Tax Notes

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THE EFFECTIVE USE OF TRUSTS IN CONNECTION WITH INCOME SPLITTING (PART I OF IV)

— Michael Goldberg, Tax Partner, Minden Gross LLP, MERITAS law firms worldwide and founder of "Tax Talk with Michael Goldberg", a quarterly conference call about current, relevant and real life tax situations for professional advisors who serve high net worth clients.

Special thanks to Ryan Chua of Minden Gross LLP for his comments on earlier drafts of this series of articles. All errors and omissions are the author's.

Based on a host of recently enacted legislation attacking the use of offshore trusts by Canadians,[1] eliminating immigration trusts, severely restricting testamentary trust tax benefits, generally attempting to eliminate inter-provincial testamentary tax planning opportunities,[2] and so on, it seems safe to say that the federal government views the use of trusts in Canada dimly these days. And yet, even following all of this legislative upheaval, and even if one assumes that more changes may still be coming, it is likely that trusts will continue to be highly used estate planning and succession planning vehicles in Canada.

The main reasons for the endurance of trusts for these purposes are that they are incredibly useful tools that permit individuals to maintain varying amounts of control over assets that they dispose of as part of their estate and succession planning, whether such dispositions occur while they are alive or after they are dead, and due to the flexibility that can be built into trusts to accommodate all manners of changes in family situations. Another significant reason that trusts will continue to be used is that, even with all of the legislative changes and the general chilly tax climate impacting trusts, they continue to provide a host of opportunities for shifting income from high rate taxpayers to low rate taxpayers, which is generally referred to as income splitting.

In the first instalment of this series of articles, some of the basic tax requirements for using trusts to split income will be reviewed. The second instalment of the series will delve into a number of common income splitting opportunities that are accessible through the use of trusts, namely:

- planning to allow additional family members to access their capital gains exemption (sometimes called capital gains exemption (or CGE) multiplication);
- preferred beneficiary and age 40 trust planning;
- prescribed rate loan planning; and
- Ontario surtax planning.

The third instalment of the series will provide a historical overview of income splitting using testamentary trusts, and will touch on the upheaval to trusts, wills, and estates practices caused by the enactment of Bill C-43. Finally, in the last instalment of the

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[1] See Bill C-48, *Technical Tax Amendments Act, 2012*, which received royal assent on June 26, 2013.

[2] All of these items were dealt with in Bill C-43, *Economic Action Plan 2014 Act, No. 2* ("Bill C-43"), which was enacted on December 16, 2014.

series we'll review some of the benefits and risks of planning with Alberta trusts and with trusts deemed to be resident under subsection 94(1) of the *Income Tax Act* (the "Act").[3]

Income Splitting Basics

Income and Capital Encroachment

The ability to use a trust to income-split with family members is dependent on the actual terms of the instrument under which any particular trust is formed.[4] For example, discretionary family trust deeds will generally contain broadly drafted powers to permit trustees to make discretionary allocations of income and capital among the beneficiaries of a trust. In addition, a properly drafted trust deed should define "income" as including income for all purposes of the Act.

Unfortunately, many older trust deeds will not include a definition of income that dovetails with the Act. For example, I've seen some trusts where income has been defined as income for GAAP purposes. In other situations, I've seen trust deeds where there is no definition of income at all, in which case the income of those trusts is left to be determined under the law of trusts.

In both of these cases, the terms of the trust deed will likely not permit the allocation of capital gains or "phantom income"[5] to beneficiaries. However, so long as the trust deed contains a broad capital encroachment power, it may still be possible to structure capital distributions that permit the trust to allocate its actual realized taxable capital gains income to capital beneficiaries and, under certain circumstances, it may even be possible to allocate taxable income from deemed capital gains to capital beneficiaries.[6]

Taxable Allocation of Income and Losses

Assuming that it is possible to allocate income from a trust for trust and tax law purposes, then it should be possible to use a trust for income splitting because, pursuant to subsection 104(13), amounts allocated and made "payable" to a beneficiary in a particular year will be taxable in the beneficiary's hands instead of in the trust.[7] For purposes of this and a number of other provisions in section 104, subsection 104(24) deems amounts not to have become payable unless the amounts have either been actually paid to a particular beneficiary in the taxation year or unless that beneficiary has a legally enforceable right against the trust for payment of such amounts in that taxation year.

