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NRT TAX TRAPS AND THE NON-SPECIALIST ADVISOR[1]

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This article is the third instalment in a four-part series. The fourth and final instalment will appear in next month's issue of Tax Notes.

In the second instalment of the Series we began the arduous task of providing a high-level review of the Section 94 NRT Rules with a focus on just how easy it is for a contributor to make a contribution to a trust under these rules. Since not all contributions to trusts will engage the Section 94 NRT Rules, in this, the third instalment of the Series, we will consider the types of contributions that will cause otherwise Pure NRTs to become Section 94 NRTs subject to tax in Canada.

As you may recall from the second instalment of the Series, only contributions that involve a trust with a:

(1) "resident contributor", or

(2) "resident beneficiary",

will engage the Section 94 Trust Rules.[2] Unfortunately, engaging these rules at any particular time is quite easy.

Resident Contributor

All that is required for there to be a resident contributor at a particular time is that an otherwise Pure NRT needs to have a contributor that is alive or otherwise in existence and that is resident in Canada. If the otherwise Pure NRT meets these criteria, then it will automatically be a Section 94 NRT.[3]

It is worth keeping in mind that ceasing to exist is a concept that is broader than dying. For example, it can include the winding-up of a trust or partnership and the voluntary dissolution of a corporation.[4]

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[1] Unless otherwise noted, defined terms in this article have the meaning designated in the first instalment of the Series.

[2] Unless otherwise noted, defined terms in the Act that are used in the Series can be found in subsection 94(1).

[3] The CRA has commented on the requirements to be a resident contributor in document 2012-0448681E5, dated January 4, 2013.

[4] In the case of an involuntary dissolution, query whether a corporation can be said to have ceased to exist prior to the expiry of the period permitted to revive such a corporation (see corporate legislation such as subsection 241(4) – (6) of the *Business Corporations Act* (Ontario), R.S.O. 1990, Chapter B.16). This is because until such period has run, if the corporation is revived, it will be treated as having never ceased to exist (see *Leger v. The Queen*, 2010 FCA 278).

Wolters Kluwer

Example 1 – New immigrant to Canada

Effective following 2014, the "immigrant trust" rules in the Act were eliminated. Since that time, the only grandfathering provisions that will allow an otherwise Pure NRT that has a contributor resident in Canada to avoid the new Section 94 NRT Rules will be in the rare situation in which a Pure NRT that was formed before 1960 has received no contributions by an individual (other than a trust) after 1959.

Consequently, if a client has immigrated to Canada and at any time after 1959 but prior to immigration that client made a contribution to a Pure NRT, that trust will be caught by the Section 94 NRT Rules, and it will become a Section 94 NRT.[5]

Example 2 – Granny Trust – Provision of services by Canadian resident

This example involved a Canadian resident client whose granny had created an otherwise Pure NRT for the granny's beneficiaries, including the Canadian resident client. It turns out that the Canadian client just happens to be an investment wizard. Well, being a good granddaughter she starts providing all sorts of cutting-edge advice to the otherwise Pure NRT and refuses to allow the trust to pay her any fee let alone an arm's length fee sufficient to satisfy the arm's length transfer requirement. What a shame since the provision of the advice for less than arm's length compensation will constitute a contribution by a Canadian and the Section 94 NRT Rules will cause the otherwise Pure NRT to become a Section 94 NRT.[6]

Example 3 – Canadian subsidiary of EU family Business – non-interest bearing loan

Let's assume that the Canadian resident client in this example who, as you may recall, started the Canadian subsidiary of the EU family business owned by the Pure NRT of which he is a beneficiary receives an arm's length salary for his services from the Canadian subsidiary. Assuming that it can be established that the provision of services by the client (and any other Canadian residents) constitutes "exempt service", there shouldn't be an indirect contribution to the Pure NRT; however, assume that one day in the future the Canadian subsidiary has an urgent need for liquidity and the client does what most Canadian business persons typically do — he makes a non-interest bearing loan to the Canadian subsidiary. Unfortunately, this loan won't qualify as an arm's length transfer. If the loan results in an increase in the FMV of the trust's shares of the EU corporation,[7] then the making of the loan would constitute a contribution and the Section 94 NRT Rules will likely be engaged.

Unfortunately, due to how broad the contribution concept is, it is entirely possible that clients who make contributions to otherwise Pure NRTs will often not even know that a contribution has been made in any of these types of situations. In fact, until you or some other advisor discovers the contribution, the client might not even know that the trust has become a Section 94 NRT.

Resident Beneficiary

Even if a trust doesn't have a resident contributor at a particular time, it could still be a Section 94 NRT where it has a resident beneficiary.

As the definition suggests, a resident beneficiary will exist if, at a particular time, a trust has a beneficiary that is resident in Canada. Fortunately, simply having a beneficiary resident in Canada is not enough to cause a trust to have a resident beneficiary.

The trust must also have a "connected contributor" at that time. With a limited exception for contributions made during certain periods when a contributor was not a Canadian resident, a connected contributor will include any

[5] As a planning point, consider asking clients who have immigrated to Canada about whether they are aware of any trusts that they or members of their family have worked for, are beneficiaries of, or have established.

[6] The provision of services related to the administration of the trust should be an "exempt service" and should not result in a loss of Pure NRT status, regardless of the consideration paid by the trust.

