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Current Items of Interest 4

Focus on Current Cases 8

Recent Cases 13

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AN UPDATE ON THE US NET INVESTMENT INCOME TAX FOR US CITIZENS IN CANADA

— *Max Reed*[1]

For many US citizens who are resident in Canada, the Net Investment Income Tax ("NIIT") is the only US tax they pay every year. Without a foreign tax credit or exemption, the imposition of the NIIT results in double taxation since the investment income is also subject to tax in Canada. This article reviews and provides an update on some strategies to relieve this double taxation.

1. Basics of Double Taxation

The NIIT applies to a US citizen's investment income if the US citizen has income above a certain threshold (modified adjusted gross income of US$125,000–$250,000, depending on filing status). Unlike regular income tax that is imposed under Chapter 1 of the *Internal Revenue Code* (the "Code"), the NIIT is imposed under Chapter 2A. Because the normal foreign tax credit only applies to Chapter 1 taxes, the Code does not provide any foreign tax credit that can reduce the NIIT.

For US citizens in Canada, most investment income subject to the NIIT is sourced to Canada under Article XXIV of the Canada-US Tax Treaty, with the exception of US-source dividends and US rental income. That means that Canada has the primary right to tax the investment income. If the US does not permit a credit against the NIIT, the NIIT is effectively double taxation. It sits on top of the Canadian tax, even though the Canadian tax rate is generally higher than the US rate.

2. Canadian Foreign Tax Credit Against the NIIT

The denial of the foreign tax credit in the US would not be an issue if Canada instead granted a foreign tax credit for the NIIT paid to the US. For some types of income, Canada's domestic sourcing rules differ from the Canada-US Tax Treaty rules described above (under which most investment income subject to the NIIT is Canadian-source). The Canadian domestic sourcing rules outlined in CRA Folio S5-F2-C1 provide a substantially broader range of income that is US-source than the Canada-US Tax Treaty does.

Therefore, by sourcing the investment income pursuant to the Canadian domestic rules, a Canadian credit for the NIIT would theoretically be available in some cases.

However, although dated, our understanding of the Canada Revenue Agency's ("CRA") position regularly applied at the CRA Appeals Branch is that Canada-US Tax Treaty Article XXIV(4)(a) precludes the creditability of the NIIT on US-source income in Canada. This position seems wrong given that the general purpose of the Canada-US Tax Treaty is

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ameliorative, and that the express text of Canada-US Tax Treaty Article XXIX(1) instructs that the Canada-US Tax Treaty is not to restrict credits or benefits that would otherwise be available under domestic law. Nevertheless, the CRA seems intent on adhering to its position, and for most US citizens in Canada it will be Canadian-source NIIT that is the biggest double tax exposure. That would be improved with the US offering a foreign tax credit.

3. US Tax Relief From the NIIT

Shortly after the NIIT's enactment, Kevyn Nightingale of MNP published an article[2] putting forward two strategies to exempt US citizens abroad from the NIIT:

(1) Canadian-resident US citizens are exempt from the NIIT under the US-Canada Social Security Totalization Agreement ("SSTA") (the "SSTA Position");

Or alternatively

(2) Canadian resident US citizens can claim a foreign tax credit for foreign-source NIIT (the "FTC Position").

We have spent significant effort expanding on and developing the arguments made in Kevyn's original article with respect to both the SSTA Position and the FTC Position.

The Internal Revenue Service's ("IRS") position since at least January 1, 2019, if not earlier, is to disagree with both positions. They have taken that position consistently in various litigation and at IRS Appeals (which has in our experience only sided with the IRS on this issue). Recent court decisions muddy the IRS' position.

a. The SSTA Position

The only published authority on the SSTA Position is the opinion expressed by the Court in *Paul Young Kim v. United States*.[3] This case considered the US-Korea SSTA. After extensive reasoning, the Court concluded that it was "plausible" that the US-Korea SSTA provided an exemption from the NIIT. The conclusion was left open for the parties to provide further evidence on the shared expectations of the parties to the SSTA. Alas, despite a thorough search, there is simply no evidence available as to the intention of the parties. And so the litigation in the *Kim* case was withdrawn by consent of the parties.

Our firm assisted Guy Glaser of the Brager Tax Law Group with the development of the arguments in this case which go significantly beyond the position originally outlined by Kevyn nearly 10 years ago. Despite the Court in *Kim* leaving the matter open for another day, our view is that ultimately the US government will prevail on this issue under all SSTAs. Worse, the exemption position under the US-Korea SSTA is stronger than under the Canada-US SSTA. Regardless, the *Kim* case provides enterprising taxpayers, who are not afraid of a dispute with the IRS, some support for the SSTA position.

b. The FTC Position

The second position is that the Canada-US Tax Treaty requires the provision of a US foreign tax credit against the NIIT.

Overly simplified, the logic in support of this conclusion is as follows:

(A) The NIIT is an income tax and is a "covered tax" under Canada-US Tax Treaty Article II.

(B) The US is obliged to provide a foreign tax credit under Canada-US Treaty Article XXIV(1) because a failure to do so violates the "general principle" that the foreign tax credit rules should alleviate double taxation.

(C) Separate and apart from the general credit in Canada-US Treaty Article XXIV(1), the provisions in Articles XXIV(4), XXIV(5), and XXIV(6) require the provision of an FTC against the NIIT for US citizens who are also Canadian tax residents.

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[2] www.thetaxadviser.com/issues/2014/apr/nightingale-april2014.html.

[3] United States District Court for the Central District of California, Docket NO. 5:22-CV-00691; see www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/ftc-claim-in-net-investment-income-tax-refund-suit-is/7gh2k.

