Tax Notes

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

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Part I of this series of articles reviewed some of the basic tax requirements for using trusts to split income. In the second instalment of the series we will review some common income splitting opportunities that are accessible through the use of trusts. In particular, capital gains exemption ("CGE") multiplication planning, preferred beneficiary and age 40 trust planning, prescribed rate loan planning, and Ontario surtax planning will each be reviewed in turn.

CGE Multiplication Using Trusts

Although it is possible to multiply the CGE among family members by issuing shares directly to the family members, doing so can result in the current shareholder suffering a loss of both control over the shares and flexibility in arranging his or her future planning. For example, unborn persons at the time the planning is put in place would not be eligible to share in the CGE multiplication. Also, for various personal, creditor or other reasons, the benefit of hindsight might have lead the current shareholder to determine that it would have been better not to give shares to a particular person. Unfortunately, once property, such as shares, has been given away it is often very difficult to get it back.

Provided that one is dealing with a typical discretionary family trust deed, multiplication of the exemption should be possible by relying on the rules in subsections 104(21) and (21.2) of the *Income Tax Act* (the "Act").[1] In addition, it should generally be possible to avoid many of the drawbacks associated with direct share ownership since, subject to the trustees complying with their fiduciary duties, they will generally be free to choose to allocate the exempt capital gains (i.e., CGEs) among some or all of the trust beneficiaries, including beneficiaries who were born following the creation of the trust.

Preferred Beneficiary Election and Age 40 Trusts

In addition to the general rules that permit income splitting, there are some special rules that permit income splitting and CGE multiplication without making amounts payable to beneficiaries.

[1] Unless otherwise noted all statutory references are to the Act. These rules were discussed in Part I of this series of articles under the heading "Character of Income".

For example, when a "preferred beneficiary election" can be in compliance with the tests set out in subsection 104(14) it will be possible to cause income of a trust to be taxable in a qualifying beneficiary's hands even though no amount is made payable to the beneficiary. However, since 1995 the ability to use the preferred beneficiary election has generally been limited to situations involving disabled beneficiaries. Prior to that time, the preferred beneficiary election was much more widely used.

Another special situation that can enable income splitting without making amounts payable is where the so-called "age 40 trust" rules in subsection 104(18) are complied with.[2]

In order to qualify as an age 40 trust, amounts that would have otherwise been income of a trust in a particular taxation year must meet a number of conditions. In particular, the amounts cannot have become payable in the year and they must be held in trust for an individual who has not turned 21 in the year. In addition, the individual beneficiary's rights must have vested and they must not be subject to the exercise or failure to exercise any discretionary power. Finally, the individual beneficiary's rights must not be subject to any condition to receive the income other than that the individual survive to an age not exceeding 40 years. It is for this reason that these trusts are often referred to as age 40 trusts.

Prescribed Rate Loan Planning

The Loan for Value Exception

In general, low interest rate loans that are made directly or indirectly through a trust to spouses (including common-law partners), non-arm's length minors, and other non-arm's length persons that allow such persons to earn income from property will be caught by the personal attribution rules in the Act,[3] which will result in all of the income and losses (and for spouses all of the capital gains and capital losses) being attributable back to the lender. Fortunately these rules will not apply in any situation involving "loans for value".[4]

Planning that uses the loans for value exemption to the attribution rules is commonly referred to as prescribed rate loan planning. In order to qualify for the loan for value exception to the personal attribution rules, a loan will need to meet a number of conditions.[5]

First, the loan must bear interest at the lesser of the prescribed rate of interest in place at the time the loan is made and an arm's length interest rate at that time. In general, the prescribed rate will be the lower of these rates, and currently that rate is 1%. In addition to bearing interest at the appropriate rate, interest on the loan must actually be paid to the lender no later than 30 days after the end of the particular year. This latter condition is extremely important since a failure to pay interest by the time limit in any particular year will cause the prescribed rate exception to cease to apply to that loan forever.

Benefits of Prescribed Rate Loan Planning

Although loans for value could be and often are directly made to individuals, the flexibility and control provided by making these loans to trusts often makes trusts the ideal vehicle of choice for making such loans.