[7] It may be possible for one to craft arguments that the making of a particular loan that does not constitute an arm's length transfer would not result in an increase to the FMV of the trust's shares of the EU corporation. For example, arguably a demand loan made by the Canadian resident to the Canadian subsidiary should not increase the fair market value of the shares held by the trust as it would not increase the fair market value of the equity of the Canadian subsidiary or otherwise affect the fair market value of the property held by the trust. However, such a loan may nonetheless result in a transfer of property to the trust pursuant to paragraph 94(2)(*c*) if one of the reasons for making the loan was to avoid or minimize a liability under Part I of the Act. Such a discussion is beyond the scope of this Series.

contributor who was ever a resident of Canada even if the contributor ceases to exist.

If a trust has Canadian resident beneficiaries and the contributor ceases to be a Canadian resident or ceases to exist, then the resident beneficiary concept will expand the application of the Section 94 NRT Rules to situations not caught by the resident contributor definition.

It is worth noting that the term resident beneficiary specifically excludes "successor beneficiaries", which is a term that includes certain closely related persons whose right to be a beneficiary is dependent on the death of a contributor.[8] As a result, if a trust has a connected contributor and at some point after the connected contributor's death a resident Canadian becomes a beneficiary of the trust, then the trust could fall into the Section 94 NRT Rules and become a Section 94 NRT.

Electing Trusts

An otherwise Pure NRT that has received even a nominal contribution from persons who are resident contributors or connected contributors will become a Section 94 NRT, and all of its income will be caught by the Section 94 NRT rules unless the trust is able to file an election to become an electing trust. If this election is filed, then only income from the so-called "resident portion" of the trust property will be taxable in Canada.

Essentially the resident portion of the trust property will be all of the trust's property derived from a resident contributor or a connected contributor. The resident portion of the income from the trust property will be tracked separately from the non-resident portion of the trust's property. For older trusts where record keeping may not be available, tracking could be a challenge.

Aside from tracking problems, one of the other big issues with the electing trust rules is that the election must be made in writing at the time of filing the Section 94 NRT's first taxation year after 2006 in which it is both deemed to be a Section 94 NRT and has a non-resident portion.[9] Due to certain transitional rules, older trusts generally had until June 26, 2014 to file the election. However, other than the transitional exception there does not appear to be any ability to late-file (or revoke) an election to be an electing trust. This seems particularly cruel when one considers both the breadth of the contribution rules that have been reviewed in the Series and the possibility that the application of the Section 94 NRT Rules may not be discovered until well after the deadline for filing the election.

Liability for Section 94 NRT Taxes

Collecting taxes from a Section 94 NRT will often not be easy since the Section 94 NRT Rules can apply to NRTs that have very little nexus to Canada. So, it should come as no surprise that the Section 94 NRT Rules come with some pretty powerful collection provisions to collect the taxes from persons resident in Canada. In particular, paragraph 94(3)(*d*) makes resident beneficiaries and resident contributors jointly and severally liable for a Section 94 NRT's unpaid taxes.[10] Although subsection 94(7) together with subsection 94(8) may in some situations create a "recovery limit", which can limit the amount that the CRA can recover from a resident beneficiary or contributor, the relief will often not be available.

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At this point hopefully it has become clear that the Section 94 NRT Rules have been drafted way too broadly. These rules may apply in many situations that could impact on non-specialist advisors and their clients and when they do their application can be harsh. In addition, even when the Section 94 NRT Rules offer relief, such as for an electing trust, one may often find it to be impossible for a Section 94 NRT to take advantage of the relief provided in the Act.

The fourth and final instalment of the Series will begin by reviewing the impact of the Section 94 NRT Rules first applying and later ceasing to apply to a trust. It will then review how the Section 94 NRT Rules can negatively impact on traditional cross-border Canada–US testamentary planning for Canadian clients with US beneficiaries. The Series will close with a review of some tax traps involving Pure NRTs.

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

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[8] Exempt persons, such as government and tax exempt entities, and persons who are "successor beneficiaries" (see the defined term in subsection 94(1)) at a particular time are also excluded from being resident beneficiaries.

[9] For a more detailed discussion on this subject see the article by Harris et al. (cited in the first instalment of the Series).

[10] Pursuant to the rules in subsections 94(16) and (17) it is possible for one or more "electing contributors" to elect to pay each of their proportionate shares of a Section 94 NRT's tax liability. The rules relating to electing contributors are complex but there are excellent discussions of these rules in the Harris et al. article, which was cited in the first instalment of the Series.

CURRENT ITEMS OF INTEREST

Government Provides Tax Relief to Canadians Affected by Alberta Wildfires

On May 6, 2016, the Minister of National Revenue announced that the CRA will offer tax relief to Canadians affected by the wildfires surrounding the Fort McMurray and northeast Alberta area. Where individuals, businesses, and first responders may be unable to file or pay taxes on time, the Minister encourages them to make a request for taxpayer relief (often done by submitting form RC4288). The CRA also maintains a general information page that relates to the tax implications of disaster relief. Additional measures taken by the CRA to help those affected by this event include:

- ceasing all collections, audit activities, and administrative correspondence;
- cancelling penalties and interest for impacted individuals who are unable to file their tax return or pay amounts owing;
- designating telephone agents to provide assistance to those affected by the wildfires; and
- collaborating with Canada Post to ensure that taxpayers expecting a refund or benefit payment will have secure access to their mail.

