Tax Notes

July 2016
Number 642

Supreme Court Reaffirms Supremacy of Solicitor-Client Privilege 4

Current Items of Interest 5

Focus on Current Cases 7

Recent Cases 9

Wolters Kluwer

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

— 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.

This article is the last instalment of the four-part series.

In this, the fourth and final instalment of the Series, we'll examine what happens when trusts become subject to and then cease to be subject to the Section 94 Trust Rules. Using this knowledge and the technical knowledge described in the second and third instalments of the Series we'll then analyze how the Section 94 NRT Rules apply to common cross-border testamentary planning undertaken by Canadians who have US beneficiaries (i.e., the fourth example described in the first instalment of the Series). I have also added a discussion of how the choice of executors, trustees and how even assisting ailing and/or aging family members can inadvertently engage the Section 94 NRT Rules. As a bonus, the Series will close out with a review of some tax traps involving Pure NRTs.

Impact on a trust of becoming and ceasing to be subject to the Section 94 NRT Rules[2]

Canada is one of the few tax jurisdictions in the world that subjects its residents to tax on emigration: the so-called departure tax, where immediately prior to emigration the departing resident is deemed to have made an FMV disposition of all of the emigrant's property other than property such as Canadian real property and most property used in a business carried on through a permanent establishment in Canada. Similar concepts apply at the time a taxpayer immigrates to Canada; property other than the types of property excluded from the emigration rule is deemed to be brought into Canada at a tax cost equal to its FMV. These rules are found in section 128.1.

A major issue that can arise where a trust becomes or ceases to become subject to the Section 94 NRT Rules is that the rules in subsection 94(4) will cause the trust to become subject to a modified version of the rules in section 128.1 relating to immigration and emigration.

Among other things, the subsection 94(4) rules generally cause a trust to have a deemed year-end prior to its change in status and they will also generally provide for a step-up in the adjusted cost base ("ACB") of most assets owned by a trust that becomes a Section 94 NRT. In addition, a trust that ceases to be a Section 94 NRT will be deemed to dispose of all of its property, immediately prior to the change in status, on a fully taxable basis. As was the case under section 128.1, property such as Canadian real property and most property used in a business carried on from a permanent

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

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

establishment in Canada are excluded from these deemed disposition rules.[3]

Unfortunately, if a trust is not properly monitored it could change its status among one or more of being a factually resident Canadian trust, a Pure NRT, and a Section 94 NRT, and if these changes in status occur the application of the subsection 94(4) rules could give rise to among other things the untimely creation of year-ends and the deemed taxable realization of gains for Canadian income tax purposes.

Example 4 – Canadian estate planning for US beneficiaries[4]

Canadian resident clients who have significant estates and who also have US heirs, are often encouraged by their US tax counsel to put in place special planning in respect of the portion of their estate that is intended to be left to their US beneficiaries. In particular, I commonly see US counsel advising those clients to have their estates fund one or more special US trusts (each a "US Trust"). This type of US Trust is generally formed to accomplish objectives that include: potentially continuing the trust indefinitely;[5] providing protection of the gift from creditors of the US beneficiary, including spousal creditors of the US beneficiary; and avoiding the gift becoming part of the US beneficiary's US taxable estate, which would otherwise cause the inheritance to become subject to US estate tax.

Unfortunately, the Section 94 NRT Rules would seem to catch otherwise Pure NRTs formed for this purpose. This result occurs because instead of a deceased parent, who will have ceased to exist on his or her death, contributing[6] the property to a US Trust, it is the estate of the deceased parent that will be considered to have made the contribution.[7] The result is that even with the most careful of planning, the Canadian estate will be a resident contributor to the US Trust and this will cause the US Trust to become a Section 94 NRT.[8]

While the US Trust is a Section 94 NRT it will be subject to Canadian taxation and based on prior CRA commentary it appears doubtful that treaty relief will be provided under Canada's tax treaties.[9] The result could well be double taxation unless the competent authorities intervene.

The US Trust will then continue to be a Section 94 NRT at least until the deceased parent's estate is wound-up, at which time if there are no Canadian resident beneficiaries the Section 94 NRT Rules should cease to apply to the US Trust. As described in the preceding section, immediately prior to losing its status as a Section 94 NRT the US Trust will, pursuant to subsection 94(4), be deemed to have a taxation year-end making it taxable on income earned up until that date and, subject to the exceptions mentioned previously, it will be deemed to dispose of all of its property on a taxable basis for Canadian tax purposes. US advice may be required to ensure that the US Trust, which at that point in time will have become a Pure NRT, has the best US tax attributes possible following emigration from Canada.

Although in cases where there are significant delays in winding up an estate the subsection 94(4) deemed disposition could give rise to material tax consequences, if the US Trust's sojourn in Canada as a Section 94 NRT is a short one, then hopefully the impact of having been a Section 94 NRT will be mainly limited to administrative nuisance and will not give rise to significant tax consequences.

Finally, it is again worth mentioning that even after the US Trust becomes a Pure NRT again, if it is not properly monitored or, if in the future a Canadian becomes a beneficiary of the US Trust, then the US Trust could find itself once again trapped in the Section 94 NRT rules.

Bonus Example – Choice of Executors, Trustees and Assisting Aging and/or Ailing Family Members

While working on a file, I recently discovered another very scary section 94 NRT real-life situation that could impact the general practitioner. I have no doubt that I'll continue to discover other situations.

If non-residents are appointed as executors of an estate and/or are found to have central management and control of an estate they could cause the estate itself to become a Section 94 NRT. If the subsection 70(5) deemed disposition on death taxes would have arisen in any case, then the subsection 94(4) tax consequences of such a status change would hopefully be more aggravating then problematic. However, if the subsection 70(5) taxes had been expected to

---

[3] It would appear that the rules that permit the posting of security pursuant to the provisions in subsection 220(4.5) *et seq.*, should apply to Section 94 NRTs that become liable to pay emigration taxes pursuant to subsection 128.1(4).