There are three reported decisions on the foreign tax credit for the NIIT: *Toulouse v. Commissioner of Internal Revenue*,[4] *Paul Young Kim v. United States*,[5] and *Christensen et al. v. United States*.[6] *Toulouse* and *Christensen* involve the US-France Tax Treaty and *Kim* addresses the US-Korea Tax Treaty. There are no reported cases involving the Canada-US Tax Treaty.

Distilled to their essence, and reconciling the conclusions in each case:

(A) The IRS concedes in all three cases that the NIIT is a covered income tax subject to the various tax treaties.

(B) All three reported decisions stand for the proposition that the provision in the treaties at issue that is equivalent to the Canada-US Tax Treaty Article XXIV(1) does not provide an independent credit against the NIIT.

(C) The *Christensen* case stands for the proposition that there is an independent credit against the NIIT under the provisions equivalent to Articles XXIV(4), XXIV(5), and XXIV(6) of the Canada-US Tax Treaty.

Technically, each treaty requires a separate interpretation to accomplish the intent of the respective treaty partners, but the US courts seem content to simply replicate the logic of *Toulouse* with respect to the general foreign tax credit provision (point B). As many esteemed commentators have pointed out, that conclusion is flawed and leads to absurd results. If the general treaty foreign tax credit is simply a carbon copy of the foreign tax credit under the Code, then what is the point of the treaty? If Congress simply eliminated the foreign tax credit altogether, would that mean that the treaty would not guarantee any foreign tax credit? That is an absurd result and yet it is the extension of the reasoning developed in *Toulouse* and followed exactly in *Kim* and *Christensen*. One hopes that eventually an appellate court will step in and clean up this absurd result.

Christensen stands alone in addressing the treaty provisions specifically applying to US citizens resident abroad. Those provisions were not discussed in *Toulouse* or *Kim*, and other related cases such as *Kappus v. Commissioner of Internal Revenue*[7] and *Jamieson v. Commissioner*[8] (both regarding the application of foreign tax credits to the alternative minimum tax) leave their interpretation unaddressed. The provisions in the US-France Tax Treaty Article XXIV(2)(b)(i) are substantially similar to the provisions in the Canada-US Tax Treaty Article XXIV(4). As such, *Christensen*, combined with the multitude of other authority including the text and context of Canada-US Tax Treaty Article XXIV(4), the Letter of Transmittal to the Canada-US Tax Treaty, the technical notes to the various protocols, and other lesser authority, provide a reasonable, and uncontradicted, basis for a US citizen in Canada to take a foreign tax credit against the NIIT on foreign-source income. Almost certainly, the IRS will not agree and will dispute the position. *Christensen* will be appealed. And so the landscape remains uncertain.

4. Conclusion — The Way Forward

The landscape for Canadian-resident US citizens facing double taxation due to the NIIT is frustrating and confusing. But the above discussion yields the following general principles:

(1) The fight against double taxation caused by the NIIT is far from over.

(2) For US citizens in Canada with NIIT on US-source income (under the Canadian domestic sourcing rules) there is the potential for a Canadian foreign tax credit. Given the frequency with which the CRA reviews foreign tax credit claims and the firm position of CRA Appeals, this position is probably not that practical unless the amount is large enough to warrant litigating.

(3) The SSTA Position will ultimately likely not prevail in the fullness of time, but the current authorities provide some support for taking the position.

(4) For US citizens resident in Canada with NIIT on foreign-source income, the technical case for a foreign tax credit under the Canada-US Tax Treaty is strong. Given that the IRS will contest the position, the effort is likely best made on a refund claim to reduce risk. The refund claim can potentially go back six years under certain Canada-US Tax Treaty-based processes.

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[4] 157 T.C. 49 (2021), scholar.google.ca/scholar_case?case=813116451479656327&q=Toulouse+commissioner&hl=en&as_dt=2006&as_vis=1.

[5] *Ibid*, footnote 3.

[6] United States Court of Federal Claims No. 20-935T, ecf.cofc.uscourts.gov/cgi-bin/show_public_doc?2020cv0935-66-0.

[7] 337 F.3d 1053 (2003), scholar.google.ca/scholar_case?case=17102213650899832146&q=Kappus&hl=en&as_dt=2003.

[8] 70 T.C.M. 1372 (1995), scholar.google.ca/scholar_case?case=17071887713440252617&q=Jamieson+v.+Commissioner+&hl=en&as_dt=2003.

CURRENT ITEMS OF INTEREST

Changes Coming to T4/T4A Reporting

Beginning with the 2023 tax year, issuers (including employers and pension plan administrators) of the T4 *Statement of Remuneration Paid* and T4A *Statement of Pension, Retirement, Annuity, and Other Income* must report on a T4 or T4A slip whether, on December 31 of the taxation year to which the information return relates, a payee or any of their family members were eligible to access dental insurance, or dental coverage of any kind, including health spending and wellness accounts, due to their current or former employment.

This reporting requirement is mandatory beginning with the 2023 tax year, and will continue to be required on an annual basis. Failing to report this information may result in financial penalties. To support these new reporting requirements, the following changes were made to the T4 and T4A slips:

- Box 45, *Employer-offered Dental Benefits*, was added to the T4. This new box will be mandatory for all slips.
- Box 015, *Payer-offered Dental Benefits*, was added to the T4A. This new box will be mandatory if an amount is reported in Box 016, *Pension or Superannuation*. The box will otherwise be optional.

The CRA may reject any T4 or T4A slip that is filed without this information. For calendar year 2023 only, it is not mandatory to fill out the new box when and only when code 1 is applicable. This administrative policy applies only if all reasonable efforts have been made to comply with the reporting requirements.