CRA Provides Guidance for Charities Affected by Alberta Wildfires

Several weeks ago, the CRA issued information pertaining to disaster relief for those impacted by the Alberta wildfires. On May 18, 2016, further guidance was released that pertains specifically to charities. Where a charity is unable to file its information return (Form T3010) on time, the CRA will provide relief. If a charity's records are destroyed by the fire, the CRA will assist the charity by providing them with all copies of documents on file. Further, the news release stresses that a charity should contact the CRA Charities Directorate regarding its charitable purpose if the charity wishes to raise funds to help victims. The release also includes some helpful information for donors looking to provide assistance.

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.

The question of costs when a tax appeal is allowed but mathematically unfavourable

***Kruger Incorporated v. The Queen*, 2016 DTC 1021 (Tax Court of Canada)**

Last year, Kruger Incorporated ("Kruger"), a manufacturer of paper products, was partially successful in its appeal of an income tax assessment relating to the treatment of foreign exchange option contracts held by it from time to time as a means of hedging against currency fluctuations. In that case — *Kruger Incorporated v. The Queen* (2015 DTC 1127) — the Tax Court held that Kruger was carrying on a business of speculating on such contracts and that contracts purchased — but, importantly, not those written — by it qualified as inventory and could be treated as such under section 10 of the *Income Tax Act* (the "Act").[1] The implications of the case were that derivatives held on income account in some cases could potentially qualify for the lower of cost and market method under the inventory valuation rules, thereby allowing deductible write-downs of such derivatives on a year-end basis. The Federal Government did not like this result and, accordingly, has proposed rules in the 2016 Federal Budget to deem derivatives (i.e., swap agreements, forward purchase/sale agreements, forward rate agreements, futures agreements, option agreements, or similar agreements) not to be inventory of a taxpayer. The Department of Justice has also appealed the decision to the Federal Court of Appeal.

As a result of the proposed legislative "fix" and ongoing appeal, the 2015 Kruger case has fairly limited precedential value. The 2016 decision of Justice Rip following that case regarding costs (which is the subject of this commentary) is, however, rather interesting.

Much to the disappointment of Justice Rip, the parties had failed to reach an agreement regarding costs themselves, and consequently made submissions to the Court for consideration. Interestingly, when it came time to implement the

[1] See the July 9, 2015, edition of this publication (Tax Topics 2261) for a short summary of that case.

2015 judgment (i.e., to reassess in accordance with the judgment), the CRA's calculations (with which the taxpayer concurred) were such that the original assessment could remain intact. The reason for this was that the appeal was successful only in respect of foreign exchange option contracts that had been purchased by Kruger, but not those that had been written by it, and in the year in question the ratio of written contracts to purchased contracts was approximately 4:1.

As a result, each party had an argument as to its entitlement to costs — the taxpayer on the basis of an allowed appeal and the Crown on the basis that the result was substantially in its favour given the numbers involved (i.e., since the original assessment could stand). Given this divided success, Kruger suggested that each party should bear its own costs, pointing to a line of cases which suggest that where success is divided, no order of costs ought to be made. However, the Crown took the position that it was entirely successful and that it alone should be entitled to costs. Indeed, the Crown's position on the proper treatment of the foreign exchange option contracts was confirmed in respect of 80% of the contracts at issue and the assessment appealed from was left undisturbed by the judgment. Kruger contended (and the Court accepted) that the fact the assessment could be left standing notwithstanding the judgment was an anomaly. Indeed, as the Court noted, "[o]ne normally expects that a reassessment in accordance with a judgment granting the taxpayer some relief would result in a lower amount of tax" and this presumably would have been the case had Kruger's option contract holdings in the year in question been other than what they were.

How is a Court to determine costs in such a case? In Justice Rip's view, in setting costs pursuant to section 147 of the *Tax Court Rules*, the amount of money involved in the appeal is a leading factor, in that this influences how the parties will prepare and finance the appeal, and "[w]here the amounts are appreciable, as in this appeal, the issue in law may be more complex, the facts more complicated or involved, resulting in more documents, lengthier examinations for discovery, expert evidence, etc." In this case, the Court concluded that both sides devoted significant time and effort in the course of the appeal, that the matter was complex (requiring two experts from each party), that the parties' arguments were not frivolous or untenable, and that neither party engaged in delay-causing tactics. Further, it was held that each party was successful, but to different degrees.

In addition, Justice Rip held that the matters that may be considered by a judge in determining costs are not limited to those set out in subsection 147(3) of the *Tax Court Rules*[2] and that there is no rule that prohibits a judge from distributing costs between the parties (although it is not encouraged). That said, Justice Rip noted that he had derived significant benefit from the testimony of the two Crown experts and, given the issue in appeal and the proportion of allocation of success, awarded the Crown its entire costs with respect to those experts and 50% of all other costs, noting that "[t]his may not be convention but I believe it is reasonable".