[4] Because my practice is limited to Canadian law, the discussion below is only based on my general understanding of US laws and should not be construed as US tax or legal advice.

[5] Such trusts are often referred to as "dynasty trusts".

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

[7] See for example, CRA document number 2013-0514771E5 dated June 26, 2014, and CRA document number 2014-0523071C6 dated June 16, 2014 (from the CRA Round Table at the 2014 STEP Conference, Question 12). The CRA's 2014 response contains a statement that, pursuant to paragraph 94(2)(*g*), the time the interest in the deceased's estate is acquired by the otherwise Pure NRT (usually the date of death of the deceased) will give rise to the deemed transfer by the deceased's estate to the otherwise Pure NRT and will result in a contribution to the otherwise Pure NRT by the estate. Whether this position is correct or whether the correct time of the estate's contribution is the actual time when the otherwise Pure NRT receives property from the estate is a matter that remains open to debate.

[8] As mentioned in the preceding section, the rules in subsection 94(4) will apply to deem the US Trust to have effectively immigrated to Canada. Assuming at the time of immigration the US Trust has only nominal assets then the consequences of such immigration should, in general, be mainly administrative but otherwise inconsequential from a Canadian tax perspective.

[9] See section 4.3 *Income Tax Conventions Interpretations Act,* and see cases such as *Perry v. MNR et al.*, 2008 DTC 6623 (FCA); aff'g. 2007 DTC 5625 (FC).

be deferred because a surviving spouse or spousal trust was to have received the deceased's property, then this status change could be a very serious issue.

Hopefully, because non-resident executors may be required to post an administrative bond before being able to act,[10] this issue should not arise too often in an estate context. However, this issue may be much more likely to affect *inter-vivos* trusts and, in particular, alter-ego and other lifetime trusts, where administrative bond requirements may not be required.[11]

In such situations, I understand that it is not unusual for a child to be appointed as a successor trustee for his or her parents. Even if a child is not appointed as a trustee of a trust, it is possible to imagine situations in which the child, in caring for his or her aging and/or ailing parents, might become so involved in their affairs that the child could end up exercising the true central management and control of the trust. In both of these types of situations, if the child is a non-resident and unless the child receives proper and timely advice, a change in the trust's status to being a Section 94 NRT might arise while the parent is still alive, which could give rise to potentially untimely and problematic subsection 94(4) tax consequences.[12]

Pure NRT – A Couple of Tax Traps and a Planning Point

The last topics that will be covered in the Series are thankfully *not* Section 94 NRT related issues but instead relate to Canadian issues that may impact Pure NRTs.

Tax Trap 1

As is the case for all non-residents of Canada, Pure NRTs can be taxable in Canada, though the exposure to Canadian income tax is generally limited to Canadian source income rather than their worldwide income. One issue that often comes as a surprise to advisors of Pure NRT's is that the 21-year deemed disposition rules in subsection 104(4) can apply to them if they own "taxable Canadian property".[13] This tax trap is easily missed and can often catch Pure NRTs off guard.

Tax Trap 2

Another trap that can catch Canadian beneficiaries of Pure NRTs that are personal trusts by surprise can arise where a Pure NRT makes a capital distribution to a Canadian resident beneficiary and the distributed property's FMV exceeds the ACB of the property. The essence of this trap is that even though the distributing trust is a Pure NRT, the rules in subsection 107(2) would generally cause the distribution from the Pure NRT to have been made to the Canadian resident beneficiary on a rollover basis at the ACB of the Pure NRT. As a result, without planning, the Canadian resident beneficiary will be subject to tax on gains realized in the future based on the ACB inherited from the Pure NRT, which depending on the distributed asset, could be significantly less than the FMV of the property at the time of its distribution.

A Planning Point

This issue was discussed in CRA document 2015-0582701E5.[14] One way to manage this potential tax trap is to try and ensure that only high ACB properties are distributed by a Pure NRT to its Canadian resident beneficiaries. Even if the Pure NRT does not have high ACB properties, it may still be possible to tax efficiently increase the ACB of properties prior to their distribution to Canadian resident beneficiaries. For example, subject to advice from competent foreign counsel, where a Pure NRT is located in a low tax or no tax jurisdiction and the Pure NRT has low ACB properties that it desires to distribute to Canadian residents, it may be possible to take steps to cause the unrealized gains to be realized in the foreign jurisdiction and thereby increase the ACB of the assets prior to a distribution to Canadian residents.

****

As this is the end of the Series, I hope that I've been successful in achieving the modest goals of keeping you, the non-specialist advisor's attention and giving you a high-level overview of some of the many tax traps waiting for unsuspecting practitioners in the NRT world. Actually dealing with these issues – well that is likely best left to the specialists . . .

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.

---

[10] For example, see the *Estates Act*, R.S.O. 1990, c. E.21

[11] There is no requirement in the *Trustee Act*, R.S.O. 1990, c. T.23, for a trustee of an *inter-vivos* trust in Ontario to post an administrative bond.

[12] Subject to the possibility of posting security for such tax with the CRA (which is often problematic), the results could be extremely problematic if there is insufficient liquidity to fund the subsection 94(4) taxes arising upon the status change of the trust.

[13] As that term is defined in subsection 248(1). Gains that are subject to treaty protection or that involve "exempt property" would not be caught under the 21-year rule.

[14] Dated May 25, 2015.