Although it is possible to allocate income to beneficiaries, losses realized in a trust cannot be allocated from a trust to its beneficiaries.[8]

Character of Income

Generally, income earned by a trust loses its character once it is distributed to beneficiaries,[9] so maintaining the character of allocated taxable income in the hands of beneficiaries is very important. Fortunately, section 104 contains specific rules to ensure that certain types of income retain their character.[10]

For example, subsection 104(19) ensures allocated taxable dividends will be treated as taxable dividends in the hands of trust beneficiaries, and subsection 104(20) ensures that the tax status of capital dividends is maintained. In addition, provided that a trust has been drafted appropriately, it should be possible for the trust to allocate realized capital gains to its beneficiaries under subsection 104(21) and, provided that the trust contains a broad definition of income that captures deemed capital gains, it should be possible for these types of capital gains to be allocated as well. In both

[3] Unless otherwise noted, all statutory references are to the Act.

[4] Among other terms for this instrument, it is sometimes called a trust deed or a trust settlement.

[5] For example, deemed dividends on redemptions or deemed capital gains, such as those that occur on the 21st anniversary of a trust.

[6] For examples of how this might be accomplished, see CRA document number 9531165 dated March 13, 1997, and CRA document number 9428005 dated February 24, 1995.

[7] To avoid double taxation, the Act will generally permit a trust to claim a deduction for amounts that become payable in the hands of its beneficiaries pursuant to the terms of subsections 104(6) or 104(12).

[8] However, pursuant to subsection 75(2), where this provision applies to a transferor of property to the trust, all income and capital losses from such property (or substituted property) will attribute back to the transferor. Losses of a trust from an active business will not attribute back to the transferor (see CRA document number 2013-0476871E5 dated October 3, 2014).

[9] Pursuant to subsection 108(5)(*a*) income received by a beneficiary from a trust is generally characterized as income from property.

[10] One example of where taxable income allocations will lose their character is if they are made to non-residents. In such cases the rules in subsection 212(1) will need to be consulted, as modified by tax treaty, if any.

cases, if the capital gains would otherwise be eligible for CGE treatment, then through the joint operation of subsections 104(21) and (21.2), the trust's beneficiaries will be able to claim their personal CGEs, assuming the beneficiaries are otherwise eligible to do so.

As was mentioned previously, even without broad income definitions in the trust deed, so long as the trust deed contains broad capital encroachment powers, and provided that capital distributions are made in the year that those gains are realized, it may still be possible to allocate the trust's capital gains and exempt capital gains (CGEs) to capital beneficiaries.[11]

Complying with the Terms of the Trust

In order to enjoy the benefits of income splitting and CGE multiplication, allocations of trust income and distributions of trust property must be made in accordance with the terms of each particular trust deed to beneficiaries of a particular trust or, if the terms of the trust permit, for the benefit of those beneficiaries.

If the trustees of a trust purport to make allocations or distributions to non-beneficiaries of the trust, such trustee actions will be made in breach of the terms of the trust deed and, in addition to any trust law consequences of such breaches, the income that was intended to be allocated will, for purposes of the Act, remain taxable in the trust. In addition, a tax-deferred rollout of appreciated property of the trust pursuant to subsection 107(2) to persons who are not beneficiaries of the trust will not be possible. As a result, if distributions of trust property are made to non-beneficiaries, the trust will be fully taxable on any unrealized gains in respect of such distributions.[12] This latter issue can be particularly problematic for trusts reaching their 21st anniversary. If these results aren't bad enough on their own, the recipient of such allocations and distributions will likely be considered to have received a benefit from the trust which would subject that person to tax on the value of the benefit under subsection 105(1).

This article first appeared in the Wolters Kluwer newsletter The Estate Planner No. 242, dated March 2015.

TECHNICALLY INEQUITABLE — THE COMPUTATION OF ARREARS INTEREST UNDER SUBSECTION 187(2)

— Adam Friedlan, Friedlan Law, Richmond Hill, Ontario

In *Bakorp Management Ltd. v. The Queen*, 2015 DTC 1072 (TCC), the issue in dispute was the interpretation of subsection 187(2) of the *Income Tax Act* (the "Act"), a provision which computes arrears interest on outstanding Part IV tax. The facts in the case were not in dispute. Bakorp Management Ltd. ("Bakorp") was assessed Part IV taxes in connection with dividends it received in respect of its 1993 and 1995 taxation years. The balance due dates for the payment of the Part IV taxes in respect of Bakorp's 1993 and 1995 taxation years were, respectively, June 30, 1993 and June 30, 1995. Bakorp tendered payment of $13,333,059 in respect of the Part IV taxes payable in respect of its 1995 taxation year when it filed its 1995 T2 tax return on June 10, 1995.

