpayer's interpretation of subparagraph 152(4)(a)(i). Regardless, the Court in *Revera* only decided to set aside the Minister's decision and to return it to the Minister for redetermination.

The Minister has appealed the Federal Court's decision to the Federal Court of Appeal. In the meantime, the *Revera* case indicates that there is potentially room for taxpayers to argue that subparagraph 152(4)(a)(i) allows the Minister to reassess a tax return beyond the usual reassessment period for a taxpayer's benefit. If this is the case, it also raises the question of how the Minister is supposed to exercise her subparagraph 152(4)(a)(i) discretion. This development must be treated cautiously, as the Court did not decide that the Minister had discretion to apply subparagraph 152(4)(a)(i) in the taxpayer's favour. The Court also did not provide any comment on the proper interpretation of the provision. Rather, it only decided that the Minister's decision that she did not have discretion to apply the provision was unreasonable, based on the deficiency of the Minister's reasons.

—Colton Dennis, Summer Student

USE OF NEGATIVE PARTNERSHIP ADJUSTED COST BASE RULES TO GENERATE CDA FOUND TO BE ABUSIVE UNDER THE GENERAL ANTI-AVOIDANCE RULE

***Gladwin Realty Corporation v. The Queen*, 2019 DTC 1048 (Tax Court of Canada)**

In this case, the Tax Court of Canada considered whether the general anti-avoidance rule ("GAAR") applied to a series of transactions that permitted the taxpayer to distribute the full amount of a gain on a sale of

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property as a tax free capital dividend, while offsetting the gain in a manner that gave rise to a "doubling up" of the capital dividend account ("CDA") through an elective deemed capital loss under subsection 40(3.12) of the *Income Tax Act* (the "Act").

On March 1, 2007, the taxpayer formed a limited partnership and acquired a limited partnership interest. On April 10, 2007, the taxpayer transferred a property with an accrued capital gain into the partnership on a tax-deferred basis under subsection 97(2) of the Act.

On August 8, 2007, the partnership sold the property, giving rise to a $23,346,822 capital gain. On the day the property was sold, the partnership lent $24,463,142 to the taxpayer's direct shareholder in exchange for a promissory note issued by the shareholder.

On September 26, 2007, in order to avoid the additional 10 2/3% refundable tax on the aggregate investment income of a Canadian-controlled private corporation, the taxpayer was continued from the *Canada Business Corporations Act* to the *BVI Business Companies Act, 2004* so that it would no longer be a Canadian-controlled private corporation. The taxpayer remained a private corporation and a corporation resident in Canada.

On September 28, 2007, the partnership paid an in-kind partnership distribution of $24,647,301 to the taxpayer by distributing the note that was owing to the partnership by the taxpayer's direct shareholder to the taxpayer. Pursuant to paragraph 53(2)(c), the $24,647,301 distribution reduced the taxpayer's adjusted cost base in its partnership interest by an equivalent amount.

Subsection 40(3.1) provides that a limited partner will generally be deemed to have recognized a gain from the disposition, at the end of the partnership's fiscal period, of the limited partner's interest in the partnership if the limited partner is required to deduct an amount under subsection 53(2) in excess of the limited partner's adjusted cost base.

Given that the first fiscal period of the partnership ended on October 1, 2017, the taxpayer reported a deemed capital gain of $24,311,654, being the amount of the distribution in excess of the taxpayer's adjusted cost base, under subsection 40(3.1). As a result of the deemed capital gain recognized by the taxpayer under subsection 40(3.1), the taxpayer added $12,155,827 to its CDA.

Subparagraph 53(2)(e)(i) adds the amount of income and gains allocated to a particular partner to the partner's adjusted cost base in the partner's partnership interest only for fiscal periods ending before that time. Therefore, there is a timing difference between the decrease in a partner's adjusted cost base for distributions and the increase in the partner's adjusted cost base for income and gains allocated to the partner.

The partnership allocated an amount of gains and income to the taxpayer for the partnership's fiscal period ending October 1, 2017. The taxpayer correspondingly added $11,673,410 to its CDA as a result of the allocation of the gains to it by the partnership.

Pursuant to subparagraph 53(2)(e)(i), immediately after the fiscal period of the partnership ending October 1, 2007, the taxpayer added an amount to its adjusted cost base of its partnership interest corresponding to its proportionate allocation of the gains and income of the partnership for the fiscal period of the partnership.