SUPREME COURT REAFFIRMS SUPREMACY OF SOLICITOR-CLIENT PRIVILEGE

— *Roderick McBey, Tax Analyst, Wolters Kluwer*

In two unanimous decisions released June 3, 2016, the Supreme Court of Canada has reaffirmed the supremacy of solicitor-client and notary-client privilege ("solicitor-client privilege") over the need for the state to be able to obtain information to aid in the collection of taxes.

The facts in the lead case of *Canada (Attorney General) v. Chambre des notaires du Québec* (2016 DTC 5067) are that the Canada Revenue Agency sent notaries practicing law in Québec requirements to produce information pursuant to section 231.2 of the *Income Tax Act (Canada)* (the "Act"), claiming that the information in question fell within the accounting records exception in the definition of "solicitor-client privilege" in subsection 232(1) of the Act. Concerned that there was a risk that the information sought might contain client information that is protected by solicitor-client privilege, some of the notaries contacted the Chambre des notaires du Québec, which instituted a declaratory action against the Attorney General ("A-G") of Canada and the Canada Revenue Agency ("CRA") seeking to have sections 231.2 and 231.7 and the accounting records exception to the definition of "solicitor-client privilege" in subsection 232(1) declared to be unconstitutional and of no force and effect with respect to notaries. The Barreau du Québec joined the proceedings as an intervener to ensure that any declaration made by the courts would apply equally to lawyers.

The Quebec Superior Court and Court of Appeal both ruled in favour of the Chambre and Barreau, so the A-G of Canada and CRA appealed to the Supreme Court of Canada. The Advocates' Society, Canadian Bar Association, Federation of Law Societies of Canada, and Criminal Lawyers' Association all joined the proceedings before the Supreme Court as interveners.

In reviewing the issues before it, the Supreme Court considered whether the relevant provisions infringed upon the rights against unreasonable search and seizure guaranteed by section 8 of the *Canadian Charter of Rights and Freedoms* (the "Charter") and, if so, whether the infringement could be justified under section 1 of the Charter as a reasonable limit prescribed by law in a free and democratic society.

In dismissing the appeal, the Supreme Court noted that solicitor-client privilege is a "principle of fundamental justice" and a "civil right of supreme importance in the Canadian justice system" which must remain as close to absolute as possible such that any provision which interferes with solicitor-client privilege more than is absolutely necessary will be deemed unreasonable. The Court noted that the threshold for a provision being considered unreasonable is quite low and a provision will only withstand Charter scrutiny if its impact on solicitor-client privilege is minimal.

Analyzing the provisions in question, the Court held that they infringed upon the Charter for the following reasons:

(1) The client, to whom the privilege belongs, is given no notice of the requirement;

(2) The provisions place an inappropriate burden solely on the notary or lawyer concerned;

(3) Compelling disclosure of the information being sought is not absolutely necessary; and

(4) No measures have been taken to help mitigate the impairment of professional secrecy.

The Court distinguished the current case from the *Thomson Newspapers* case. In *Thomson Newspapers* (*Thomson Newspapers Ltd. v. Canada (Director of Investigation and Research, Restrictive Trade Practices Commission)*, [1990]1 S.C.R. 425), the Supreme Court stated that it might be appropriate to find that there is a lower expectation of privacy in an administrative context where there is routine access to information for regulatory purposes, and to apply a less strenuous standard in determining whether or not a seizure was reasonable, and therefore constitutional. The Court noted that the key difference between the situation in the present case and the one in *Thomson Newspapers* was that here the party in possession of the information is the notary or the lawyer, not the person who is subject to the regulatory framework.

The Court stated that while the requirement scheme served legitimate purposes, namely tax audits and the collection of amounts owed to the CRA, the existence of an important purpose could not justify sidestepping the protection afforded by section 8 of the Charter. It went on to observe that the constitutional defects in the requirement scheme were all the more unacceptable in its view since they could easily have been mitigated and remedied by way of measures that were compatible with the state's obligations relating to the protection of solicitor-client privilege.

In assessing the appropriate remedy, since the Supreme Court had already found in the *McKinlay Transport* case (*R. v. McKinlay Transport Ltd.*, [1990] 1 S.C.R. 627) that the requirement scheme is generally constitutional in relation to requirements that are sent to taxpayers, the Court felt it was neither necessary nor appropriate to find that the entire scheme was invalid. Instead, it "read down" subsection 231.2(1) and section 231.7 of the Act and held that these provisions were inapplicable to notaries and lawyers in their capacity as legal advisers.

On the other hand, the Court held that the exception for a lawyer's accounting records set out in the definition of "solicitor-client privilege" in subsection 232(1) of the Act was unconstitutional and invalid since the manner in which it limited the scope of privilege was not absolutely necessary to achieve the purposes of the Act.

The Court went on to note that it did not feel it was appropriate to establish a list of documents that are *prima facie* protected by solicitor-client privilege, as whether or not a document is protected depends on what information it contains, not on what type of document it is. Rather, as previously stated in *Foster Wheeler* (*Foster Wheeler Power Co. v. Société intermunicipale de gestion et d'élimination des déchets (SIGED) inc.*, 2004 SCC 18, [2004] 1 S.C.R. 456), the Court stated that there must be a rebuttable presumption to the effect that "all communications between client and lawyer and the information they shared would be considered *prima facie* confidential in nature".

The companion case of *Canada (National Revenue) v. Thompson* (2016 DTC 5069) (with the Federation of Law Societies of Canada, Canadian Bar Association, and Criminal Lawyers' Association as interveners) dealt solely with the exclusion of the accounting records of a lawyer from the protection of solicitor-client privilege under subsection 232(1) of the Act.