On January 31, 2000, the Minister of National Revenue (the "Minister") (represented by the Canada Revenue Agency) reassessed Bakorp in respect of both its 1993 and 1995 taxation years. These reassessments resulted in a significant increase in Bakorp's Part IV taxes for its 1993 taxation year, but also in a significant reduction in Bakorp's Part IV taxes in respect of its 1995 taxation year. This created a significant overpayment in respect of Bakorp's 1995 Part IV taxes (the "Overpayment").

On February 3, 2000, the Minister applied the Overpayment to Bakorp's 1993 taxation year without having been asked to do so by Bakorp pursuant to subsection 164(2). With respect to the computation of arrears interest pursuant to subsection 187(2), the Minister treated the amount of the Overpayment as paid within the meaning of subsection 187(2) as of February 3, 2000, the date the Minister applied the Overpayment pursuant to subsection 164(2). Bakorp appealed the assessment of arrears interest on the basis that the amount of the Overpayment should have been treated as paid for the purposes of subsection 187(2) on June 10, 1995, which was the date of its actual initial payment for its 1995 taxation year. The substantive issue driving the appeal was the 2% rate differential between the interest rate credited to Bakorp by the Minister in respect of the Overpayment and the interest charged on the outstanding 1993 Part IV tax liability.

[11] *Supra*, footnote 5.

[12] See, for instance, CRA document number 9637535 dated January 9, 1997.

Subsection 187(2) provides that,

> Where a corporation is liable to pay tax under this Part and has failed to pay all or any part thereof on or before the day on or before which the tax was required to be paid, it shall pay to the Receiver General interest at the prescribed rate on the amount that it failed to pay computed from the day on or before which the tax was required to be paid to the day of payment.

Bakorp took the position that the plain reading of the subsection required that interest be computed from the day that it was required to be paid (June 30, 1993) to the date of payment, which Bakorp asserted was June 10, 1995, for the portion of the tax liability equal to the amount of the Overpayment. Bakorp also argued that regardless of the date on which the Minister decided to apply the Overpayment in respect of the 1995 taxation year to Bakorp's 1993 taxation year, the Minister had the use of the relevant funds from the date on which they were actually paid (June 10, 1995). Finally, Bakorp submitted that subsection 187(2), unlike subsection 161(1) (which deals with interest on arrears of Part I and other Parts but not Part IV), does not require that the Minister apply payment to a specific year or Part IV assessment, and that had Parliament intended that an amount in the Minister's possession must be applied to a specific year or Part IV assessment, it should have said so. The Court rejected these arguments.

The Court was not persuaded that the plain meaning of the words "to the date [*sic*] of payment", as the end date for the calculation of arrears interest in subsection 187(2), could apply to a payment in respect of an entirely different year, i.e., a 1995 payment in respect of a 1993 tax obligation. The Court concluded that the "date [*sic*] of payment" referred to the date that the 1993 Part IV tax liability was extinguished, namely, the date that the Minister applied the Overpayment to such liability.

The Court held that the Minister could not apply the Overpayment to Bakorp's 1993 tax liability until it exercised its right to do so under subsection 164(2) on February 3, 2000, a few days after the Overpayment crystallized on January 31, 2000 (the date of the last reassessment for the 1995 taxation year). Until such time, the prior assessment for the 1995 taxation year was deemed to be valid and binding according to the provisions of subsection 152(8) and subsection 248(2) (which treats the tax payable by a taxpayer to be fixed by an assessment). In short, the Court ruled that an overpayment did not exist prior to January 31, 2000, so no amount existed to be applied to an assessment fixed for 1993.

The Court went on to hold that it did not agree with Bakorp's interpretation of the plain meaning of subsection 187(2), found no ambiguity in the interpretation of the provision, and held that even if it found such an ambiguity, it would not have ruled in Bakorp's favour on the basis of a textual, contextual, and purposive approach to interpretation.