— *Brian O'Neill*

Transfer pricing adjustments and penalties upheld

***Marzen Artistic Aluminum Ltd. v The Queen*, 2016 DTC 5018 (Federal Court of Appeal)**

Since 1939, the *Income Tax Act* (the "Act") has included transfer pricing provisions that govern Canadian taxpayers when paying for property or services provided by non-arm's length, non-residents of Canada. In *The Queen v. General Electric Capital Canada Inc*. (2011 DTC 5011), the Federal Court of Appeal indicated that the purpose of the transfer pricing provisions in paragraphs 247(2)(*a*) and (*c*) is to prevent tax avoidance via price distortions between non-arm's length parties. The main tenet of transfer pricing is fair market value, since the transaction price must be the value that would reasonably be reached between arm's length parties. Section 247 of the Act does not specify how to calculate fair market value, but the Supreme Court of Canada endorsed the OECD Guidelines 1995 in *The Queen v. GlaxoSmithKline Inc*. (2012 DTC 5147) as useful, although non-binding, guidelines for determining what arm's length, reasonable business people would pay.

In *Marzen*, the taxpayer did not apply arm's length principles when dealing with related parties in other jurisdictions and, accordingly, was subject to substantial transfer pricing adjustments and penalties pursuant to paragraphs 247(2)(*a*) and (*c*) and subsection 247(3) of the Act.

The decision involves Marzen, a Canadian corporation, that manufactured and sold windows in Canada. Marzen's sister company, Starline Windows Inc. ("SWI"), sold Marzen's windows in the US. Marzen was the sole shareholder of Starline International Inc. ("SII"), a company incorporated in Barbados by Longview Associated Limited ("Longview"). Longview was a Barbados-based corporation owned by Mr. Csumrik, who was appointed as the managing director of SII and who dealt at arm's length with Marzen and its affiliates.

SII was incorporated to assist Marzen in successfully penetrating the US window market, which SWI had not done successfully. SII provided marketing and sales support for Marzen in the US pursuant to a Marketing and Sales Services

[2] The opening words of that subsection state as follows: "In exercising its discretionary power pursuant to subsection (1) [i.e., determination of costs] the Court may consider [. . .]".

Agreement (the "MSSA"). SWI seconded its employees to SII on a cost plus 10% basis through a Personnel Services Agreement (the "PSA") and an Administrative and Support Services Agreement. The PSA explicitly stated that SWI and SII were separate legal entities and did not operate as a joint venture or a partnership. Marzen paid much more for services rendered by SII under the MSSA than SII paid to SWI under the PSA. SII paid Mr. Csumrik and Longview a total of US$32,500 for management services in each of 2000 and 2001.

Marzen deducted the fees paid to SII from its taxable income in 2000 and 2001, totalling C$4,168,551 and C$7,837,082. Marzen also deducted dividends received from SII, totalling C$2,011,500 in 2000 and C$5,299,620 in 2001, pursuant to section 113 of the Act, on the basis that these payments were from SII's exempt surplus.

The Minister reassessed Marzen for the 2000 and 2001 taxation years, imposing transfer pricing adjustments pursuant to paragraphs 247(2)(*a*) and (*c*), limiting Marzen's deductions in respect of fees paid from Marzen to SII to C$2.1 million in 2000 and C$2.8 million in 2001. A C$502,519 transfer pricing penalty was also imposed for 2001 pursuant to subsection 247(3).

Marzen appealed the reassessment. At the Tax Court of Canada level, Sheridan, J. determined that the MSSA was the transaction under review. He referenced the OECD Guidelines 1995 in determining:

(1) whether the MSSA terms and conditions differed from what would have been agreed upon between arm's length parties; and

(2) what transactions the MSSA should be compared to and what price arm's length parties would have agreed to for the MSSA.

Sheridan, J. first determined that the MSSA terms and conditions differed from those that parties dealing at arm's length would have agreed to, since SII received fees under the MSSA but was a "shell" corporation without risk, personnel, or assets to merit that income.

Sheridan, J. identified two transactions as relevant and comparable to the MSSA: the PSA and the management arrangement involving Mr. Csumrik, Longview, and SII. The judge accepted the Minister's assumption that the PSA fees represented an arm's length price and also determined that the US$32,500 paid by SII to Mr. Csumrik and Longview each year for management services was arm's length.

The judge followed the Comparable Uncontrolled Price method (the "CUP method") from the OECD Guidelines 1995 in determining an arm's length price. The judge held that a transfer pricing adjustment was required, and that Marzen could deduct only an additional US$32,500 in each of 2000 and 2001 because that price was reached in a comparable, arm's length transaction. The judge also found that Marzen did not make a reasonable effort to use arm's length transfer pricing and upheld a transfer pricing penalty of C$502,519 for 2001.

Marzen appealed, and Scott, J.A. of the Federal Court of Appeal, writing for the court, considered:

(1) whether the judge erred in determining that the MSSA terms and conditions differed from what would have been agreed to by arm's length parties; and

(2) whether the judge erred in finding that an arm's length party would not have paid SII fees in excess of those allowed by the Minister plus US$32,500 in each year.

Transfer pricing assessments are inherently fact-specific. Therefore, the Federal Court of Appeal would overturn the Tax Court's decision only if it included a palpable and overriding error on a question of fact. The Court of Appeal held that the Tax Court's finding that the MSSA fees paid to SII were not arm's length in amount because they were greater than would be justified by Mr. Csumrik's management contributions to Marzen on behalf of SII did not include any palpable or overriding error of fact.

The Court of Appeal found that it was open to the Tax Court to employ the CUP method as the most appropriate method of determining arm's length pricing. The Tax Court had concluded that Mr. Csumrik and SII were at arm's length, such that the US$32,500 fees payable to Mr. Csumrik and Longview reflected an arm's length value for Mr. Csumrik's management services; that amount represented the only additional deductions allowed in 2000 and 2001.