T3, *Trust Income Tax and Information Return* and Internal Trusts

The CRA has confirmed it will not require registered charities to file the T3, *Trust Income Tax and Information Return*, for internal trusts. Internal trusts are those created when a charity:

- receives property as a gift that is subject to certain legally enforceable terms and conditions; and
- holds that property as the trustee of the trust.

New Version of Form T3010 Coming January 2024

In 2022, the federal Government announced measures to boost charitable spending in Canada and passed legislation changing disbursement quota rules for registered charities. In January 2024, the CRA will release a new version of the Form T3010, *Registered Charity Information Return*, to reflect new reporting requirements. At that time, there will be two downloadable versions of the Form T3010:

- Charities with fiscal periods ending on or before December 30, 2023, should file their Form T3010 using version 23; and
- Charities with fiscal periods ending on or after December 31, 2023, will have to file their Form T3010 using version 24.

If you send an outdated version of the form, CRA will not accept it for filing.

Draft Regulations Amending the *Fuel Charge Regulations*

On November 1, the Ministry of Finance released *Draft Regulations Amending the Fuel Charge Regulations* that would implement a temporary pause of the fuel charge on deliveries of heating oil. To review the draft regulations, see fin.canada.ca/drleg-apl/2023/dramfcr-aprmrrc-1123-l-eng.html.

Latest Publications

- The Employers' Guide Taxable Benefits and Allowances has been updated for 2023; see www.canada.ca/en/revenue-agency/services/forms-publications/publications/t4130/employers-guide-taxable-benefits-allowances.html.
- List of registered investments as of December 31, 2022, has been issued; see www.canada.ca/en/revenue-agency/services/tax/registered-plans-administrators/registered-investments/registered-investments-1/2023-registered-investments-list.html.
- The T1 Filing Compliance 2023 edition (2021 tax year), a CRA publication which presents data about returns that were filed late or on time, has been published; see www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/income-statistics-gst-hst-statistics/t1-filing-compliance/2023-edition-2021-tax-year.html.
- EI Premium Rates and Maximum Insurable Earnings has been published for 2024; see www.canada.ca/en/revenue-agency/services/tax/businesses/topics/payroll/payroll-deductions-contributions/employment-insurance-ei/ei-premium-rates-maximums.html.

Progress of Legislation

- Bill C-42, *An Act to amend the Canada Business Corporations Act and to make consequential and related amendments to other Acts*, received Royal Assent on November 2, 2023 (S.C. 2023, c. 29). This Bill makes a consequential amendment to the *Income Tax Act*
- Bill C-234, *Gas Pollution Pricing Act*, is at Third Reading in the Senate. This private member's Bill would remove the carbon tax on natural gas and propane used in such activities as irrigation, grain drying, feed preparation, and heating and cooling barns and greenhouses.

Canadians Invited to Help Design New Canada Disability Benefit

On November 15, the Minister of Diversity, Inclusion and Persons with Disabilities, Kamal Khera, announced the launch of the *Canada Disability Benefit Regulations* Online Engagement Tool. This platform will collect insight and feedback from Canadians to help inform the design of the regulations for the new benefit. Canadians are invited to participate and share their views.

The *Canada Disability Benefit Regulations* Online Engagement Tool can be accessed via www.canada.ca/en/employment-social-development/programs/disabilities-benefits/consultation-canada-disability-benefit-regulations.html until December 21, 2023. There will also be additional opportunities to provide input after the formal publication of the draft regulations, which is expected to take place sometime in 2024. More information is available on the Canada Disability Benefit webpage at www.canada.ca/en/employment-social-development/programs/disabilities-benefits.html.

Notifiable Transactions Designated by Minister of National Revenue

Canada's enhanced mandatory disclosure rules include a requirement to report notifiable transactions. A transaction becomes a notifiable transaction if it is the same or substantially similar to one that is designated by the Minister of National Revenue, with the concurrence of the Minister of Finance, as outlined under section 237.4 of the *Income Tax Act*. The following transactions and series of transactions are hereby designated, effective November 1, 2023:

- NT-2023-01, Straddle loss creation transactions using a partnership;
- NT-2023-02, Avoidance of deemed disposal of trust property;
- NT-2023-03, Manipulation of bankrupt status to reduce a forgiven amount in respect of a commercial obligation;
- NT-2023-04, Reliance on purpose tests in section 256.1 to avoid a deemed acquisition of control; and
- NT-2023-05. Back-to-back arrangements.

For additional details, see www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/compliance/mandatory-disclosure-rules-overview/notifiable-transactions-designated-by-minister-national-revenue.html.

MP, DB, RRSP, DPSP, ALDA, TFSA Limits, YMPE, and YAMPE Updates

On November 1, the Government of Canada published the annual limits for money purchase plans ("MPPs"), defined benefit plans ("DBPs"), registered retirement savings plans ("RRSPs"), deferred profit sharing plan ("DPSPs"), advanced life deferred annuities ("ALDAs"), and tax-free savings accounts ("TFSAs"), as well as the year's maximum pensionable earnings ("YMPE"), and the year's additional maximum pensionable earnings ("YAMPE"). For details, see www.canada.ca/en/revenue-agency/services/tax/registered-plans-administrators/pspa/mp-rrsp-dpsp-tfsa-limits-ympe.html.

CRA Announces Maximum Pensionable Earnings and Contributions for 2024

The maximum pensionable earnings under the Canada Pension Plan ("CPP") for 2024 will be $68,500 — up from $66,600 in 2023. The basic exemption amount for 2024 remains at $3,500. Starting in 2024, a higher, second earnings ceiling of $73,200 will be implemented and used to determine second additional CPP contributions ("CPP2"). As a result, pensionable earnings between $68,500 and $73,200 are subject to CPP2 contributions. These new ceilings were calculated in accordance with the CPP legislation and take into account the growth in average weekly wages and salaries in Canada.