The Court concluded that using a simple contextual approach to Part IV, which only consists of a few sections (sections 186-187), it is clear that the liability to pay tax under Part IV is a liability to pay tax for a specific year, so that arrears of interest are calculated with respect to that specific year. Further, the Court held that, using a textual, contextual, and purposive approach to interpretation, it would be inconsistent and unharmonious to interpret subsection 187(2) to mean that any payment made in connection with a particular year can apply to any other year.

The Court also noted that to interpret subsection 187(2) in the manner suggested by Bakorp would result in rendering many other provisions of the Act inconsistent and useless or would create unnecessary conflicts within the Act.

Finally, the Court commented in *obiter* in respect of what it understood to be Bakorp's main underlying argument in the matter, that it was patently unfair for the Minister to have been in possession of the Overpayment since January 10, 1995, and still allow the taxpayer to be assessed interest at a rate 2% higher on that sum of money than the Minister paid out due to the calculation of interest under the *Income Tax Regulations*. The Court noted that this "is the law as enacted by Parliament to encourage prompt payment of taxes owing and only Parliament has the right to change it."

In the opinion of the writer, legislative action appears warranted to correct the unfairness noted by the Court in its *obiter* comments.

Adam Friedlan, Friedlan Law, Richmond Hill, Ontario, A.B., University of Chicago, J.D., University of Toronto. Friedlan Law's practice includes corporate and personal tax planning, estate planning, and legal implementation of tax and estate plans.

QUEBEC PRESENTS BALANCED BUDGET

Quebec's Minister of Finance, Carlos Leitão, tabled the 2015-2016 Budget on March 26, 2015. He stated that the Budget will restore fiscal balance and include tax relief that will total over $2.5 billion over the next five years. More specifically, the plan is intended to lower the tax burden for individuals and businesses, encourage economic investments in all regions of the province, and better align training and employment to achieve greater labour market participation.

Some of the measures introduced are taken from the recently released Quebec Taxation Review Committee Report.

For individuals, the Budget proposes to:

- gradually reduce the burden of the health contribution commencing in 2017 and eliminate it entirely in 2019;
- enhance the tax credit for experienced workers beginning in 2016;
- introduce a "tax shield" to help offset the effect of a loss of economic tax benefit when an individual's revenue increases;
- gradually increase the eligible age for the tax credit with respect to age, from 65 in 2015 to 70 in 2020; and
- introduce a new assistance program that will partially offset a municipal tax increase for seniors over the age of 65, beginning in 2016.

Some of the measures for businesses include:

- a gradual reduction in the general tax rate from 11.9% in 2015 and 2016 to 11.5% in 2020;
- a partial extension of the reduced small and medium-sized business ("SMB") rate to corporations involved in the primary sector;
- a gradual reduction of the Health Services Fund contribution rates for SMBs in the service and construction sectors;
- a reduction in the rates of the tax credit for investments relating to manufacturing and processing equipment;
- an increase in the refundable tax credit for on-the-job training periods;
- the reinstitution of the tax credit for integration of IT in manufacturing SMBs;
- the improvement of the tax credit for corporations involved in the marine or wind-power resource sector or the manufacturing sector in certain regions of Quebec;
- amendments to increase the contributions allowed for certain tax-advantaged funds to help increase economic development;
- the gradual phase-out of the restrictions on the granting of certain input tax credits under the QST system for large corporations;
- a temporary increase in some capital cost allowance rates for goods used in the liquefaction of natural gas;
- the enhancement, extension, or alteration of several refundable tax credits, primarily in the film, sound, and multimedia industries;
- new measures to enhance the integrity of the taxation system; and
- new measures to ease the transfer of a business to family members.

Budget documents, along with Wolters Kluwer commentary, are posted on the provincial tax News Tracker on CCH Online and IntelliConnect, and are also available in the *Quebec Tax Reporter* online and on DVD.

ALBERTA BUDGET 2015

Alberta Budget 2015 was presented on March 26, 2015, by the Alberta Minister of Finance, Robin Campbell. The decrease in the price of oil has had and will continue to have a drastic impact on provincial revenues. In response, Budget 2015 introduced several new tax-related measures, including two new income tax brackets, increases to fuel and tobacco taxes, and a new health care levy.