As this decision makes clear, taxpayers that transact with non-arm's length parties in other jurisdictions must carefully consider the Act's transfer pricing provisions and employ reasonable efforts to ensure their transactions comply with the transfer pricing requirements, for example by following the OECD Guidelines 1995, ensuring that amounts paid reflect arm's length principles.

— *Alyssa Novoselac, Summer Student, and Brianne Paulin, Summer Student*

Ontario Court of Appeal finds assessed taxes under appeal are "contingent claims" disentitling Minister to preferred treatment in taxpayer's bankruptcy

***Schnier v. Canada (Attorney General)*, 2016 DTC 5007 (Ontario Court of Appeal)**

The issue in this appeal was narrow but significant: Are amounts owing pursuant to one or more reassessments that are under appeal when a bankrupt taxpayer applies for a discharge from bankruptcy "personal income tax debt" under the *Bankruptcy and Insolvency Act* (the "BIA")? Section 172.1 of the BIA may afford the Minister additional rights and potential remedies when a bankrupt taxpayer seeks discharge with "personal income tax debt" of $200,000 or more, which represents 75% or more of the bankrupt's total unsecured proven claims.

In the instant case, it was undisputed that the bankrupt taxpayer owed taxes of approximately $70,000. However, the taxpayer had appealed multiple reassessments flowing from historical investments in tax shelter schemes. The amounts subject to appeal totalled approximately $4.4 million. The taxpayer's appeals were outstanding when, following personal bankruptcy proceedings, the taxpayer applied to the court for a discharge. When combined, the undisputed tax owing and the tax subject to the reassessments easily exceeded the $200,000/75% threshold of section 172.1 of the BIA.

The Registrar in Bankruptcy found that the reassessed taxes owing were contingent claims because they were in dispute at the time of the taxpayer's application for a discharge. Therefore, in the Registrar's view, the disputed amounts were not "personal income tax debt" that counted towards the $200,000/75% threshold under the BIA and could not be so considered until the tax appeals had run their course (assuming that the Minister's reassessments were upheld in whole or part).

The Minister unsuccessfully appealed this determination to the Superior Court. The Minister then appealed to the Court of Appeal. The appeal was somewhat a matter of principle, as the Minister did not seek to overturn the particular taxpayer's discharge. The Minister simply sought a declaration that section 172.1 of the BIA applied to the taxpayer at his discharge, presumably as a precedent for future cases.

The Court of Appeal (per Gillese, Blair, and Brown J.J.A.) dismissed the Minister's appeal.

The Minister argued that assessed taxes — whether subject to an appeal or not — are "payable forthwith" pursuant to section 158 of the *Income Tax Act* (the "Act"). Further, the Minister argued, subsection 152(8) of the Act deems an assessment to be "valid and binding". In combination, the Minister argued that these two provisions rendered the face amount of any assessed tax to be "personal income tax debt" as of the date of the (re)assessment, irrespective of any appeal. On policy grounds, the Minister also argued that to hold otherwise would provide taxpayers with an advantage in bankruptcy proceedings. They could simply appeal their reassessments before a discharge hearing to carve out the taxes owed, and thus keep themselves out of the $200,000/75% threshold of section 172.1 of the BIA.

The Court did not accept the Minister's arguments. Its reasons were relatively short. On the issue of the Act, the Court found that the Minister ignored crucial phrases and provisions. For example, subsection 152(8) of the Act provides that an assessment is valid and binding "subject to being varied or vacated on an objection or appeal". As the reassessments in this case were subject to an appeal, they were not "valid and binding" as of the date of the discharge application. Similarly, the Court noted that subsection 248(2) of the Act, which provides that tax payable by a taxpayer fixed by an assessment or reassessment, is "subject to variation on objection or on appeal". As well, section 225.1 of the Act prevents the Minister from enforcing steps to collect assessed amounts when a taxpayer has appealed an assessment. The Court found that, until the appeal process is concluded, the amount of the tax payable, if any, cannot be known. As such, it is open to a trustee in bankruptcy (and ultimately the Registrar and lower court judge in this case) to characterize those amounts as "contingent" and not proven claims (and therefore not part of the $200,000/75% test in section 172.1 of the BIA).

The Court indicated that its holding was consistent with the prevailing case law involving open tax appeals in bankruptcy, including *Re Port Chevrolet Oldsmobile Ltd.*, 2002 BCSC 1874 (a case involving similar issues under the *Excise Tax Act*) and *Re 2723250 Canada Inc.*, 2011 QCCS 6119 (which involved a disputed tax claim by the Agence du revenue du Québec).

Turning to the Minister's policy argument, the Court found that its holding would not necessarily allow bankrupt taxpayers to abuse the Act's appeal mechanisms to push themselves outside of section 172.1 of the BIA prior to a discharge. The Court noted that it would be open to the Minister to seek an adjournment of a discharge hearing so that a tax appeal could be decided. The Minister did not seek an adjournment in this case. In fact, here the taxpayer had agreed to hold his appeal in abeyance pending resolution of three lead test cases. Those cases were decided (in the Minister's favour), and appeals exhausted, prior to the taxpayer's application for a discharge but while the taxpayer's own appeal remained open. The Court noted that it would have been open to the Minister to notify the taxpayer of the outcome of the three test cases prior to the discharge hearing. It did not do so, and there was no explanation for the Minister's delay.