Employee and employer CPP contribution rates for 2024 remain at 5.95%, and the maximum contribution will be $3,867.50 each — up from $3,754.45 in 2023. The self-employed CPP contribution rate remains at 11.90%, and the maximum contribution will be $7,735.00 — up from $7,508.90 in 2023.

Employee and employer CPP2 contribution rates for 2024 will be 4.00%, and the maximum contribution will be $188.00 each. The self-employed CPP2 contribution rate will be 8.00%, and the maximum self-employed contribution will be $376.00. Contributors are not required or permitted to make contributions on pensionable earnings above $73,200.

For more information, visit Canada.ca.

Deadline to File Underused Housing Tax Return Extended

On October 31, the Minister of National Revenue announced that owners affected by the Underused Housing Tax ("UHT") will have until April 30, 2024, to file their returns for the 2022 calendar year without being charged penalties or interest. Prior to the announcement, the deadline was October 31, 2023.

The CRA has published a new online self-assessment tool (www.canada.ca/en/services/taxes/excise-taxes-duties-and-levies/underused-housing-tax/who-file-pay.html#determine) to help determine if you:

- Need to file the return and pay the tax;
- Need to file the return but not pay the tax because you may qualify for an exemption from paying the UHT; or
- Do not have to file a UHT return or pay the tax because you are an excluded owner.

If you're an affected owner of residential property in Canada, you must file a separate UHT return by April 30, 2024, for each property you owned on December 31 of the 2022 and 2023 calendar years to avoid penalties and interest.

New Reporting Requirements for Trusts

The Government of Canada has introduced new reporting requirements for trusts.

The change in reporting requirements means that affected trusts will be required to file a T3 Trust, *Income Tax and Information Return* (T3 return) and a Schedule 15 (Beneficial Ownership Information of a Trust) with the CRA every year. Many trusts will be filing a T3 return for the first time. Before the introduction of the new reporting requirements, a trust that did not earn income, dispose of capital property, or make distributions of income or capital in a year was generally not required to file an annual return.

Affected trusts must now complete an annual T3 return which includes a Schedule 15 for tax years ending after December 30, 2023. Some trusts are exempt from the new reporting requirements, like registered plans, qualified disability trusts, and others.

An affected trust must provide additional information for all reportable entities such as trustees, settlors, beneficiaries, and controlling persons for the trust, including those who may have been a reportable entity for only part of the year.

The deadline for the T3 return and Schedule 15 is 90 days after the trust's tax year end. The tax year end for most trusts is the end of the calendar year. Trusts with a December 31, 2023, tax year end will need to file their T3 Return and Schedule 15 by March 30, 2024. Since this falls on Saturday, your return will be considered filed on time if the CRA receives it, or it is postmarked, on or before April 2, 2024 (the next business day). If you do not file an annual T3 return and you are required to, penalties may apply.

Measures to Lower Energy Costs

On October 26, the Prime Minister announced the following new measures to lower energy costs in Canada:

- Temporarily pausing the fuel charge on deliveries of heating oil in all provinces and territories where it currently applies for a three-year period, effective November 9, 2023. To implement the pause, the government intends that the fuel charge would not be payable by registered distributors on light fuel oil delivered exclusively for use in providing heat to a home, building, or similar structure. The exemption will apply upfront without the need for an exemption certificate for fuel delivered on or after November 9, 2023, and before April 1, 2027.
- Doubling the rural top-up for pollution pricing rebates (Climate Action Incentive payments) from 10% to 20%, with increased payments to rural residents starting in April 2024. To be eligible for the rural top-up, an individual must reside outside a Census Metropolitan Area based on the most recent census published by Statistics Canada before the taxation year.
- New supports will begin rolling out in Atlantic Canadian provinces that have agreed to joint federal-provincial delivery of Oil to Heat Pump Affordability programs, with potential to expand to other provinces and territories that agree to support the delivery of the enhanced federal program. This support will help households with low to median incomes by,
  - Making the average heat pump free for at or below median-income households by increasing Oil to Heat Pump Affordability grants up to $15,000, from the current maximum of $10,000. The additional $5,000 for homeowners who install a heat pump will match provincial and territorial contributions via co-delivery programs.
  - Upfront payments of $250 for at or below median-income households that use heating oil and sign up to switch to a heat pump through a joint federal-provincial government program.

Ontario Removing Full Provincial Portion of HST on Qualifying New Rental Housing

Following on the heels of the federal government's announcement on September 14, the Ontario government is taking steps to remove the full 8% provincial portion of the HST on qualifying new purpose-built rental housing. The removal of the provincial portion of the HST would apply to new purpose-built rental housing such as apartment buildings, student housing, and senior residences built specifically for long-term rental accommodation, that meet the criteria. The enhanced rebate would apply to qualifying projects that begin construction between September 14, 2023, and December 31, 2030, and complete construction by December 31, 2035.

Mandatory Disclosure Rules (Update)

On November 2, the publication *Mandatory disclosure rules — Guidance* was updated once again. See www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/compliance/mandatory-disclosure-rules-overview/guidance-document.html for the latest version of the document.

FOCUS ON CURRENT CASES

This is a regular feature examining recent cases of special interest, coordinated by Ron Dueck of Dentons Canada LLP. The contributors to this feature are from Dentons Canada LLP, Montréal, Toronto, Calgary, Edmonton, and Vancouver.

Quebecor Inc. v. Le Roi, 2023 TCC 142 (Tax Court Of Canada) — Transferring Property With Accrued Capital Gain To Parentco To Utilize Loss of a Subsidiary and Increase ACB of the Transferred Property Does Not Constitute Abuse Under the GAAR

Background

Québecor Inc. (the "Taxpayer") is a public company operating in the media and telecommunications sector.