Budget documents, along with Wolters Kluwer commentary, are posted on the provincial tax News Tracker on CCH Online and IntelliConnect, and are also available in the *Alberta and Territories Tax Reporter* online and on DVD.

UPDATE TO INCOME TAX FOLIO S6-F2-C1, DISPOSITION OF AN INCOME INTEREST IN A TRUST

On March 17, 2015, the Canada Revenue Agency released revisions to Income Tax Folio S6-F2-C1, Disposition of an Income Interest in a Trust. A taxpayer who disposes of, by assignment or otherwise, an income interest in a trust in favour of another person will be subject to the provisions of subsection 106(2) and must include the proceeds of disposition in income. The changes to this Income Tax Folio are primarily made for readability purposes by replacing the words "or was at any time a unit trust after 1999" in the last sentence of ¶1.2; this change applies to the English version only. Paragraph 1.2 is further revised by adding a comment that "For the 2016 and subsequent tax years, the reference in ¶1.2 to 'testamentary trust' will be replaced with 'graduated rate estate', and the reference to 'an inter vivos trust' will be replaced with 'a trust.'"

Moreover, the Income Tax Folio is revised to make way for the pending legislative amendments made by S.C. 2014, c. 39, s. 32 (formerly Bill C-43). Paragraph 1.8 is revised to add a comment that "For the 2016 and subsequent tax years, subparagraph 69(1)(*b*)(ii) will be applicable to any disposition by way of a gift." Proceeds received via the transfer of a legal right pursuant to this section must be included in income pursuant to subsection 106(2).

INCOME TAX FOLIO S3-F6-C1, INTEREST DEDUCTIBILITY

Last month, the Canada Revenue Agency ("CRA") released Income Tax Folio S3-F6-C1, Interest Deductibility. This Folio primarily references paragraph 20(1)(*c*) of the *Income Tax Act*. Effective March 6, 2015, it replaces and cancels Interpretation Bulletin IT-533, Interest Deductibility and Related Issues.

Folio S3-F6-C1 includes:

- additional commentary and examples relating to participating payments (¶1.2–¶1.5), links between borrowed money and current/eligible/ineligible usages (¶1.37, ¶1.40, and ¶1.43), and policy loans (¶1.59 and ¶1.84– ¶1.86);
- references to significant jurisprudence, such as *Thomas Gifford v. The Queen*, 2004 DTC 6120 (SCC) (¶1.7) and *Mark Resources Inc. v The Queen*, 93 DTC 1004 (TCC) (¶1.57); and
- relevant legislative changes and CRA positions regarding the general limitation applicable to contingent liabilities or amounts (¶1.13– ¶1.18), interest on amounts paid under an appropriation act (¶1.66) or the acquisition of an interest in an annuity contract (¶1.67–¶1.68), and loss consolidation arrangements within a corporate group (¶1.71–¶1.75).

In addition, the Folio highlights several *Income Tax Act* provisions applicable to the deduction of interest expense at ¶1.100.

Suggestions concerning the Folio's structure and content may be submitted to the CRA at folios@cra-arc.gc.ca. The period for comment ends June 6, 2015.

CRA RELEASES UPDATED GUIDE FOR SMALL BUSINESSES

The Canada Revenue Agency ("CRA") recently released an updated version of its guide RC4070(E) Rev. 14 — Information for Canadian Small Businesses. Small businesses comprise a large and growing portion of Canada's economy, and this guide provides important coverage of many of the taxation issues small businesses may encounter, including information about the following:

- business structure and record keeping (page 9);
- goods and services tax/harmonized sales tax (page 14);
- payroll deductions and remittances (page 19);
- audits, objection, and appeals (page 26); and
- CRA conventional and online services (page 31).

The guide also provides a chart of important filing and remittance dates (page 32) as well as an extensive listing of relevant guides, forms, interpretation bulletins, and memoranda (page 34). This most recent version of the guide has also been updated with information pertaining to prize commissions received by lottery ticket retailers (page 3) and details about direct deposit of federal government payments (page 37).

FOCUS ON CURRENT CASES

This is a regular 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 "Employees Profit Sharing Plan" as Sham

***Dimane Enterprises Ltd. v. The Queen*, 2015 DTC 1013 (Tax Court of Canada)**

Dimane involved a dispute over whether an arrangement maintained by an owner-manager that purported to be an "employees profit sharing plan" ("EPSP") within the meaning of section 144 of the *Income Tax Act* (the "Act") was, in fact, a sham. The Tax Court concluded that it was.