On May 30, 2008, the taxpayer paid a capital dividend to its direct shareholder in the amount of $23,829,237, being the aggregate of the CDA created by the deemed gain under subsection 40(3.1) and the non-taxable portion of the capital gain allocated by the partnership to the taxpayer under paragraph 96(1)(c). The taxpayer paid the capital dividend by way of a distribution to its shareholder of a portion of the $24,463,142 promissory note owing by the taxpayer's shareholder to the partnership.

Subsection 40(3.12) provides that a corporation which is a member of a partnership at the end of the partnership's fiscal period may, in certain circumstances, elect to treat the adjusted cost base in the partner's partnership interest as a capital loss in an amount not exceeding prior gains required to have been reported under subsection 40(3.1). Pursuant to subparagraph 53(2)(c)(i.2), the amount of any loss deemed to have been incurred under subsection 40(3.21) will reduce the electing person's adjusted cost base in the partner's partnership interest.

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The second fiscal period of the partnership ended on September 29, 2008. In its 2008 income tax return, after having already paid a capital dividend using the CDA created from the deemed gain under subsection 40(3.1), the taxpayer elected under subsection 40(3.12) to offset the deemed gain arising under subsection 40(3.1) through a commensurate reduction in the taxpayer's adjusted cost base in its partnership interest.

The Minister audited the taxpayer and issued a determination reducing the taxpayer's CDA under GAAR, which determination the taxpayer appealed to the Tax Court.

As the taxpayer conceded that there was a tax benefit and that the series of transactions implemented to obtain the tax benefit gave rise to avoidance transactions, the Tax Court focused its attention on determining whether the avoidance transactions were a misuse or abuse under subsection 245(4).

The Tax Court first identified the object, spirit, and purpose of the relevant rules used to obtain the tax benefit. For this purpose, the Tax Court sorted the rules into two groups: rules pertaining to the CDA mechanism, being subsections 83(2), 89(1), and 184(2); and rules pertaining to negative adjusted cost base, being subsections 40(3.1) and (3.12).

In respect of the CDA mechanism rules, the Tax Court found that the rules were intended to promote integration and ensure that income was taxed at a comparable rate whether earned directly by an individual or indirectly by the individual through a corporation. The Tax Court acknowledged that the rules in the Act do not always achieve integration, but stated that this fact did not detract from the finding that the CDA mechanism rules were intended to promote integration.

In respect of the negative adjusted cost base rules, the Tax Court identified subsection 40(3.1) as a specific anti-avoidance rule enacted to combat tax-sheltered partnerships by imposing tax on limited partners who extract funds, or allow passive investors to claim losses, in excess of invested capital. The Tax Court was of the view that legislators were aware that the operation of subsection 40(3.1) could produce unduly harsh results for common limited partnership structures and thus enacted subsection 40(3.12) to alleviate double taxation that may otherwise arise from the timing difference between distributions that reduce the adjusted cost base of partnership interests and the allocation of partnership income which increases the adjusted cost base of such interests.

Having identified the object, spirit, and purpose of the CDA mechanism rules and the negative adjusted cost base rules, the Tax Court considered whether the transactions undertaken by the taxpayer constituted abuse of the CDA mechanism rules through the use of the negative adjusted cost base rules.

The Tax Court noted that pursuant to a partially agreed statement of facts, the taxpayer had acknowledged that it had sought counsel as to how to time the transactions to generate two capital gains, take advantage of the CDA produced by those gains, and produce a capital loss that would offset the latter capital gain.

The Tax Court found that the CDA mechanism rules had been abused as their rationale was to achieve integration of the taxation of capital gains realized by a corporation. The taxpayer misused subsections 40(3.1) and (3.12) to achieve, through a timing difference, over-integration due to a second capital gain, which was offset by a capital loss under subsection 40(3.12).

While the outcome of this case may be unsurprising, it is worth considering the breadth of the potential scope of the abuse the Tax Court found. In essence, the Tax Court looked to the 1966 Carter Commission Report to find a broad policy in the Act against achieving over-integration (albeit a policy grounded in numerous provisions in the Act). As noted by the taxpayer, the Act frequently taxes in a manner that does not give rise to integration (e.g., on gains realized by a public corporation), and over-integration is not an infrequent result due to timing differences between rules, as was the case here, or for other reasons.