In July 1987, the Taxpayer acquired approximately 10% of the common shares of Abitibi Consolidated Inc. ("Abitibi Consolidated").

In October 2000, the Taxpayer made a significant investment in Québecor Media Inc. ("Québecor Media") whereafter it held approximately 45% of the shares of Québecor Media. Québecor Media used the proceeds of this investment to acquire all of the shares of Groupe Vidéotron ltée ("Groupe Vidéotron") which held all the common shares of 3662527 Canada Inc ("3662527"). The Carlyle Group held all of the Class C preferred shares in 3662527.

In December 2000, the Taxpayer transferred its shares of Groupe Vidéotron to its wholly owned subsidiary 9071-4866 Québec Inc. ("9071-4866") on a tax-deferred basis under subsection 85(1) of the *Income Tax Act* (the "ITA") in consideration for common shares of 9071-4866. Groupe Vidéotron and 9071-4866 then amalgamated under subsection 87(1), which enabled the surviving company Groupe Vidéotron to bump its adjusted cost base ("ACB") of its common shares in 3662527 under paragraph 88(1)(*d*) of the ITA to $400,000,000.

In December 2003, the Carlyle Group sold all of its class C preferred shares of 3662527 to a newly incorporated wholly owned subsidiary of Quebec Media, 9101-0827 Québec Inc. ("9101-0827") for a purchase price of $125,000,000.

By December 2004, the fair market value of Québecor Media and 3662527 shares dropped due to a period of slowdown of the economy and activities. On December 14, 2005, the following series of transactions (the "December 2005 Transactions") were undertaken:

- The Taxpayer transferred its shares of Abitibi Consolidated to 3662527 on a tax-deferred basis under subsection 85(1) in exchange for 1,000 class D preferred shares of 3662527 with an aggregate redemption value of $190,000,000.
- 3662527 reduced the capital account of its Class C preferred shares from $200,000,000 to $5,000, which reduction was added to 3662527's contributed surplus account.
- 3662527 then redeemed its class D preferred shares in consideration for the issuance of a promissory note to the Taxpayer with a principal amount of $190,000,000, resulting in a tax-free intercorporate dividend being deemed to be paid under subsections 84(3) and 112(1) of the ITA.
- The Taxpayer then exchanged the promissory note for the shares of Abitibi Consolidated held by 3662527, resulting in 3662527 realizing a capital gain on the disposition of the shares. The Taxpayer's ACB in the shares was increased to approximately $190,000,000, being the fair market value of the promissory note.
- 3662527 was then wound up under subsection 88(2). The diminished value of the shares of 3662527 was then less than the redemption value of its Class C preferred shares, resulting in 9101-0827 receiving all of the assets of 3662527 on the wind-up. The assets included the shares of Vidéotron Telecom ltée ("Vidéotron Telecom"), the operating company of 3662527, and cash of approximately $45,000,000. Québecor Media received nothing on the wind-up.

As a result of the wind up, 3662527 was deemed to have disposed of its assets at their FMV, in accordance with subsection 69(5), and it reported a capital loss from the disposition of its shares of Vidéotron Telecom, which was used to offset the capital gain realized on the disposition of Abitibi Consolidated shares.

In 2007, Abitibi Consolidated amalgamated with Bowater to form Abitibi Bowater Canada (“Abitibi Bowater”). As part of this amalgamation, the Taxpayer disposed of its common shares of Abitibi Consolidated in exchange for shares of Abitibi Bowater. The Taxpayer reported a capital loss of approximately $95,000,000.

The Minister of National Revenue (the “Minister”) reassessed the Taxpayer by notice of reassessment regarding its 2007 taxation year pursuant to the general anti-avoidance rule (the “GAAR”) in section 245 of the ITA, whereby the Minister reduced the ACB of the common shares of Abitibi Consolidated disposed of by the Taxpayer from approximately $190,000,000 to $1, resulting in: (1) the denial of the claimed capital loss of approximately $95,000,000, and (2) the assessment of a capital gain of approximately $95,000,000.

Issues and Tax Court Decision

In rendering its decision in 2023, the Tax Court of Canada was asked to determine whether the GAAR applied. To that end, the Court was required to answer the following questions:

1. Did the Taxpayer receive a tax benefit from one transaction or from one transaction in a series of transactions within the meaning of subsections 245(1) and 245(2)?

2. If so, was the transaction that generated the tax benefit an avoidance transaction within the meaning of subsection 245(3)?

3. If so, did the avoidance transaction result in an abuse of one of the provisions of the ITA within the meaning of subsection 245(4)?

Did the Taxpayer Obtain a Tax Benefit from the Series of Transactions?

The Court held that the “series of transactions” included the December 2005 Transactions and the Taxpayer obtained a tax benefit as a result of the series of transactions within the meaning of subsection 245(1) and 245(2). Specifically, the series of transactions allowed the Taxpayer to increase the ACB of its Abitibi Consolidated shares by approximately $190,000,000 and to realize a capital loss of $95,000,000 on the disposition of the shares in exchange for Abitibi Bowater shares.

Was the Tax Benefit Generated from an Avoidance Transaction?

To answer the second question, the Court held that it must determine whether it is reasonable to conclude that the transactions were carried out primarily for *bona fide* purposes other than to obtain a tax benefit. To make this determination, the Court looked at a letter from KPMG that explicitly stated that the purpose of the series of transactions was to increase the ACB of the Abitibi Consolidated shares in order to reduce the capital gain that would be realized on the future disposition. The letter stated that to achieve the goal, 3662527 was put in a position to realize a capital loss of its assets to its shareholders. Based on this letter, the Court held that under subsection 245(3), the series of transactions were not carried out primarily for a *bona fide* purpose other than to obtain a tax benefit and constituted an avoidance transaction.