Richard Arab ("Richard") was, at the relevant times, the president and sole director of the taxpayer, Dimane Enterprises Ltd. The taxpayer carried on the business of providing consulting services to companies operating in the Alberta oil patch. The taxpayer's only office was a room in Richard's residence. Richard, his spouse, and their four children (two of whom were, at the relevant times, minors) were the taxpayer's shareholders and also employees. The children's employment duties primarily comprised shovelling snow, mowing the lawn, cleaning the house, and sorting mail.

The taxpayer established an EPSP on the advice of a tax planner in order to "handle" income splitting. The taxpayer designated Richard and his spouse as the trustees under the arrangement. The EPSP was administered by a "Committee" of which Richard was the sole member. Richard opened a separate bank account in respect of the EPSP. The taxpayer contributed amounts to the EPSP and, at the end of each year, following discussions with his spouse, Richard allocated amounts contributed to the EPSP to himself, his spouse, and their children on an arbitrary basis. That is, the allocations had no relation to the contributions that participants made to the taxpayer's profitability.

In particular, for the taxpayer's 2004 tax year, the taxpayer transferred a total of $130,000 to the EPSP account, which was allocated and paid as follows: $27,000 to Richard; $25,000 to Richard's spouse; $15,000 to each of Richard's two eldest children; and $24,000 to each of Richard's two minor children.

For the taxpayer's 2005 tax year, the taxpayer transferred a further $130,000 to the EPSP account, which was allocated and paid as follows: $10,000 to Richard; $10,000 to Richard's spouse; and $55,000 to each of Richard's two minor children.

Richard controlled the bank accounts in respect of his minor children. He caused payments to be made from those accounts to him, which were characterized as reimbursements for expenses incurred on behalf of the minor children, including clothing, family trips, hockey fees, haircuts, piano lessons, bed comforters, extracurricular activity fees, movie tickets, dry cleaning, shoes, and electronics.

Richard's eldest two children in turn paid portions of their EPSP allocations to Richard, including for vehicle repairs, college tuition, vacation, credit card payments, and other living expenses.

The Minister denied the taxpayer deductions for EPSP contributions made in 2004 and 2005. The taxpayer appealed. The Tax Court (per D'Arcy J) dismissed the appeal.

The Minister made three alternative arguments in support of denying the taxpayer deductions:

(1) the EPSP was not validly implemented — the terms of the plan were not complied with and there was no *bona fide* intention to do so;

(2) the EPSP was a sham; and

(3) the contributions made by the taxpayer were neither reasonable nor related to the taxpayer's business.

In response, the taxpayer argued that the EPSP was indeed valid because it met the enumerated requirements for an EPSP under section 144 of the Act. The taxpayer further argued that case law is clear that in order for a sham to be found, there must be a level of deceit. Here, there was no evidence that the taxpayer or any of its employees had acted with deceit. Finally, the taxpayer argued that section 67 of the Act (requiring deductible outlays and expenses to be reasonable) would not apply in the circumstances, since the taxpayer's EPSP contributions were allocations of profit, not outlays or expenses.

The Court cited *J.R. Saint & Associates Insurance Agencies Ltd.* (2010 TCC 168) for the proposition that three conditions must be met for an arrangement to be considered an EPSP:

(1) payments must be computed by reference to the profits of the employer's business;

(2) such payments must be made to a trustee; and

(3) all amounts received by the trustee must be allocated each year by the trustee to the employees who are beneficiaries under the arrangement.

With respect to the first condition, the taxpayer had made an election under subsection 144(10) to deem the arrangement to be one under which payments are computed by reference to profits. Accordingly, the Court acknowledged that the first condition for an EPSP was technically met. The Court seems to have accepted that the arrangement met the remaining two conditions as well, and stated that it need only address the Minister's argument that the arrangement was a sham. The Court determined that it was.

The Court relied on the Federal Court of Appeal's holding in *2529-1915 Québec Inc.* (2009 DTC 5023) that a sham "requires an element of deceit which generally manifests itself by a misrepresentation by the parties of the actual transaction taking place between them." The Court concluded that, in substance, Richard — the taxpayer's controlling mind — never gave up control of the funds allocated to his minor children. He simply moved amounts between bank accounts that he controlled. In fact, Richard admitted in testimony that the minor children had no control over the funds allocated to them. Similarly, the Court found that the funds allocated to the two eldest children were simply directed back to Richard "in an attempt to hide the real transactions", which were payments by the taxpayer to Richard.