Perhaps in acknowledgement of the broad nature of the resulting abuse, the Tax Court stated that the conclusion reached in this case was based on the particular context in which the transactions were implemented and that the outcome could differ in a different context.

It is noted that this case arose in the context of the old definition of "capital dividend account" in subsection 89(1). This definition was amended in 2013 to exclude from the computation of CDA capital gains and losses triggered by subsections 40(3.1) and (3.12). However, notwithstanding this legislative change, the approach of the Tax Court in considering GAAR remains of interest.

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The taxpayer has filed an appeal of the Tax Court's decision to the Federal Court of Appeal.

—Justin Shoemaker

RECENT CASES

MAJORITY OF COURT OF APPEAL FINDING FEDERAL GREENHOUSE GAS POLLUTION PRICING ACT TO BE CONSTITUTIONAL

By reference pursuant to section 8 of the *Courts of Justice Act*, the Lieutenant Governor in Council referred to the Ontario Court of Appeal the question of whether the federal *Greenhouse Gas Pollution Pricing Act* was unconstitutional, in whole or in part.

A majority of the Court held that the federal legislation under consideration was constitutional. The majority (including one concurring opinion) held that the federal legislation was within Parliament's jurisdiction to legislate in relation to matters of "national concern" under the "Peace, Order and Good Government" clause of section 91 of the *Constitution Act*. That majority concluded that the charges imposed by the federal legislation were not taxes, were regulatory in nature, and connected to the purposes of the legislation and were constitutional. In the view of the majority, the need for a collective approach to a matter of national concern, and the risk of non-participation by one or more provinces, permitted the federal government to adopt minimum national standards to reduce greenhouse gas emissions and the legislation under consideration did that and no more. The majority also held that the legislation left ample scope for provincial legislation in relation to the environment, climate change, and greenhouse gas emissions, while narrowly constraining federal jurisdiction to address the risk of provincial inaction. A single member of the Court of Appeal held, in dissent, that while Parliament had significant authority to legislate in a variety of ways to reduce greenhouse gas emissions and to accomplish the goals of the legislation under consideration, Parts 1 and 2 of that legislation did not constitute a valid exercise of the federal government's authority under the national concern branch of its "Peace, Order and Good Government" power and was therefore unconstitutional.

Greenhouse Gas Pollution Pricing Act (Re)

2019 DTC 5090

DEEMED TRUST AND SUPER PRIORITY LIEN IN FAVOUR OF THE CROWN NOT ATTACHING TO PROCEEDS OF INSURANCE

A property owned by a tax debtor was destroyed by fire and the proceeds of insurance on that property were claimed by both the Canada Revenue Agency and the mortgagee of the property. A Court order was issued requiring that the disputed amount be paid into Court, and an applications judge subsequently determined, under the terms of the mortgage, any money payable under the contract of insurance was not the property of the mortgagor/tax debtor because of the standard mortgage clause. The applications judge held that the effect of the standard mortgage clause was to create a separate, independent, and distinct contract of insurance between the mortgagee and the insurer. While the mortgage itself constituted a security interest, the separate contract of insurance created by the standard mortgage clause did not create a security interest within the meaning of section 227 of the *Income Tax Act* (the "Act"). The proceeds of insurance were, consequently, not subject to the deemed trust rule in subsection 227(4.1) of the Act. The Crown appealed from that decision.

The appeal was dismissed. The Newfoundland and Labrador Court of Appeal held that the facts of the appeal were not in dispute and that the appeal turned on the question of the correct interpretation of both the deemed trust provisions in the Act and the standard mortgage clause. The Court reviewed the relevant provisions of the mortgage agreement before concluding that the insurance proceeds were not caught by a security interest within the meaning of section 227 of the Act. It held that the insurance proceeds were payable to the mortgagee under the separate policy of insurance which was created by the standard mortgage clause. In the appellate Court's view, the insurance proceeds "belonged" to the mortgagee and

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could never have been considered property of the tax debtor. As a result, the deemed trust and super priority lien in favour of the Crown did not attach to those proceeds, and the Crown's appeal was therefore dismissed.