Was the Avoidance Transaction Abusive to One of the Provisions of the ITA?

The Court stated that in order to determine whether an avoidance transaction is abusive to one of the provisions of the ITA, it must conduct a two-step analysis. The first step involves determining the purpose or spirit of the provisions of the ITA that are invoked to obtain the tax benefit. The second step involves determining whether the transaction at issue is consistent with the purpose or the spirit of the provisions, or whether it frustrates them. The Court performed the two-step analysis on sections 3, 38, 53, and 54 and subsections 39(1), 40(1), 69(5), 85(1), and 88(2) of the ITA.

The Purpose and Spirit of the Provisions

The Court found that the purpose and spirit of the capital gains and loss regime of the ITA, specifically sections 3, 38, 53, and 54 and subsections 39(1), 40(1), is to tax the increase and decrease in the economic value of property following its disposition. The Court held that the purpose and spirit of subsection 85(1) is to allow the transfer of property by a shareholder to a taxable Canadian corporation on a tax-deferred basis and to ensure that the deferred capital gains are taxed in the future.

The Court held that the purpose of section 88 is to create two regimes that apply on the wind-up of a Canadian corporation. It stated that subsection 88(1) allows for a tax-free transfer of the subsidiary's assets to its parent, whereas subsection 88(2) does not. The Court found that the purpose and spirit of subsection 88(2) is to provide the rules on the taxable wind-up regime to which certain specific anti-avoidance rules do not apply.

Does the Avoidance Transaction Abuse the Purpose or Spirit of Sections 3, 38, 53, and 54 and Subsections 39(1), 40(1), and 85(1)?

The Court held that the Crown failed to demonstrate that any of the provisions designed to limit the deduction of unrealized losses applied in this case or that the avoidance transaction abused them. The Court said that subsection 85(1) allows related corporations to transfer a property with unrealized capital gains from one corporation to another, such that the latter may deduct the capital loss against the capital gain realized from the disposition of the transferred property. The Court held that this is what the Taxpayer did — it transferred the Abitibi Consolidated shares to 3662527 and 3662527 declared the capital gain in connection with the disposition of the shares.

The Court also held that a taxpayer may reduce a potential capital gain on a transferred property under subsection 85(1) by increasing the ACB of the property as long as the amounts used to increase the ACB have been subject to tax. The Court found that the Crown failed to demonstrate that the $190,000,000 promissory note, which was used by the Taxpayer to increase in the ACB of Abitibi Consolidated shares, was not subject to tax.

Does the Avoidance Transaction Abuse the Purpose or Spirit of Subsections 69(5), 84(2), and 88(2)?

The Crown argued that 3662527 was not entitled to use the capital loss realized by the deemed disposition of its assets on the wind-up to offset the capital gain resulting from its disposition of Abitibi Consolidated shares to Québecor in consideration for the promissory note. The Crown stated that the loss should have been deducted only in computing 3662527's income for the final taxation year and should not have been retained in the form of the increased ACB of the Abitibi Consolidated shares held by Québecor. The Crown argued that subsection 69(5) cannot be used to increase the ACB of the shares of another entity.

The Court held that the Crown failed to show that the Parliament intended to prevent the incorporation of a corporation to allow related corporations to benefit from the application of subsection 88(1) rather than subsection 88(2). Also, the Court stated that the Crown did not demonstrate that the purpose or spirit of subsections 88(1) and 88(2) was frustrated. The Court held that it could not accept the Crown's argument regarding subsection 69(5) because to do so would be giving a broader interpretation of this provision. The Court noted that the decrease in the fair market value of the shares of Québecor Media and its subsidiaries was caused by a slowdown of the economy and activities. The Court held that the loss claimed was a reflection of a reduction of the Taxpayer's economic power.

Conclusion

The Court concluded that the Crown failed to demonstrate that the avoidance transaction amounted to an abuse of sections 3, 38, and 54 and subsections 39(1), 40(1), 69(5), 84(2), 85(1), and 88(2) of the ITA. Thus, the Court allowed the appeal and found that the Minister was incorrect to reduce the ACB of the common shares of Abitibi Consolidated held by the Taxpayer, add a capital gain of $95,000,000 to the Taxpayer's income from the disposition of the common shares, and deny the Taxpayer's capital loss of $95,000,000 from the disposition of the common shares.

— *Shinjin Kang*

Gilchrist Properties v. The King, 2023 DTC 1094 (Tax Court of Canada) — The Bar to Striking a Pleading of the Minister Remains High; the Test Case for "Non-CCPC Plans" Continues

Background

Gilchrist Properties Ltd. (the "Taxpayer"), was incorporated under the Alberta *Corporations Act* in 1963. At all relevant times, the Taxpayer had its head office in Richmond, British Columbia, and all of its directors and officers were resident in Canada for tax purposes. On May 28, 2014, the Taxpayer entered into an Agreement for Sale of a real estate property located in Richmond, British Columbia. Prior to completion of the sale, the Taxpayer was continued under the laws of the British Virgin Islands ("BVI"). The sale was completed on June 23, 2015, and the Taxpayer reported a capital gain of $23,078,192 and a taxable capital gain of $11,539,096 in its T2 tax return filed on April 30, 2016. The Taxpayer declared therein that it was an "other private corporation". The Taxpayer's capital dividend account was credited by the amount of the non-taxable portion of the capital gain, leaving a balance of $11,737,549.

The Minister of National Revenue (the "Minister") issued an initial assessment in respect of the 2016 taxation year on October 13, 2016. For the 2019 taxation year, the Taxpayer declared an aggregate dividend in the amount of $11,737,549, being the balance remaining in its capital dividend account, and elected that it be treated as a non-taxable capital dividend pursuant to subsection 83(2).