While the decision addresses a highly situational issue under a narrow provision of the BIA, it is interesting for its broader finding that assessed amounts subject to open objections or, in this case, appeals, are "contingent claims" within the meaning of the BIA. While the Court appeared to close the door on the potential for taxpayers to abuse this finding when seeking a discharge from bankruptcy, the Court's reasons in this regard were highly specific to the facts of this case. It is possible that bankrupt taxpayers in different factual circumstances may be able to now rely on *Schnier* to dispute assessed taxes prior to a discharge and avoid the more stringent discharge regime of section 172.1 of the BIA. While the Minister may have procedural remedies in this regard, it is not certain, based on *Schnier,* that those remedies would always succeed to curtail such a strategy.

— *Mark Firman*

Foreign Exchange Gains: Federal Court of Appeal considers the application of subsection 39(2) to debenture conversion

***The Queen v. Agnico-Eagle Mines Limited*, 2016 DTC 5056 (Federal Court of Appeal)**

In this decision, the Federal Court of Appeal considered whether a taxpayer, Agnico-Eagle Mines Limited, had realized foreign exchange gains under subsection 39(2) of the *Income Tax Act* (the "Act") as a result of the conversion of certain US dollar denominated convertible debentures into common shares of the taxpayer, which shares were listed for trading on the New York and Toronto stock exchanges.

In February 2002, the taxpayer issued 143,750 US$1,000 convertible debentures due on February 15, 2012. The terms of the trust indenture governing the debentures granted holders the right to convert each of their debentures into a fixed number of common shares (71.429) in full satisfaction of the taxpayer's obligation to repay the principal amount of the debenture. The terms of the trust indenture also granted the taxpayer the right to redeem all or a portion of the outstanding debentures at a price equal to the aggregate principal amount of the debentures selected for redemption plus any accrued and unpaid interest. In satisfaction of its payment obligations upon either the maturity or redemption of the debentures, the indenture permitted the taxpayer to pay the redemption price in common shares according to a formula weighing the average trading price of the common shares on the New York Stock Exchange.

At the time the debentures were issued, the foreign exchange rate was C$1.588 to US$1.00, meaning that the principal amount of each debenture, as measured in Canadian dollars, was $1,588.

In December 2005, by way of a directors' resolution, the taxpayer approved the redemption of all outstanding debentures at a price of US$1,022.68 per debenture, representing both the principal amount of the debt and accrued interest thereon. By resolution, the amount was to be paid on February 15, 2006, through the issuance of 63.4767 common shares per outstanding debenture.

According to the terms of the indenture, holders of the debentures were permitted to maintain their conversion rights, allowing them to receive 71.429 common shares per convertible debenture up to the date of the redemption.

Between December 2005 and February 15, 2006, given the obvious benefit of exercising the conversion right before the scheduled redemption date, all but 1,111 of the convertible debentures were converted to Agnico-Eagle common shares. As compared to the time at which the debentures were initially issued, the Canadian dollar was trading at a significantly higher rate; in this regard, during the conversion period the US dollar foreign exchange rate fluctuated between C$1.1443 and C$1.1726 per US$1.00. On February 15, 2006, the remaining 1,111 debentures were redeemed by the taxpayer.

The taxpayer did not report any capital gains on the conversions that took place in December 2005 in its 2005 taxation year, but did report a capital gain on the 2006 conversions and redemptions in its 2006 tax return — albeit using a methodology that the taxpayer later admitted was incorrect.

Through two separate reassessments issued in 2010 and 2011, the Minister reassessed the taxpayer pursuant to subsection 39(2) of the Act in respect of foreign exchange gains representing the difference between the principal amount of the convertible debentures issued in 2002, in Canadian dollars, and the amount, expressed in Canadian dollars, of the outstanding debt extinguished in 2005 and 2006 by the conversions and redemption of the debentures for common shares.

The taxpayer objected to the reassessments and, when the reassessments were upheld by the Minister, appealed the reassessments to the Tax Court of Canada.

Subsection 39(2) provides generally that a taxpayer who has made a gain or sustained a loss from the fluctuation in the value of a foreign currency relative to the Canadian dollar is deemed to have a capital gain or capital loss, as the case may be. In this appeal, the Tax Court had to determine whether the amount paid by Agnico-Eagle to extinguish its obligations under the convertible debentures meant that it had made a gain as a result of the relative increase of the Canadian dollar against the US dollar between the time the convertible debentures were issued and the time they were repaid.

Given the relative increase in the value of the Canadian dollar compared to the US dollar, from C$1.588 per US$1.00 in 2002 to as high as C$1.1443 per US$1.00 in 2005 and 2006, much of the Minister's case turned on the time at which the relevant events occurred. Section 261 requires taxpayers to compute their income tax results using Canadian currency, with paragraph 261(2)(*b*) specifying that the conversion to Canadian currency is to take place "using the relevant spot rate for the day on which the particular amount arose".

After considering these issues, the Tax Court upheld the deemed capital gain in respect of the redemption but overturned the Minister's assessment of the deemed capital gain in respect of the conversions. According to the Tax Court, the amount the taxpayer paid to extinguish the obligations represented by the convertible debentures was "not necessarily" reflected in the trading price of the common shares at the time of their issuance but was instead referable to the parties' agreement. By her reading of the trust indenture and prospectus, the Tax Court judge found that the 71.429 common shares per debenture were to be issued at a price of US$14.00 per common share, representing an aggregate amount of US$1,000. As regards the timing of the currency conversion to Canadian dollars as required by section 261 of the Act, the Tax Court held that the US$1,000 amount "arose" at the time the convertible debentures were initially issued, not at the time that the conversion feature was exercised and the debentures were converted to common shares. As a result, the foreign exchange gain was nil — both the issuance amount (US$1,000) and extinguishment amount (US$1,000) were subject to the same foreign exchange rate.