Canada (AG) v. Nortip

2019 DTC 5087

APPEAL FROM IMPOSITION OF FINE FOR FAILURE TO FILE T1135 ALLOWED

The taxpayer, who had participated in an employer-sponsored share purchase program, became aware after the 2015 filing deadline that he should have filed a T1135 for 2015, when the value of his shares first exceeded $100,000. He advised the Canada Revenue Agency of this and then completed and filed T1135 forms for both 2015 and 2016, and continued to file T1135s annually as required. He was assessed a $2,500 penalty for not filing his 2015 T1135 form on a timely basis and he appealed from the imposition of that penalty.

The appeal was allowed. The Tax Court of Canada reviewed the relevant portion of the CRA's guide and forms with respect to the requirement to file a T1135. It held, based on that review, that the information provided was unclear and would not have been sufficient to make a reasonable person in the taxpayer's situation aware of the need to file a T1135. In addition, the Court noted that the appellant was not cavalier about his income tax obligations, and that any benefit and all income received on the shares were properly reported and tax paid. No amount was misrepresented, mischaracterized, or omitted in his 2015 tax return. Further, upon finding out that the T1135 notification form filing requirement was engaged in 2015, the appellant promptly filed it for both 2015 and going forward. The Court concluded that, on the facts, the case was one in which it was appropriate to apply a due diligence defence, and it did so. The appeal was allowed, and the penalty assessment vacated.

Moore v. The Queen

2019 DTC 1103

APPEAL DISMISSED WHERE TAX COURT LACKED JURISDICTION TO REVIEW MINISTER'S DECISION

Following the settlement of a dispute that arose in relation to a prior taxation year with respect to the amount of non-capital loss carryforwards, the corporate taxpayer filed a request with the Minister to have the amount of non-capital losses which had been claimed for the 1992 taxation year reduced. The Minister refused such request and the taxpayer appealed to the Tax Court of Canada. That Court held that the three conditions which must be fulfilled in order for the reassessment provisions in subsection 152(4.3) to apply had not been satisfied. The Court held as well that the question of whether the requested adjustments should have been made was a matter that should have been brought before the Federal Court and not the Tax Court. The taxpayer's appeal was dismissed, and it appealed from that dismissal to the Federal Court of Appeal.

The appeal was dismissed. The Federal Court of Appeal held that the first question for determination was whether the Tax Court possessed jurisdiction to interpret subsection 152(4.3) in order to determine whether the Minister was required to make the requested adjustments. As such was a question of law, the standard of review was correctness. The appellate Court held that the jurisdiction of the Tax Court was limited to references and appeals as provided in the *Tax Court of Canada Act*. There was no provision which would permit the Tax Court to judicially review the Minister's decision and to interpret subsection 152(4.3) of the *Income Tax Act* to decide whether the Minister was required to make the requested adjustments. It therefore did not possess such jurisdiction. The appellate Court held that the taxpayer should instead have sought judicial review of the Minister's decision in the Federal Court. Since the taxpayer did not do so, the Minister's decision to not make the adjustments for the 1992 taxation year must stand, and the appeal from the Tax Court decision was dismissed.

Bakorp Management v. The Queen

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2019 DTC 5088

APPEAL FROM DENIAL OF CLAIM FOR INTEREST DEDUCTION ALLOWED

The taxpayer obtained an interest-bearing loan in order to pay two damages awards. One such award was against him personally and the second was a joint damages award against the taxpayer and a company of which he was a shareholder, officer, and director. Funds from that loan sufficient to satisfy the joint damages award were advanced to the company that was jointly liable in damages and an agreement was entered into providing for the repayment of those funds to the taxpayer, with interest. The taxpayer then claimed a deduction for interest amounts paid on the portion of the first loan that represented the amount advanced to the company to pay the joint damages award. Such deduction was denied on assessment and the taxpayer appealed.

The appeal was allowed. The Tax Court of Canada held that the issue in the appeal was whether there was a loan between the appellant and the company, or whether the appellant had paid the damages on his own account. In order to determine the deductibility of the interest amounts paid, it was required, under the tests set out in the jurisprudence, to characterize the nature of the appellant's direct use of the loaned funds and whether the purpose behind that use was an income-earning purpose. The Court held that in making that characterization, the issue for determination was whether the borrowed money was used for the purpose of earning income from property and the Court concluded that it was. In the Court's view, the direct use of the loaned funds was to make an interest bearing loan to the company that was jointly liable in damages, and that the legally enforceable loan agreement thereby acquired was property to the appellant. The Court concluded that one of the purposes of the loan was to earn income. While such purpose was an ancillary purpose, it was a *bona fide* objective of the investment, capable of providing the requisite purpose for interest deductibility under paragraph 20(1)(c) of the *Income Tax Act*. The appeal was therefore allowed.