On December 23, 2020, the Minister issued a reassessment of the 2016 taxation year (the "Reassessment") taking the position that the Taxpayer remained a Canadian-controlled private corporation ("CCPC") despite the continuance under the laws of BVI. As a result, the Minister increased the Taxpayer's Part 1 tax relying on subsections 123.3 and 123.4 of the ITA. In the alternative, the Minister relied on the "general anti-avoidance rule" ("GAAR") set out in subsection 245(2) of the ITA on the basis that the Taxpayer had entered into a series of transactions that resulted in an abuse of the ITA.

In its Notice of Appeal, the Taxpayer took the position that the Reassessment was statue-barred because (1) if the Taxpayer was a CCPC, the Reassessment was issued beyond the normal reassessment period of three years for a CCPC, (2) alternatively, the Taxpayer was not a CCPC for the reassessed taxation year, and (3) the GAAR does not apply to the subject transaction.

In its Reply, served on the Taxpayer on April 1, 2022, the Minister took the position (1) that the Taxpayer knew or ought to have known that it was a CCPC in the reassessed taxation year, and (2) that its misrepresentation that it was an "other private corporation" and not a CCPC was a misrepresentation attributable to the Taxpayer's neglect, careless or willful default.

The Taxpayer then filed a motion on October 31, 2022, to strike out the Minister's Reply without leave to amend on the grounds that (1) the alleged misrepresentation that the Taxpayer was an "other private corporation" is a statement of mixed fact and law and therefore cannot be considered a misrepresentation, (2) the Reply failed to identify or assert any actions or omissions supporting the allegation that there was neglect, carelessness, or willful default — such that the Reply disclosed no reasonable grounds for opposing the appeal, and (3) the fact that the allegation of misrepresentation in the Reply is not supported by a single statement of fact makes it plain and obvious that the Minister has no reasonable prospect of being successful.

Issues and Tax Court Decision

The Minister argued that it is entitled to avail itself of the "fresh step rule" under section 8 of the Rules, which prevents a party from attacking an irregularity after the expiry of a reasonable time after it became aware of the irregularity, or if the moving party took fresh steps in the proceeding. The Taxpayer argued that the lack of a factual basis in the Reply was more than a simple irregularity, and that the "fresh step rule" should not override the Appellant's right to a fair trial.

Regarding the Taxpayer's first argument, the Court held that "even if it can be said that the impugned paragraph contains a statement of mixed fact and law, the Federal Court of Appeal has indicated that "[t]here is no principle of law that a statement of mixed fact and law cannot stand" (citing *Canada v. Preston*, 2023 FCA 178). Regarding the Taxpayer's second argument, the Court held that the Minister's assertion that "the Taxpayer knew or ought to have known that it was a CCPC" set out the essential facts necessary to prove its case, and that the Appellant was conflating the facts pleaded and the evidence to adduce those facts: "It is inappropriate in the context

of a motion to strike to ask the Court to draw a negative inference regarding the evidence that the Respondent will be expected to adduce at trial."

Regarding the Taxpayer's third argument, the Court found that the prospects of the Minister's success rested on whether the Taxpayer was not a CCPC, which would determine whether or not the Reassessment was statute-barred. As the evidence on this issue had not been established, the Court held that the Taxpayer's argument on this point also failed.

Regarding the Taxpayer's follow-on argument that the Minister should not be able to avail itself of the "fresh step rule" under Rule 8, the Court found that numerous steps had been taken after the close of pleadings, including a request for a timetable order, exchanging lists of documents and completing examinations for discovery. Therefore, the Court found that by undertaking the various steps in the litigation process following the close of pleadings, the Taxpayer had waived any irregularity contained in the Reply.

Conclusion

The bar to a successful motion to strike the Minister's pleadings remains high. The Minister's pleading that a Taxpayer made a misrepresentation attributable to the Taxpayer's neglect, careless or willful default, despite being a statement of mixed fact and law, was found to be a sufficient pleading without any additional facts asserted to support this claim. Taxpayers should further note that proceeding to further steps in the litigation process when aware of an irregularity in prior pleadings may be sufficient basis for Rule 8 to bar any further motions in respect of such irregularity.

— *Ron Dueck*

Mattio Bertone v. Canada Revenue Agency, 2023 DTC 5107 (Federal Court of Canada) — Court Finds Decision to Impose Interest and Penalties on Taxpayer Over 90 Years of Age Alleging Illiteracy Reasonable

Background

Mr. Bertone (the "Taxpayer") was a contractor for more than 30 years. He was required to pay instalment taxes for his 2003, 2005, and 2006 taxation years. He made partial payments in 2003, but not in 2005 or 2006.

The Taxpayer had retained the services of an accountant, Ubaldo Pietrantonio, until 2006, when his file was transferred to Mr. Pietrantonio's daughter, Diana Pietrantonio.

The Taxpayer filed late returns for the taxation years of 2002, 2003, and 2006 to 2009. After failing to file his 2007 tax return, the Minister sent letters notifying him of his default in July 2008, January 2009, and March 2009. The 2007 return was finally filed late in June of 2009. However, the taxes owing for 2007 and several previous years were not paid. Arrangements with the CRA Collections department were largely unsuccessful. Notices of Reassessment were issued for the Taxpayer's 2007 to 2009 taxation years in December 2011. The Taxpayer filed Notices of Objection. Notices of Reassessment were then issued in December 2014 for the amounts of approximately $64,000, $8,000, and $4,000 for the three years.