The facts in the case are that Duncan Thompson, a lawyer, received a requirement from the CRA to disclose various documents relating to his personal finances, as well as his current accounts receivable listing. Mr. Thompson provided the CRA with certain material, but claimed solicitor-client privilege attached to his accounts receivable which contained the identities of his clients. The CRA applied to the Federal Court for a compliance order against Mr. Thompson pursuant to section 231.7 of the Act. Mr. Thompson objected and filed a notice of constitutional question with the Federal Court arguing that subsection 232(1) did not override solicitor-client privilege in relation to his accounting records and that the requirement served on him violated section 8 of the Charter.

The Federal Court found against Mr. Thompson, but on subsequent appeal, the Federal Court of Appeal allowed his appeal in part, holding that while accounting records generally constitute evidence of a transaction or act rather than a privileged communication there may be rare cases where such records do contain privileged information, and sent the matter back to the Federal Court for a new hearing. It also dismissed the Charter argument on the basis that a class privilege does not attach to accounting records and client names. The Minister appealed the decision of the Federal Court of Appeal to the Supreme Court of Canada solely on the question of the proper interpretation of subsection 232(1).

Citing *Maranda* (*Maranda v. Richer*, 2003 SCC 67, [2003] 3 S.C.R. 193) the Court stated that while it was true that not everything in a solicitor-client relationship will be privileged, facts connected with that relationship (such as the bills of account at issue in *Maranda*) must be presumed to be privileged absent evidence to the contrary.

Reviewing the legislative history of subsection 232(1), the Court found a clear intention on the part of Parliament to exclude a lawyer's accounting records from the protection of solicitor-client privilege and distinguished the case at bar from *Blood Tribe* (*Canada (Privacy Commissioner) v. Blood Tribe Department of Health*, 2008 SCC 44, [2008] 2 S.C.R. 574), where the legislation evidenced no such intention. However, it went on to say that "Parliament's intent and its ability, in constitutional terms, to define solicitor-client privilege in a particular way for the purposes of the administration of the *Income Tax Act* are not necessarily equivalent", and where a seizure is involved section 8 of the Charter must be considered. The Court then went on to refer to its decision in *Chambre des notaires* that subsection 232(1) is constitutionally invalid and allowed the appeal.

The Court noted that information contained in lawyers' accounting records is presumptively privileged and that its disclosure, like other information in a lawyer's possession, cannot be required unless a court first determines whether or not solicitor-client privilege actually applies. It went on to comment that should Parliament choose to amend the existing disclosure scheme to remedy its defects, it would be necessary to take this into account and ensure clients are both notified when a court is considering making an order requiring disclosure of information that might be privileged, and allowed to participate in the process so that they can assert their rights to privilege should they choose to do so.

CURRENT ITEMS OF INTEREST

Bill C-15 Receives Royal Assent

On June 22, 2016, Bill C-15, *An Act to implement certain provisions of the budget tabled in Parliament on March 22, 2016 and other measures*, received Royal Assent and was added to the statutes of Canada as S.C. 2016, c.7. Most sections of Canadian Tax Reporter Commentary have already been updated to reflect these amendments.

Department of Finance Announces Enhancements to CPP

On June 20, 2016, Minister of Finance Bill Morneau announced that an agreement in principle to enhance the Canada Pension Plan ("CPP") was reached among the federal, provincial (except Manitoba and Quebec), and territorial Finance Ministers. To strengthen the CPP, the Ministers agreed to increase the income replacement from $^{1}/_{4}$ to $^{1}/_{3}$ of pensionable earnings, and increase the maximum pensionable earnings amount by 14%.

Also, to reduce the impact on businesses and employees, three additional measures were agreed upon:

- a "gradual 7-year phase-in" of the enhancements beginning January 1, 2019;
- enhancing the federal Working Income Tax Benefit ("WITB") for low-income workers; and
- providing a tax deduction for employee CPP contributions associated with the enhanced portion.

CRA Releases Interest Rates for Third Quarter

The CRA released its annual prescribed interest rates for the third quarter of 2016 (in effect from July 1, 2016, to September 30, 2016). These prescribed rates generally apply to amounts that individuals and corporations owe to the CRA. Since the prescribed rates for the second quarter of 2016 were released, only one change has occurred: the annual rate applicable to corporate taxpayers' pertinent loans or indebtedness changed to 4.50% (up from 4.45% in the second quarter).

Corporations Can Now Efile T1135 Online

Effective May 16, 2016, corporations may electronically file the T1135 form for 2014 and later taxation years. Individuals have been able to file the T1135 electronically since February 9, 2015.

Department of Finance Launches Consultation Regarding 30 Percent Rule for Pensions

The Department of Finance launched a consultation for federally-regulated pension plans. Specifically, the consultation explores the elimination (or the relaxation) of the 30 percent rule, which effectively prohibits federally-regulated pension plans from acquiring more than a 30% voting stake in a company. This rule ensures that these pension plans remain passive investors which cannot acquire controlling stakes in a company. The consultation seeks feedback regarding the active or passive investor role of pension funds and how the elimination of the rule will affect their investment returns.

The consultation also seeks feedback with respect to the tax implications of eliminating the 30 percent rule. Specifically, the Department is concerned that by acquiring controlling stakes in companies, tax-exempt pension funds could significantly reduce the tax liability of those companies. This can be done by converting most of the equity into debt with tax-deductible interest payments (i.e., earnings stripping via related-party debt). Also, pension funds could acquire controlling stakes in private flow-through entities and reduce taxes payable as the income would be flowed through to the tax-exempt pensions.

Although this income would ultimately be taxed in the hands of pensioners, the Department is concerned about the length of this deferral and its effect on tax revenues. Notably, the consultation seeks feedback on whether extending the thin capitalization rules and tax on SIFT entities should apply to Canadian pension plans.

Monthly Prescribed Interest Rates for Leasing Rules

The CRA announced that the prescribed rate for the month of July with respect to the leasing rules is 2.87%. A compilation of all of these monthly prescribed rates can be found in the official release.