Black v. The Queen

2019 DTC 1097

PETITION FOR ORDER OF RESCISSION WITH RESPECT TO SERIES OF TRANSACTIONS CARRIED OUT BY FAMILY TRUST ALLOWED

In 2008 and 2009, two family trusts carried out a series of transactions intended to protect assets from future creditors, without incurring any income tax liability. The structure of those transactions, which involved the payment of dividends from corporations to discretionary trusts, was based on the prevailing interpretation of section 75(2) of the *Income Tax Act*. In 2012, however, the Federal Court of Appeal held that the interpretation relied on was incorrect, and the Minister subsequently reassessed such transactions on the basis that dividends paid to the trusts as part of the series of transactions were taxable. The petitioners then applied for rescission of the series of transactions, and the petition was opposed by the Minister on the grounds that the transactions constituted tax avoidance within the meaning of the general anti-avoidance rule, for which the equitable remedy of rescission was not available.

The petition was allowed. The British Columbia Supreme Court held that the main issue for determination was whether a previous decision of the British Columbia Court of Appeal on the remedy of rescission applied in the circumstances. The Court reviewed the transactions considered in that previous decision and the transactions undertaken by the petitioners. It concluded, based on that review, that the facts of the case before it were sufficiently similar to the previous decision in which rescission had been granted that it was bound by that previous decision. In addition, the Court held that such previous decision was not, as argued by the Minister, distinguishable, as the Court in that decision had considered the factor of tax avoidance. Finally, the Court held that the previous decision by which it was bound had not been expressly overruled in subsequent appellate jurisprudence and so it was not open to the Court to disregard it. The petition was therefore allowed and the remedy of rescission granted.

Collins Family Trust v. Canada (AG)

2019 DTC 5085

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APPEAL DISMISSED WHERE MEMBER ALLOCATIONS OF INCOME AND LOSSES BY LIMITED PARTNERSHIP NOT REASONABLE

A family business reorganized their existing business structure to create a limited partnership, with family members each holding units of that limited partnership. The stated reason for the reorganization was to meet specific business, tax, and creditor-proofing goals. The Minister disagreed, finding that the reorganization was tax-driven, created to divert future income and growth to family trusts and to avoid taxes, either individually or due to the deemed disposition on death. The Minister reassessed under section 103 of the *Income Tax Act* to reallocate the income and losses among the partnership unit holders in accordance with their initial capital contribution for their units, on the basis that the allocation called for under the limited partnership structure was not reasonable. The members of the partnership and the partnership itself appealed from those reassessments, and the appeals were heard on common evidence.

The appeals were dismissed. The Tax Court of Canada noted that the wording of section 103(1.1) of the *Income Tax Act* requires that where two or more members of a partnership who are not dealing with each other at arm's length agree to share any income or loss of that partnership, it is necessary that the allocation of such income or losses be reasonable in the circumstances, having regard to the capital invested or work performed by those members. Where such allocation does not meet the section 103(1.1) requirement, that provision deems the allocation to be the amount that is reasonable in the circumstances. The Tax Court of Canada reviewed the capital contribution and income allocation provisions of the limited partnership structure before concluding it was obvious that there was no correlation between contributions to capital by the partners and entitlement to distribution of income. The Court also considered the work performed in the partnership by the various partners and held that the allocation of both income and losses in the partnership agreement was similarly unreasonable. Overall, the allocation of income and losses would not be acceptable to arm's length business people in the position of the members of the partnership, having regard to their own business interests. The Court concluded, therefore, that such allocations were properly subject to reallocation by the Minister and that the Minister's reallocation of both income and losses was reasonable. The appeals from the Minister's reassessments were therefore dismissed.

Aquilini (Estate) v. The Queen

2019 DTC 1096

Footnotes

[1] Generally speaking, the deduction is allowed under paragraph 110(1)(d) if the exercise price is not less than the fair market value of the underlying shares at the time the agreement is entered into, the employee deals at arm's length with the employer, and the shares are prescribed shares under Regulation 6204 of the *Income Tax Regulations* (the "Regulations"). The deduction is allowed under paragraph 110(1)(d.1) in the case of CCPC shares if they are held for at least two years.