The Taxpayer filed an application for relief in July 2015, which was granted in part due to the time taken processing the application. The Taxpayer filed a second application for relief in July 2019, which was again granted in part due to the time processing the application. The Taxpayer then filed a third application for relief in January 2021, submitting that (1) his level of literacy was under the threshold of autonomy; (2) he trusted Ms. Pietrantonio as he had trusted her father for nearly 40 years, but she knowingly submitted income tax returns in an erroneous manner and allegedly copied his signature on at least two occasions; (3) it would be unfair for him to suffer for the mistakes of his accountant; and (4) the penalties imposed were not necessary, since he had always paid his fair share of income tax to the Crown and had always complied with his payment agreements.

The Minister's representative agreed to cancel the interest on arrears up until the December 2014 date, when the CRA had settled the Taxpayer's objection, at which point the Taxpayer could not be said to not have been aware of his tax obligations. However, the Minister's representative upheld the late filing penalties and interest on the late installments as the Taxpayer had been clearly made aware of these deadlines. The Minister's representative determined that the Taxpayer's age (being now in his eighties) was not a factor at the time the assessments were issued, and that his literacy was likewise not a factor.

Issues and Tax Court Decision

The issue before the Court was whether or not the decision by the Minister's representative was reasonable — whether it is "based on an internally coherent and rational chain of analysis and is justified in relation to the facts and law that constrain the decision maker" (*Canada (Minister of Citizenship and Immigration) v. Vavilov*, 2019 SCC 65 at paragraphs 16–17).

Situations where taxpayers are relieved of tax obligations resulting from errors made by their accountants are very rare (*Neyedly v Canada (Attorney General)*, 2020 DTC 5054): "errors attributed to third parties are not considered extraordinary circumstances justifying relief...taxpayers are 'generally considered responsible for errors made or delays caused by third parties acting for the taxpayers for income tax matters.'"

The Court found that illiteracy was not a sufficient impediment to reasonably cause the Taxpayer to not have been aware of his obligation to submit his income tax returns and to pay instalments in a timely manner. The Court further found that the Minster was correct in its assessment that the Taxpayer could not reasonably be said not to have been aware of the amount of taxes he owed after December 2014 when his tax obligations were settled with the CRA. Perhaps most tellingly, the Court stated:

> I must say that, given his past as a self-taught businessman with his own company and several rental properties, I have difficulty accepting the depiction of Mr. Bertone given at the hearing, according to which he is an illiterate man who is heavily dependent on his accountant. In that regard, counsel for Mr. Bertone conceded that there was probably insufficient evidence before me to support such an allegation. (para. 27)

Conclusion

Not unsurprisingly, the Court confirmed that the CRA will not be found to be acting unreasonably when imposing interest and penalties on a taxpayer after many years of negotiations and interest relief. Claims of illiteracy are unlikely to hold water in respect of numbers, particularly where a taxpayer seems able to read numbers in the context of running the business being taxed.

— *Ron Dueck*

RECENT CASES

Tax Court Answers Rule 58 Question Regarding Trusts and Taxable Dividends

Paragraph 186(1)(*a*) of the *Income Tax Act* (the "Act") provides for a tax of 38⅓% on assessable dividends received in a taxation year except for those received from a connected corporation. The Appellants were reassessed for such a tax, and brought the following question of mixed law and fact to the Court under Rule 58 of the *Tax Court Rules (General Procedure)*: "Where a trust designates a portion of a taxable dividend (the "Amount") received on a share of the capital stock of a taxable Canadian corporation (the "Issuer"), pursuant to subsection 104(19) of the Act, such that the Amount is deemed to have been received by a beneficiary (the "Beneficiary"), when is it determined whether the Issuer is connected with the Beneficiary for purposes of paragraph 186(1)(*a*) of the Act?"

The Tax Court analyzed the question as follows. Subsection 186(4) defines two corporations as "connected" if one controls or owns more than 10% of the shares of the other. The Court's textual analysis showed that the time for determining connection is when the dividend is received. To determine this, the extremely complex "hierarchy" of deeming rules in Part K of the Act must come into play. Specifically, under the Court's interpretation of subsection 104(19), "the dividend is received by a corporate beneficiary on the same date as the date that it was received by the trust."

Vefghi Holding Corp. et al. v. The King

2023 DTC 1081

Decision Appellant Failed to Act Promptly was Unreasonable

The Applicant had filed two tax forms late — her 2016 and 2017 tax forms were filed in 2020. The Canada Revenue Agency ("CRA") assessed the Applicant penalties and interest of about $6,000. The Applicant provided medical information relating to both her and her husband but the CRA denied her request, finding that the couple's medical situation did not prevent them from filing the required forms on time. The Applicant contended that the officer's decision was unreasonable because it failed to take proper account of her medical circumstances. She also provided additional documentary evidence on this application for judicial review.

The Federal Court allowed the application for judicial review. In deciding whether new evidence should be admitted and if the CRA officer's decision was unreasonable, the Court observed that in cases of judicial review new evidence is not normally admissible; however, there are exceptions to the general rule: (1) when the new evidence simply provides background information that might help the reviewing judge; (2) when the evidence shows that there was an absence of evidence before the decision-maker on a particular point; and (3) when the evidence shows defects in the evidentiary record. The evidence adduced by the Applicant fell under the second exception. The Court held that the evidence about the Applicant's GST filing showed that the CRA officer had failed to consider her parallel request for relief (on identical grounds). Similarly, the evidence chronicling her communications with the CRA showed, contrary to the decision of the officer, that she acted fairly promptly. The medical information the Applicant provided to the CRA described the long-standing challenges she was experiencing in areas such as decision-making, time management, and accuracy, which made it difficult for her to carry out complex tasks such as filing tax returns. The CRA officer's decision did not respond meaningfully to the medical evidence tendered and unreasonably found that the Applicant had failed to act promptly to file her forms. Accordingly, the Court allowed the application for judicial review.

Thomas v. AG of Canada

2023 DTC 5086

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