CRA Revises Administrative Review Process for SR&ED Claims

Administrators of the SR&ED Program have completed a year-long consultation with stakeholders with respect to improving the dispute resolution policy. Based on the findings of the consultations, it was found that the procedures for administrative reviews required the following improvements:

(1) enhanced monitoring and tracking of administrative reviews; and

(2) making the delivery of administrative reviews more consistent across Canada.

With respect to the first improvement, the CRA has introduced Form RC532, *Request for Administrative Review*. Going forward, claimants must submit this form to request a review of an SR&ED claim. All forms will be sent to a single intake centre and forwarded to the regional SR&ED assistant directors. The Guidelines for Resolving Claimants' SR&ED Concerns have been updated to meet the second goal. These improved guidelines will assist regional management teams in ensuring that administrative reviews are conducted consistently across the country. Moreover, claimants will only be allowed to request an administrative review after receiving a proposal letter package from a claim review team.

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.

Minister Not Bound by Foreign Rectification Orders

***Canadian Forest Navigation Co. Ltd. v. The Queen*, 2016 DTC 1041 (Tax Court of Canada)**

If a foreign affiliate of a Canadian corporation obtains rectification orders from a court in the affiliate's home jurisdiction to alter the characterization of distributions the affiliate made to its Canadian parent, is the Minister bound to follow those foreign orders in assessing the parent corporation's liability for Canadian income tax? The Tax Court concluded in this decision that the Minister is not.

The taxpayer, Canadian Forest Navigation Co. Ltd., was a Canadian-controlled private corporation based in Montreal. The taxpayer had two wholly-owned subsidiaries, one of which was based in Barbados and the other in Cyprus. Both subsidiaries operated ships used in transporting goods in international traffic. In 2005 and 2006, the subsidiaries each paid a series of amounts to the taxpayer which the parties treated as a dividend. The taxpayer included the amounts in its income for the relevant taxation years, but also claimed the offsetting deduction in paragraph 113(1)(*a*) of the *Income Tax Act* for dividends received out of the exempt surplus of a foreign affiliate.

Following an audit by the Canada Revenue Agency, the Minister reassessed the taxpayer to disallow the paragraph 113(1)(*a*) deductions, presumably on the basis that the foreign affiliates' earnings were not exempt surplus. In 2010 and 2011, the Barbadian and Cypriot subsidiaries applied for and obtained rectification orders from their local courts to re-characterize the amounts from "dividends" to "advances" that the subsidiaries made to the parent, resulting in indebtedness from the taxpayer to the subsidiaries. The applications to the local courts were made without notice to the Canada Revenue Agency.

The taxpayer appealed the Minister's reassessments on the basis that, in light of the foreign rectification orders, the Minister erred in treating the amounts received by the taxpayer from its two subsidiaries as dividends. Before the taxpayer's appeal proceeded to trial, the Tax Court ordered that the issue of whether the Minister was required to respect the foreign rectification orders should be separately determined as a question of law pursuant to Rule 58 of the *Tax Court of Canada Rules (General Procedure*).

In its decision on the Rule 58 question, the Tax Court (*per* Lamarre A.C.J.) concluded that the foreign rectification orders did not bind the Minister and therefore did not preclude the Minister from taking the position that the taxpayer received dividends from its foreign subsidiaries.

The basis for the Court's decision was twofold. First, the Tax Court held that, because Quebec was the only province with a nexus to the parties, Quebec private international law was controlling. Relying on *Kuwait Airways Corp. v. Iraq*, 2010 SCC 40, at para. 20, the Court observed that foreign judgments are not enforceable in Quebec in and of themselves under the *Civil Code of Quebec*, but rather there must be an application to a court to declare a judgment enforceable; that procedure is a judicial demand that gives rise to an adversarial relationship. Second, the Court observed that rectification is a non-monetary judgment. Accordingly, a Quebec court deciding whether to recognize the foreign rectification orders would review the foreign courts' decisions to ensure that they do not conflict with domestic Canadian law (*Pro Swing Inc. v. Elta Golf Inc.*, 2006 SCC 52).

As a consequence of these two lines of case law, the Tax Court concluded that in order for the foreign rectification orders to be binding on the Minister, the taxpayer must first have the orders recognized in a competent tribunal in Quebec. That application should be on notice to the Minister so that the Minister could test the substance of the rectification decisions and ensure that all of the necessary information was before the foreign courts when the orders were granted. Moreover, the Tax Court noted that because rectification is only granted on a case-by-case analysis of the parties' intentions and actions, the Quebec court might find that the equitable relief should be granted as between the parties to the transactions — the taxpayer and its subsidiaries — but refuse to extend the relief to bind the Minister (*Canada (Attorney General) v. Groupe Jean Coutu (PJC) inc.*, 2015 QCCA 838, leave to appeal to Supreme Court granted and appeal heard and reserved on May 18, 2016.[1])

Despite the Tax Court's conclusion that the foreign rectification orders were not binding, the Court indicated that the taxpayer could rely on the orders in presenting its evidence at trial. The trial judge would determine the weight to be accorded to the orders when assessing whether the reassessments were correct.

The Tax Court's decision in this case highlights the importance of rectification proceedings, the scope of which is currently under reserve at the Supreme Court. The Court in this case affirmed that a Canadian corporation engaging in

[1] This case was heard along with an appeal from *Fairmont Hotels Inc. v. Canada (Attorney General)*, 2015 DTC 5073 (ONCA)

international transactions cannot count on rectification orders of a foreign court without taking the step of having those orders recognized by a provincial superior court. Importantly, the taxpayer's subsidiaries' failure to provide notice to the Minister of the applications, even though the taxpayer knew reassessments were likely, may have influenced the Court's decision not to countenance what appeared to be an attempt to avoid arguing the merits of a rectification application in Canada.