Further, the Court did not accept that the amounts paid from the children to Richard were reimbursements for expenses incurred on the children-employees' behalf. Rather, the purported expenses were simply "family expenses" that parents incur for children as a matter of course.

Finally, the Court concluded that none of the children contributed to the taxpayer's profit. Their alleged employment services — shovelling snow, mowing the lawn, cleaning the house, and sorting mail — were normal familial chores that children must do for their parents. Any "services" rendered were rendered for the benefit of the parents and not the taxpayer.

The decision is an interesting application of the sham doctrine to EPSPs. Fundamentally, the decision underscores the risk to owner-managers of attempting to reduce tax payable through technical ruses that do not reflect the substance of one or more transactions. *Dimane Enterprises* is not the first instance in which an owner-manager has failed to establish that family members are "employees" of a home-based business and that their so-called remuneration is something more than an attempt to conceal income that is, in substance, being paid to the owner. *Dimane Enterprises* may, however, be notable for the disproportionate degree to which family-employees were allegedly compensated based on the "services" provided. The decision may also have broader implications for challenges to family trusts when deductions are claimed for income distributed to children beneficiaries that is then "returned" to a parent.

— *Mark Firman*

Crown Not Required To Be Given Notice of Rectification in a Case in Which No Tax Is Payable

***Attorney General of Canada v. Brogan Family Trust*, 2015 DTC 5008 (Ontario Superior Court of Justice)**

Brogan dealt with an unsuccessful request by the Crown to set aside a rectification order granted years earlier without notice having been provided to the Crown.

In 2004, Mr. Brogan sought tax advice. As a result of that advice, he restructured his business, including settling a family trust. In early 2010, Mr. Brogan became aware of an error in the 2004 trust agreement and sought to rectify the error through an application to the Ontario Superior Court of Justice (the "Court"). Notice was not given to the Crown. The application was granted on November 26, 2010 (the "Order").

Just before the Order was granted, the trust sold a business and reported the allocation of the proceeds to the beneficiaries. The Canada Revenue Agency began to audit the sale in June 2012, and received a copy of the Order in August 2012. Nine months later, on May 22, 2013, the Crown brought its motion to the Court to set aside the Order.

The Court denied the request to set aside the Order on three grounds:

(1) the Court held that the Crown failed to bring its motion on a timely basis;

(2) the Court held that the Crown was not a proper party to the motion; and

(3) the Court held that the Crown had not been entitled to notice.

The Crown argued that the reason for its nine-month delay before bringing the motion to set aside the Order was that the auditor was not familiar with rectification orders and did not understand that the Crown had not been notified of the application. The Court had no sympathy, noting that the auditor's supervisors had the requisite knowledge and understanding.

With respect to whether the Crown had standing to challenge the Order, the Court found that the Crown did not meet the prerequisite of being a party who "will be affected by a judgement". Notably, in this case the Order was sought and received in the same taxation year as the business sale. Accordingly, as the Order corrected the error before the end of the taxation year, no tax liability crystallized. The Crown's interest was only in a potential claim, unlike a typical circumstance in which rectification is sought to reduce an existing tax liability.

Finally, the Court found that notice to the Crown had not been required. The Crown argued that it was entitled to notice whether or not it had status as a creditor. The Court disagreed, finding that the Crown is required to be given notice of a proposed rectification proceeding only when its legal interests might be directly affected by the outcome, such as where the CCRA (as it then was known) is a creditor.

In recent years, the Crown has sought notification of all rectification applications regardless of its standing as a creditor. This case is a reminder for practitioners that Crown notice is not mandatory in all cases; accordingly, before providing notice to the Crown, practitioners should consider whether the Crown has an actual legal interest in a particular rectification request.