Almost continuously since the middle of 2009, it has been possible to lock in a prescribed rate loan at a 1% interest rate. The result of the rate being so low is that a borrower who has received such a loan does not need to generate very much net income from the loan in order to cover the debt payments and, assuming that the borrower is taxed at a lower rate than the lender, income splitting will have been achieved. Of course, if actual returns earned by the borrower are also low, the benefits of the income splitting may be quite limited, especially when costs and aggravation

[2] Rules in subsections 104(13.1) and (13.2) might also be used to designate amounts paid by a trust to a beneficiary as being taxable only in the trust, which can give rise to a number of income splitting benefits. For example, for testamentary trusts these rules would allow designated amounts paid out to beneficiaries to still enjoy the testamentary trust's graduated tax rates. Even where non-testamentary trusts are used, these rules may provide certain inter-provincial tax planning benefits. However, due to the December 16, 2014, enactment of Bill C-43, *Economic Action Plan 2014 Act, No. 2* (discussed further in Part III of this series of articles), effective for the 2016 and subsequent taxation years, the ability to utilize the designations provided under these provisions will be significantly restricted.

[3] See, in particular, subsection 56(4.1) (low interest loans made for the benefit of non-arm's length persons where certain reasonability tests are met), sections 74.1 (income or losses from the transfer or loan of property made for the benefit of spouses or minors), section 74.2 (capital gains or capital losses from the transfer or loan of property made for the benefit of spouses), and section 74.3 (extends the rules in sections 74.1 and 74.2 to loans made to certain trusts).

[4] The rules in section 120.4 (Kiddie Tax rules), while not attribution rules, must also be kept in mind when prescribed rate planning involves minors.

[5] The loan for values in respect of subsection 56(4.1) are found in subsection 56(4.2) and nearly identical rules in respect of sections 74.1, 74.2, and 74.3 are found in subsection 74.5(2) (there are also exclusions for transfers made for fair market value consideration in subsection 74.5(1) but these are not relevant to this discussion).

of the planning are factored in.[6] Also, since interest must actually be paid each year it will be desirable that the investments generate annual cash returns to facilitate payment.

Although equity markets have been generally performing extremely well as of late, interest sensitive markets have continued to lag, which might make prescribed rate loan planning less beneficial for some fixed income investors. However, over time it is anticipated that even the returns in these markets will return to historical norms and since, subject to future legislative changes, the current 1% prescribed rate can be locked in forever, putting this planning in place while rates are low may yield long-term family benefits.

Modifications to Higher Rate Pre-Existing Prescribed Rate Loans

Because prescribed rate loans are forever, some clients may still have older prescribed rate loans in place at rates in excess of the current 1% prescribed rate. If you run into one of these older loans and want to impress your client by helping them to refinance the loan to take advantage of the current 1% prescribed rate, you will want to make sure you do it correctly.

Simply amending the rate on the loan does not work. Neither does refinancing the loan with proceeds of a new loan.

In fact, it appears that the only way to refinance an existing prescribed rate loan with a lower prescribed rate loan is for the borrower to actually dispose of its income earning properties and to use the proceeds to repay the original loan.[7] In some cases this may result in the realization of taxable income on the disposition and, as a result, it may turn out that leaving the high rate loan in place will continue to be preferable to refinancing the loan.

Ontario Provincial Surtax Planning

In general, if the Kiddie Tax rules in section 120.4 are applicable to income earned by a child, the child will pay tax on that income at the child's top marginal tax rate. While this is generally true, in Ontario there may still be some advantage to income splitting with minor children provided that the child has little, if any, other income.

The reason for this benefit is that Ontario provincial surtaxes will not become payable until the child's income exceeds the Ontario provincial surtax thresholds. Savings from this type of planning are generally quite modest. For example, for each minor receiving $42,000 of ordinary investment income, split income savings in 2014 will be a bit less than $2,900. Actual savings will differ depending on the type of income earned and may be more or less than this amount. There will also be some additional compliance costs to this planning so actual savings will be somewhat lower than this amount, but for some, even with these costs and depending on the number of minor children a person has, this planning will still be worth pursuing.

[Please note: At the time this article was written, the 2015 Ontario Budget had not been presented.]

This article first appeared in the Wolters Kluwer newsletter The Estate Planner No. 243, dated April 2015.