Although the Tax Court indicated that Quebec law concerning recognition and rectification was controlling, it seems unlikely that a different outcome would prevail in similar circumstances where there is a nexus to a common law province. The doctrine governing rectification differs at common law but the outcomes tend to be the same, and the Supreme Court's decision in *Pro Swing* governs recognition of non-monetary judgments across the country.

— *Paul Davis*

Bank's Realization on Cash Collateral Provided by Tax Debtor in Support of Guarantee Triggered Section 160 Liability

***M. Soutar Décor 2000 Ltd. v. The Queen*, 2016 DTC 1053 (Tax Court of Canada (Informal Procedure))**

In this case, the Tax Court held that a bank seizure of cash collateral provided by the tax debtor as security for a loan to a company owned and operated by the tax debtor's son was caught by section 160 of the *Income Tax Act* (the "Act"), and thus caused the company to become liable for the tax debts of the tax debtor.

The facts in the case were relatively straight-forward. In 2001, the tax debtor's son created a corporation to operate a paint and decorating business and was seeking debt financing for the corporation's operations. The bank was prepared to provide financing in the form of a capital loan and an operating line of credit, but required that the tax debtor provide a personal guarantee and other security for the debts of the corporation. Initially, the tax debtor provided a first charge over his house as additional security. However, as the tax debtor later sold the house and bought a replacement home of lesser value, the bank required the tax debtor to provide $120,000 of cash collateral in 2002 to cover the gap between the value of its security and the amount of the corporation's debt. After the corporation repaid its capital loan in 2004, the bank reduced its cash collateral requirement to $75,000.

In 2007, the tax debtor died and the bank subsequently demanded that the corporation repay its operating line of credit. When the corporation did not do so within the timeframe contemplated in the bank's demand, the bank realized on the cash collateral and applied the $75,000 amount towards the then outstanding balance of the line of credit. The corporation later repaid the excess. At the time of the tax debtor's death, he owed tax in respect of the 2002 and 2005 taxation years.

Section 160 of the Act is a provision that the Canada Revenue Agency can use to recover unpaid tax debts from a person that does not deal at arm's length with the tax debtor if the person (directly or indirectly) received property from the tax debtor. Where section 160 applies, the Minister is entitled to reassess the transferee for the amount of any unpaid tax debt that existed on the date of the transfer to the extent that the value of the transferred property exceeds the fair market value of any consideration the transferee paid for the transfer.

In this case, the Minister reassessed the corporation for the tax debtor's 2002 and 2005 tax liabilities that existed at the time of the tax debtor's death on the basis that the bank's seizure of the $75,000 cash collateral to repay a portion of the corporation's outstanding indebtedness under its line of credit was a transfer of property by the tax debtor to the corporation.

In the Tax Court, the corporation acknowledged that there was a transfer of property from the tax debtor to the corporation in the circumstances. However, the corporation's position was that the transfer took place when the tax debtor provided security to the bank for the corporation's debts in 2001, which is a time that predated the assessed tax debts. Had the corporation been able to persuade the Tax Court that the tax debtor's issuance of a guarantee in favour of the corporation was a transfer of property by the tax debtor to the corporation and that the other security granted by the tax debtor was, in fact, security for the tax debtor's performance under the guarantee (rather than the corporation's obligation to repay under the terms of the bank debt), the corporation would then have been able to argue that the bank's realization of the cash collateral was not an indirect transfer of property to the corporation, as the liability discharged by the payment was the tax debtor's own obligation under his guarantee rather than the corporation's obligation under the terms of the bank debt.

Unfortunately for the corporation, the Tax Court (*per* Bocock J.) rejected the corporation's argument that the granting of security by the tax debtor to the bank constituted a transfer of property by the tax debtor to the corporation. The legal basis for the Tax Court's conclusion in relation to the issuance of the guarantee was based solely on the reasoning that "[a] guarantee is a contingent obligation and remains so until demanded." With respect, it appears that in this instance the Tax Court failed to recognize the distinction between the guarantee, on one hand, and the debt created when the guaranteed obligation goes into default. Clearly, the latter is a contingent obligation and remains so until the

default. However, given that the expression "property" is defined in subsection 248(1) of the Act to include "a right of any kind whatever. . .or a chose in action", it is difficult to understand how the bundle of rights associated with a guarantee could avoid being characterized as property for purposes of the Act. Had the Tax Court accepted that the granting of the guarantee was a transfer of property, it should be noted that there would have still remained the question of whether the corporation could be considered to be the direct or indirect recipient of that property.

In the end, the Tax Court came to the conclusion that the bank's seizure of the collateral in 2007 and its application of the funds toward the corporation's bank debt was a transfer of property from the tax debtor to the corporation for the purposes of section 160 of the Act and, therefore, the corporation was liable for the 2002 and 2005 tax debts of the tax debtor. To reach this conclusion, the Tax Court seems to have characterized the events in 2007 as a circumstance in which the bank was acting on behalf of the tax debtor (through the rights granted under the guarantee) to deposit the cash collateral to the loan account in favour of the corporation. Although the Tax Court was troubled by the fact that this transfer from the tax debtor to the corporation took place in the absence of any act by the tax debtor or the corporation, or any intention by any parties to thwart the Minister's collection efforts, the Tax Court was satisfied with the outcome because the corporation clearly received the full economic benefit of the amount of the cash collateral seized by the bank.

— *John Yuan*

RECENT CASES

Taxpayer in substantial compliance with requirements entitled to claim public transit tax credit

The taxpayer claimed a public transit tax credit in his return for 2013. The claim was made for his expenditures on an electronic payment card used for his daily commute from home to work and back. The taxpayer provided the Canada Revenue Agency with copies of his credit card statements for all of 2013, as evidence that he was the person who acquired and paid for the transit services. In 2015 the taxpayer was asked to support his claim by providing records issued by the transit authority which had issued the cards. He was unable to do so, as the transit authority could not provide such records except on a go-forward basis. His claim for the credit was consequently denied, and he appealed from that decision.