The Crown appealed to the Federal Court of Appeal. Ryer J.A., writing for the Court, found that the trial judge had committed a reviewable error by simultaneously reaching two mutually irreconcilable conclusions as to how the conversion and redemption features of the debentures should be characterized.

On one hand, the Tax Court had characterized the shares issued under the redemption feature as payment for the extinguishment of the principal amount plus accrued interest on the convertible debentures, creating foreign exchange gains subject to subsection 39(2).

On the other hand, the Tax Court had characterized the shares issued under the conversion feature as a subscription for shares and not a means by which the taxpayer repaid its indebtedness. The Tax Court had in effect held that when holders agreed to purchase the convertible debentures, rather than paying for US$1,000 in debt, the holders were subscribing for the future issuance of the common shares if the debentures were ever converted. According to Ryer J.A. this was an erroneous finding because, amongst other reasons, it would be illogical for the holders, who acquired common shares on conversion, to peg the value of the shares they received to the US$1,000 (representing 71.429 common shares at US$14.00 per share) they initially paid to acquire the convertible debentures. Ryer J.A. found that the fixed number of shares issuable under the conversion feature was meant to allow holders to extract more than the US$1,000 initial purchase price of each debenture. If the price of the Agnico-Eagle shares ever exceeded US$14.00 per share, the conversion feature would put the debentures "in the money" and allow holders to receive in shares more than the initial US$1,000 of value the holders initially invested in the debentures.

Having rejected the Tax Court's construction of the conversion right, Ryer J.A. undertook to interpret the provisions of the indenture he considered to be relevant to the appeal.

Looking first to the express words of the indenture, Ryer J.A. concluded that the indenture left little ambiguity that the common shares issued on a conversion were meant to satisfy the taxpayer's obligation to repay the principal amount of the debentures and extinguish any remaining rights and obligations of the debenture holders against the taxpayer.

Drawing an analogy between the redemption of preferred shares in *The Queen v. MacMillan Bloedel Ltd.* (99 DTC 5454 (FCA)) and the conversion of debt securities in the case at bar, Ryer J.A. indicated that, for the purposes of subsection 39(2), a taxpayer will realize a foreign exchange gain on a debt conversion when, due to currency fluctuations, the taxpayer pays less to convert a debt security into a share than the taxpayer initially received when it issued the debt security.

In order to determine the foreign exchange rate applicable to the extinguishment amounts, Ryer J.A. considered when the repayments "arose" within the meaning of subsection 261(2). Accepting the argument of the Crown, Ryer J.A. ruled that the extinguishment "arose" on the respective conversion dates of each of the debentures.

This conclusion was not dispositive of the matter, however, as the actual quantum of the amount paid by the taxpayer on the conversion date remained to be determined. As an interpretive aid, Ryer J.A. looked to the subsection 248(1) definition of "amount", meaning "money, rights or things expressed in terms of the amount of money or the value in terms of money of the right or thing".

With this definition in mind, Ryer J.A. considered the terms and conditions of the trust indenture, which provided a formula for determining how the quantum of the repayment amount was to be determined in respect of fractional shares on a debenture conversion. Under this formula, the taxpayer was obliged to pay cash equal to the market value of any fractional shares on the date of conversion, using a methodology set out in the trust indenture to determine that market value. As further evidence that the quantum of the extinguishment amount was meant to be the market value of the consideration paid by the taxpayer rather than the amount of the debt extinguished under the debenture, Ryer J.A. looked to the Ontario *Business Corporations Act* (the "OBCA") procedure for valuating shares. Paragraph 23(4)(*b*) of the OBCA, which was cited by the directors of the taxpayer in their share issuance resolution, pegs the fair value of consideration receivable for shares at "not less than the amount of money" an issuer would have received if it issued the shares for money. Applying this valuation mechanism to subsection 39(2), Ryer J.A. concluded that in order to calculate any foreign exchange gains the Minister would have to compare the Canadian dollar amount converted on the day the debentures were issued with the Canadian dollar amount calculated at the time at which shares were issued on conversion of the debentures. That latter amount was to be determined by taking the number of shares received on a conversion date multiplied by the market value of the common shares received upon a conversion of the debenture as expressed in Canadian dollars at the foreign exchange rate on the date of conversion, using the methodology set out in the trust indenture (in respect of fractional shares) to determine that market value. If the amount received by the taxpayer on issuance of the debentures, expressed in Canadian dollars at the exchange rate on the day of issuance, exceeded the market value of shares issued on conversion, expressed in Canadian dollars at the exchange rate on the day of conversion and using the methodology set out in the indenture to determine the market value, the taxpayer would have a foreign exchange gain for purposes of subsection 39(2).

Having established the correct approach to be applied by the Minister, Ryer J.A. allowed the Crown's appeal and ordered the matter to be remitted to the Minister for reassessment.