[2] In its publication *Rewarding Talent*, the firm Index Ventures reviewed the employee stock option rules for 73 countries and ranked Canada second in terms of tax "friendliness" (Estonia was first). See the Index Ventures website at www.indexventures.com/rewardingtalent.

[3] Owing to the lack of monetary and other restrictions, non-qualified stock options "are the options making the news as creating large fortunes for officers and employees"; James M Bickley, *Summary: Employee Stock Options: Tax Treatment and Tax Issues* (Congressional Research Services, 2012).

[4] Interestingly, previous Department of Finance positions relied on these rationales to justify the preferential one-half inclusion of stock option benefits. For example, see Department of Finance, "Report on Federal Tax Expenditures—Concepts, Estimates and Evaluations 2018", Part 3, at 124; and more generally the Department of Finance 1984, 2000, and 2010 budget papers.

[5] The arguments are set out in detail in Daniel Sandler, "The Tax Treatment of Employee Stock Options: Generous to a Fault" (2001) vol. 49, no. 2 *Canadian Tax Journal* 259, and Calvin Johnson, "Stock and Stock Option Compensation: A Bad Idea" (2003) vol. 51, no. 2 *Canadian Tax Journal* 1259.

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[6] As noted by Sandler, *ibid* at 297-98, “No preferential tax treatment should be necessary in order to compel a corporation to do what is in its own best interests. In order to substantiate the provision of tax incentives for stock options, it would have to be shown that stock options are socially desirable, that the amount of employee stock options issued in the absence of a tax preference is suboptimal, and that a tax preference would increase the number issued to a higher level. This point has not been the subject of any rigorous study. Rather, it is assumed without proof of its validity.”

[7] More generally, some commentators in the business world criticize the business case for the use of employee stock options, aside from the tax considerations. Roger Martin, former dean of the University of Toronto Rotman School of Management, argues that employee stock options encourage executives to “pursue strategies that fatten their wallets at shareholders’ expense” (“Taking Stock” (2003) vol. 81, no. 1 *Harvard Business Review* 19) and are based on the “wrong-headed coupling of the real market (the business of designing, making and selling products and services) with the expectations market (the business of trading stocks, options and complex derivatives)” (excerpt from *Fixing the Game: Bubbles, Crashes and What Capitalism Can Learn from the NFL*, published at https://rogerlmartin.com/lets-read/fixing-the-game). Henry Mintzberg, business management professor at McGill University, savages the use of employee stock options and stock grants, arguing that they “represent the most prominent form of legal corruption that has been undermining our large corporations and bringing down the global economy. Get rid of them and we will all be better off for it” (“No More Executive Bonuses!” *Wall Street Journal*, June 14, 2012). Warren Buffett, chairman of Berkshire Hathaway, is also not a fan of employee stock options, arguing that they do not give executives the same stake as shareholders since the shareholders will suffer if the price declines whereas the executives will not (“Stock Options Are Faulted By Buffett” *New York Times*, March 11, 2002).

[8] “The Taxation of Employee Stock Options,” (2005) *OECD Tax Policy Studies* No. 11.

[9] Department of Finance, 2000 Federal Budget papers. The deferral was subsequently repealed in the 2010 Federal Budget.

[10] In its June 17, 2019, news release accompanying the draft legislation, the government states that the employers who meet prescribed conditions are intended to be “start-up, emerging, and scale-up companies” that are not CCPCs. Stakeholders were invited to submit comments with respect to the prescribed conditions by September 16, 2019.

[11] In contrast, other tax preferences in respect of CCPCs, such as the small business deduction and enhanced investment tax credits, are phased out if the CCPC’s taxable capital exceeds $10 million.

[12] Applying the formula in subsection 110(1.31), A would equal $100,000, and B and C would each equal $300,000.

[13] Applying the formula in subsection 110(1.31) for each year, A would equal $50,000, and B and C would each equal $250,000.

[14] The Department of Finance explanatory notes to the provision provide a useful example of this ordering rule.

[15] The Department of Finance explanatory notes also provide an example of this ordering rule.

[16] Employees in the highest federal tax bracket of 33% would see another 16.5% of tax added to their benefits, whereas non-CCPC employers subject to the 15% general corporate tax rate could save 15% of tax from their deductions. Provincial tax considerations would vary.

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