The appeal was allowed. The Court accepted the taxpayer's uncontested and credible evidence that he had acquired the transit payment cards and that the cards acquired entitled him to go only between the two stations that were the start and end of his daily commute to and from work. His evidence that he had provided the CRA with credit card statements documenting such purchases was also accepted by the Court. The Court was satisfied that the card acquired and used by the taxpayer fit the statutory definition of an "eligible electronic payment card". Overall the Court was satisfied that the statutory requirements for the public transit tax credit had been met, but for the issuance of documentation by the transit authority. The taxpayer had attempted to obtain such documentation but it could not be issued unless it was requested in advance of the record date needed. The Court held that denial of the credit because of a systems issue within a qualifying transit organization was an unreasonable extension of the statutory requirements. In the Court's view, where such a requirement was to be imposed, it was incumbent upon the CRA to make its compliance requirements known to the public well in advance of a filing requirement, and it had not done so. The taxpayer's appeal was allowed.

Mendoza v. The Queen

2016 DTC 1089

Penalty for failure to file Form T1135 properly imposed where taxpayers not demonstrating due diligence

The taxpayers were a husband and wife who owned foreign property with a value in excess of $100,000 during the 2008 through 2011 taxation years. They did not file T1135 information returns for any of those years within the time required. The minister assessed a penalty under section 162(7) in respect of that failure. The taxpayers appealed from that penalty assessment and argued that they had believed that, since they were not required to file income tax returns for the years in question, they were also not required to file a T1135 return and were therefore entitled to a due diligence defence.

The appeal was dismissed. The Court held that the issue for determination was whether the taxpayers were diligent in their compliance efforts and acted reasonably. It reviewed the filing history of the appellants and the history of their dealings with the Canada Revenue Agency. It concluded that there were serious issues with respect to the husband's credibility. In the Court's view, he was evasive in giving testimony and he had included inaccurate information in a

previous voluntary disclosure to the CRA dealing with his non-compliance. The Court concluded that, on the facts, there was no reasonable basis to believe that the appellants were unaware of their obligation to file their T1135 forms. They had not, in the Court's view, demonstrated due diligence or made reasonable efforts to comply with their obligations, and a penalty for that failure was properly imposed.

Samson et al. v. The Queen

2016 DTC 1088

Minister's assessment on reasonableness of business expenses incurred referred back for reconsideration

In his return for the 2011 taxation year, the taxpayer reported business income, business expenses, and a resulting business loss. In his assessment of the taxpayer for that year, the minister denied the taxpayer's claim for a deduction of certain of those business expenses. The denial was based on the minister's assumptions that the expenses were not incurred for the purpose of earning income from a business, that they represented personal or living expenses of the taxpayer, and, especially, that the amount of the expenses claimed was not reasonable. The taxpayer had reported business income for the year of $12,146 and expenses of $74,917, resulting in a business loss of $62,771. On assessment, the minister reduced the amount of business expenses to $43,063, resulting in a business loss for the year of $30,917. The taxpayer appealed from that assessment.

The appeal was allowed. The Court held that, in determining the deductibility of a business expense claimed, a two-stage analysis was required. Assuming that a source of business income had been ascertained, an initial qualitative review was to be carried out to determine whether there was a reasonable connection between the expense claimed and the source of income. The main line of enquiry in doing so was whether the expense had been incurred for the purpose of gaining or producing income from the business. The second stage of the analysis looks at the size or amount of the expense claimed and whether it is excessive. While it is not the role of the minister to second-guess the business acumen of the business owner, where the minister concludes that the impugned expense is unreasonable in the sense that "no reasonable businessman would have contracted to pay that amount" then the expenditure may be denied, in whole or in part, as unreasonable. The taxpayer had claimed a deduction for meal and entertainment expenses, for travel expenses, for motor vehicle expenses, and for consulting costs. The Court reviewed each category of expenses using the two-stage analysis. It concluded that a reduction in the amount claimed for meals and entertainment expenses was justified, but that the taxpayer was entitled to claim more than the amount allowed by the Minister. Travel expenses claimed by the taxpayer were allowed in their entirety. The Court concluded that the taxpayer had failed to demolish the assumptions made by the minister with respect to motor vehicle costs claimed and it agreed with the minister's denial of a deduction for consulting costs claimed, on the basis that the amount claimed was unreasonable. The taxpayer's appeal was allowed and the assessment referred back to the minister for reassessment and reconsideration in accordance with the Court's findings.

Anderson v. The Queen

2016 DTC 1082

Taxpayer not entitled to refund interest on amount arising from remission order

The appellant was a company engaged in oil sands development. In 1976, the federal government issued a remission order providing relief from the application of certain provisions of the *Income Tax Act* to companies engaged in a particular oil sands development project, and such change reduced the tax payable by the appellant company. The amount of the remission as assessed was credited by the minister as of the balance due date for the purpose of calculating the company's instalment obligations, thereby relieving it of the liability to pay interest which would otherwise have accrued on such instalment obligations. The minister refused, however, to provide the same treatment for the purposes of determining whether the company was entitled to refund interest under section 164. The company sought judicial review of the minister's refusal to credit the remission, acknowledge the overpayment and pay refund interest under section 164, and its applications for judicial review were dismissed by the Federal Court. The appellant appealed from that dismissal to the Federal Court of Appeal.