— *Justin Shoemaker, Articling Student*

RECENT CASES

Appeal allowed where appellant found to be eligible individual for CCTB purposes

The taxpayer was the parent of three minor children and was separated from his spouse. In 2013 all of the children lived with the taxpayer. During the relevant time period, the taxpayer employed a caregiver for his children as he was, as the result of both previous and recent injuries, unable to provide all of their care himself. He was, however, involved in their care to the extent possible given his physical limitations. The Minister concluded that the taxpayer was not an eligible individual with respect to his children for purposes of receiving the Canada Child Tax Benefit, as he was not the person who primarily had responsibility for the care of the children during the relevant period. The taxpayer appealed from that decision.

The appeal was allowed. The Court held that, in order for a person to satisfy the definition of an "eligible person" for purposes of entitlement to CCTB, he or she must reside with a qualified dependant and must primarily fulfil the responsibility for the care and upbringing of that qualified dependant. Following a review of the facts of the appellant's circumstances, the Court held that he and his family had to adapt to the circumstances created by his injuries. The jurisprudence provides that the child tax benefit provisions in the legislation should be interpreted in a compassionate way so as not to frustrate the obvious intention of Parliament to assist low income families. The Court held, on the basis of that jurisprudence and the particular facts of the appellant's situation, that the appellant was an eligible individual during the relevant period as he was the parent who primarily assumed responsibility for the care and upbringing of his children. Consequently the appellant was entitled to receive CCTB benefits during that period.

Shevchyk v. The Queen

2016 DTC 1057

Dissolved corporation required to effect revival in order to initiate appeal to Tax Court

The appellant corporation was incorporated in 2000 under the Ontario *Business Corporations Act* ("BCA") but was dissolved, and its certificate cancelled, in early 2007. In 2010, an assessment was issued against the corporation by the Minister of National Revenue and the corporation appealed from that assessment. The Tax Court of Canada held that the appellant, as a dissolved corporation, lacked the capacity to initiate an appeal to that Court from an assessment issued against it under the *Income Tax Act*. The Tax Court adjourned the appellant's pending appeal for 60 days in order to allow it to take steps to revive its corporate status. Instead, the appellant appealed to the Federal Court of Appeal from the order holding that it lacked capacity to appeal from its assessment to the Tax Court.

The appeal was dismissed. The appellate Court held that the question of whether a dissolved corporation has the legal capacity to initiate and continue an appeal in the Tax Court of Canada was a question of law, reviewable on a standard of correctness. It held as well that the Tax Court had reached the correct conclusion with respect to that question, but differed from the Tax Court on the reasons. The Tax Court had held that changes in statutory language relating to the effects of corporate dissolution made previous decisions of the Federal Court on that issue distinguishable, but the appellate Court determined that the Tax Court erred in reaching that conclusion. It was, however, open to the Federal Court of Appeal to depart from its prior decisions where warranted, and it concluded that such a departure was justified. Specifically, the appellate Court held that when the current legislative regime was considered, it was correct to conclude that the filing of a notice of appeal in the Tax Court constituted the initiation of a legal proceeding. As subsection 242(1) of the BCA does not authorize a dissolved corporation to initiate a civil proceeding, it followed that the Tax Court did not err by adjourning the appeal and requiring the corporate appellant to revive its corporate status so that it could continue the appeal. The appellate Court held as well that, while there were circumstances in which the statute did not permit the filing of articles of revival, other mechanisms existed to permit revival, such that the right of revival was real and not illusory. The appeal was dismissed, and the adjournment ordered by the Tax Court was continued for a further 60 days in order to allow the appellant to revive its corporate status.

1455257 v. The Queen

2016 DTC 5046

Penalty for failure to file by electronic means upheld on appeal

The corporate taxpayer filed its 2014 income tax return in paper form. A penalty under section 162(7.2) was subsequently assessed by the Minister, on the basis that the corporation was a prescribed corporation which was required to file by electronic means. The corporate taxpayer appealed from the assessment of that penalty, arguing that no such penalty could apply where there was no tax payable for the year, that it was not a prescribed corporation subject to the electronic filing requirement, and, finally, that there was a due diligence defence to the imposition of the penalty.

The appeal was dismissed. The principal argument put forward by the appellant was that no penalty could be imposed under the *Income Tax Act* where no tax was payable. The Court reviewed the relevant statutory provision and held that the wording of subsection 162(7.2) did not make the penalty for failing to file an electronic return conditional in any way on tax being payable by the corporation. Rather, the only condition to the imposition of the penalty was a failure to file an electronic return as required by subsection 150.1(2.1), which applied where the taxpayer is a prescribed corporation. The appellant had argued as well that it was not such a prescribed corporation. Specifically, it argued that the Minister's finding that the corporation had revenues in excess of $1 million was incorrect. The Court held that the appellant bore the onus of proving that its revenue did not exceed the $1 million threshold, but that no clear or convincing evidence was presented to the Court. Consequently, the appellant had not refuted the Minister's assumptions. The final argument raised by the appellant was that it was unaware of the electronic filing requirement and that its sole shareholder and director did his best to meet all tax filing requirements. The Court held, however, that it had not been shown that reasonable precautions had been taken to avoid the events which led to the imposition of the penalty. Specifically, there was no evidence that the necessary systems had been put in place to deal with the corporation's tax obligations, or that professional assistance in the handling of the corporation's tax matters had been sought. The penalty under section 162(7.2) was properly imposed.

Kokanee v. The Queen

2016 DTC 1052

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