— *Brandon Siegal*

RECENT CASES

Beneficiaries of RRSP did not disclaim their interest on annuitant's death and amounts subject to tax

The Minister disallowed the taxpayer estate's request to amend its 2009 tax return to remove $237,026 as income from a registered retirement savings plan ("RRSP"). Counsel for the taxpayer argued that upon the death of M, who died intestate, the proceeds of his RRSP rolled over to his spouse, D, on a tax-free basis under subsection 70(6) of the *Income Tax Act* (the "Act"). The RRSP documents originally designated M's children as beneficiaries. The children and D obtained a consent order that assigned the children's entitlement to the RRSP to D in exchange for a cottage asset in the estate. The argument was that the consent order supplanted the children's rights to the RRSP, and proceeds of the

RRSP were, therefore, a "refund of premiums" to D. In this way, the proceeds could be received tax-free into D's RRSP account and this would eliminate taxable income to the taxpayer.

The taxpayer's appeal was disallowed. The children, as designated beneficiaries of the RRSP, did not disclaim their interest but rather assigned their interest to D. Accordingly, M was deemed to have received the proceeds of the RRSP immediately before his death, and those proceeds were correctly included in his income under paragraph 56(1)(*h*) of the Act.

Re Murphy, 2015 DTC 1060

Costs on a solicitor-client basis granted to the taxpayer for Minister's "scandalous" conduct

The taxpayer filed a motion to strike a paragraph in the Minister's reply that listed incorrect and misleading information that the taxpayer had been charged for certain criminal offences which, in fact, never occurred. The taxpayer's request to strike was granted, as the Minister's pleading was scandalous and an abuse of the process of the Court as well as potentially prejudicing or delaying the fair hearing of the trial. The taxpayer sought costs on a solicitor-client basis for the motion.

Costs were granted to the taxpayer on a solicitor-client basis. Costs on a solicitor-client basis are ordered only in rare and exceptional cases and generally only where there has been reprehensible, scandalous, or outrageous conduct. To allege in a pleading that a person is charged with a criminal offence but that the charge had not been proven serves no legitimate purpose.

Simard, 2015 DTC 1063

Corporate taxpayer was "purchaser" of taxable Canadian property from non-resident vendor for purposes of section 116 of the *Income Tax Act*

The corporate taxpayer, Olympia, was a trust company acting as the trustee of self-administered RRSPs. It acquired certain shares (the "Shares") from a non-resident vendor (the "Vendor") without obtaining a section 116 clearance certificate and without remitting the statutory amount representing the non-resident vendor's deemed disposition tax on the sale of the Shares to Olympia. The Minister was therefore looking to Olympia for the amount of that deemed disposition tax. In the course of Olympia's appeal to the Tax Court of Canada, the court was asked to determine, as a question of mixed fact and law, whether Olympia was the "purchaser" of the Shares within the meaning of subsection 116(3) of the *Income Tax Act* (the "Act"). Olympia's position, in part, was that it was not the beneficial owner of the Shares in its capacity as an RRSP trustee, but merely a bare trustee, and hence was not the "purchaser" contemplated in subsection 116(3).

Olympia was the "purchaser" contemplated in subsection 116(3). Olympia, as the trustee of the RRSPs, was the initial solely seized and registered legal owner of the underlying RRSP trust property. This resulted in the disposition of the Shares by the Vendor to Olympia. Olympia therefore acquired the Shares as the party legally (as opposed to beneficially) intended, obligated, and entitled to receive them. Section 116 did not relate to the "personal" tax liability of Olympia or of any other party who was a purchaser of the Shares. Conversely, as a collection measure, the section related to the vicarious liability of any purchaser (such as Olympia) for the tax liability of any non-resident vendor (such as the Vendor) where the purchaser has failed to comply with the clearance certificate and remission provisions of paragraph 116(5)(*a*) or (*b*) of the Act. Olympia was, therefore, the "purchaser" of the Shares within the meaning of subsection 116(3) of the Act.

Olympia Trust Company, 2015 DTC 1044

TAX NOTES

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For Wolters Kluwer Limited

Tara Isard, Senior Manager, Content
Tax & Accounting Canada
(416) 224-2224 ext. 6408
email: Tara.Isard@wolterskluwer.com

Natasha Menon, Senior Research Product Manager
Tax & Accounting Canada
(416) 224-2224 ext. 6360
email: Natasha.Menon@wolterskluwer.com

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Wolters Kluwer Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
416 224 2248 · 1 800 268 4522 tel
416 224 2243 · 1 800 461 4131 fax
www.wolterskluwer.ca

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email: circdept@publisher.com