The appeal was dismissed. The Federal Court judge had held that there was no statute or contract entitling the appellant to refund interest as a result of a remission order, even where it gave rise to the refund of a tax debt which had been paid. The appellate Court found that the issue for determination on appeal was whether the remission of a tax debt pursuant to the *Financial Administration Act* can give rise to an "overpayment" as defined in the *Income Tax Act*. It held that the correctness or validity of an assessed tax liability is not affected by a remission and must be determined on the basis of the relevant provisions of the *Income Tax Act*. The effect of a remission order is limited to

forgiving a debt once it has arisen pursuant to relevant provisions of the Act. It was clear, in the Court's view, that an overpayment of taxes payable could not result without some form of payment being made beforehand, and no such payment can result from a remission order whose sole effect is to prevent the collection of what is, and remains, a validly assessed tax debt. Given that a remission order can do no more than that, no amount could be said to have been paid on account of the appellant's tax liability. The Federal Court judge did not err in holding that the appellant had no entitlement to the payment of refund interest.

Imperial Oil v. Canada (AG)

2016 DTC 5057

Assessment referred back to minister for recalculation of foreign exchange gain on debenture conversion

The taxpayer, a public corporation, issued convertible debentures in 2002. The terms of those debentures provided for their conversion into common shares of the taxpayer, together with a cash payment for any fractional share. Such conversions did take place and the minister assessed the taxpayer as having received foreign exchange capital gains in respect of those conversions during the 2005 and 2006 taxation years. The taxpayer appealed from those assessments and the Tax Court allowed the appeal holding that, based on the terms of the indenture, no foreign exchange gains were realized. The minister appealed to the Federal Court of Appeal.

The appeal was allowed. The Court held that the conclusions reached by the Tax Court judge were premised on her interpretation of the terms and conditions stipulated in the indenture which applied to the convertible debentures, and that such interpretation contained a reviewable error that warranted appellate intervention. The appellate Court concluded that the correct interpretation of those terms and conditions led to the conclusion that the indebtedness of the taxpayer that was evidenced by the convertible debentures that were converted was repaid by the issuance of the stipulated number of common shares. The results for the taxpayer of such conversion and issuance was, following paragraph 261(2)(*a*) of the *Income Tax Act*, to be determined using Canadian dollars and further, any foreign currency amount was required to be converted to Canadian dollars using a stipulated rate of exchange on the date the foreign currency amount first "arose". The issue therefore was whether, in Canadian dollars, the taxpayer paid less on the repayment of its indebtedness than it received on the issuance of the convertible debentures in 2002. The Court held that the foreign currency amount that related to each repayment by the taxpayer arose on the date of that repayment. The Court then reviewed the terms of the convertible debenture to ascertain how such repayment amount was to be determined, and concluded that the sale price of the common shares was to be determined by reference to their trading price on the conversion date. It followed that the repayment amount in respect of each convertible debenture was effectively the amount determined when the sale price of a common share on each conversion date was multiplied by the number of shares issued. A separate calculation would therefore be required with respect to each conversion. The assessment was referred back to the minister for recalculation in accordance with the reasons outlined by the Court.

The Queen v. Agnico-Eagle

2016 DTC 5056

Rule 152 order issued ordering counsel to reimburse taxpayer for half of costs award

The pre-trial judge responsible for case-management had requested submissions regarding costs to be awarded for some pre-trial proceedings and whether a Rule 152 order should be made. A Rule 152 order imposes costs against a taxpayer's counsel where counsel has caused costs to be incurred improperly or without reasonable cause or to be wasted by undue delay or misconduct. The respondent was seeking costs under the tariff . There were no submissions made by the taxpayer's counsel regarding a Rule 152 order and the taxpayer was asking either that the trial judge deal with the costs or that minimal costs be awarded.

The taxpayer was ordered to pay costs of $5,052 to the respondent and under a Rule 152 order the taxpayer's counsel was ordered to reimburse the taxpayer fifty per cent of the costs award. Costs with respect to the various pre-trial proceedings (the case-management conference, two hearings, and the two scheduled examinations for discovery) were to be awarded according to the tariff with other pre-trial costs incurred to be dealt with by the trial judge. The Court has inherent jurisdiction to award costs against counsel to control abuse of process and contempt of court issues and has statutory jurisdiction via a Rule 152 order. Both such awards are made only under extraordinary circumstances. For a Rule 152 order to be made there need not be a finding of bad faith but the Rule refers to misconduct and behaviour causing undue delay. From the facts of the case, it was reasonable to infer that the taxpayer's decision not to attend an initial examination for discovery and to refuse to answer questions at a second examination were done at the

behest of his counsel. Counsel advised the taxpayer not to answer questions on the grounds of claims of torture and unlawful coercion. Counsel was directly implicated in the taxpayer's breaches of court orders to complete discoveries. No arguable case was made to support the allegations of torture and coercion. Many cases dealing with awarding costs personally against counsel are concerned that lawyers may be deterred from handling unpopular causes or taking novel and untested positions. Such concerns are not relevant here where taxpayer's counsel's behaviour wasted the time and resources of the Court and was inexcusable. The exceptional conditions for a Rule 152 order were met and it is appropriate to award costs personally against the taxpayer's counsel.

McCarthy v. The Queen

2016 DTC 1066

TAX NOTES

Published monthly by Wolters Kluwer Limited. For subscription information, contact your Wolters Kluwer Account Manager or call 1-800-268-4522 or (416) 224-2248 (Toronto).

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

Notice: *Readers are urged to consult their professional advisers prior to acting on the basis of material in this newsletter.*

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

PUBLICATIONS MAIL AGREEMENT NO. 40064546
RETURN UNDELIVERABLE CANADIAN ADDRESSES TO CIRCULATION DEPT.
330–123 MAIN ST
TORONTO ON M5W 1A1
email: circdept@publisher.com

© 2016, Wolters Kluwer Limited

Wolters Kluwer