2015 FEDERAL BUDGET

The 2015 federal Budget was tabled on April 21, 2015. Subscribers to the *Canada Income Tax Guide* (print, DVD, and online) will have received Wolters Kluwer's *Budget Special Report* No. 084H containing the Budget Plan, the Notice of Ways and Means Motion, and commentary by Dentons Canada LLP, Joe Frankovic, and Wolters Kluwer on the proposals. Additional copies of the *Special Report* may be ordered by calling (416) 224-2248 (toll-free 1-800-268-4522), by faxing (416) 224-2243 (toll-free 1-800-461-4131), or by emailing cservice@wolterskluwer.com. The commentary, table of effective dates, and tax-related portions of the government's Budget Plan (e.g., Annex 2) are available in the *Canada Income Tax Guide* online and on DVD under the heading Federal Budget. The Budget documents are also posted on the Wolters Kluwer federal income tax News Tracker.

The 2015 Budget contained an Income Tax Notice of Ways and Means Motion with 41 resolutions as well as some revisions that were not part of the Notice of Ways and Means Motion. Of interest is the intent to introduce a simpler version of Form T1135, Foreign Income Verification Statement, for individuals holding less than $250,000 in foreign assets in a year.

Some of the key tax measures in the Notice of Ways and Means Motion included the following:

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[6] Consequently, unless the amount of a prescribed rate loan is substantial, it will generally not be worth implementing this strategy.

[7] See CRA Document No. 2002-0143985, dated October 18, 2002 and CRA Document No. 9336625, dated April 29, 1994.

Personal Tax Measures

- an increase to the lifetime capital gains exemption for the transfer of farming and fishing properties from the current $813,600 to $1 million, effective for transfers after April 20, 2015;
- an increase of $4,500 in the amount that can be contributed annually to a tax-free savings account, effective for the 2015 tax year and beyond;
- a reduction of the minimum annual withdrawal amount from registered retirement income funds, effective for the 2015 tax year and beyond;
- a new home accessibility tax credit for certain seniors and other eligible individuals, effective for the 2016 taxation year; and
- a reduction of the dividend tax credit rate for non-eligible dividends, effective for the 2016 tax year and beyond.

Corporate Tax Measures

- a reduction of the small business tax rate from the current 11% to 9%, over four years commencing in 2016;
- an increase in the capital cost allowance rates for manufacturing and processing machinery and equipment to 50% on a declining balance basis, commencing in 2016 and running until the end of 2025;
- changes relating to the taxation of synthetic equity arrangements;
- the tightening of complex and detailed anti-avoidance provisions relating to certain butterfly transactions;
- changes to the withholding provisions for certain non-resident employers; and
- the introduction of new anti-avoidance rules regarding captive insurance.

Charities

- the allowance of donations of certain private corporation shares and real estate, effective for such donations made after 2016;
- the investment by charities in certain limited partnerships, effective April 21, 2015; and
- the allowance of certain gifts to foreign charitable foundations, effective on the passing of the legislation.

Other

The Budget also announced that commencing in 2018, financial institutions will be required to exchange information with other G20 countries respecting reportable accounts of Canadian residents who are citizens of the other country, as they do now for citizens of the United States.

2015 ONTARIO BUDGET

The Ontario government's 2015 Budget, which was tabled on April 23, 2015, focuses on the government's long-term plans for managing the economy, balancing the goal of eliminating the annual deficit within two years against the well-identified need for additional investment, particularly in infrastructure. Budget documents, along with Wolters Kluwer commentary, are posted on the provincial tax News Tracker on CCH Online and IntelliConnect, and are also available in the *Ontario Tax Reporter* online and on DVD.

There are very few changes to the income tax system. Most are aimed at reducing the province's tax-delivered support to media production enterprises and to apprenticeship programs. There are no changes in income tax rates.

Ontario will parallel the federal changes to the taxation of trusts; these changes take effect after 2015, and will harmonize Ontario's treatment of resource royalties with that of the federal system.

Business Tax Credits and Support Programs

Certain corporate tax credits are being reduced, namely:

- Apprenticeship Training Tax Credit;
- Ontario Interactive Digital Media Tax Credit;
- Ontario Production Services Tax Credit;
- Ontario Film and Television Tax Credit;
- Ontario Computer Animation and Special Effects Tax Credit; and
- Ontario Sound Recording Tax Credit.

Other Tax Measures

- Ontario's resource taxation system will be harmonized with those of the other Canadian jurisdictions.
- A new levy of 3 cents per litre will be imposed on beer sales starting in November 2015.
- Northern Ontario Provincial Land Tax will be gradually increased.
- The hydro debt retirement charge will be eliminated for residential users after 2015.

FINANCE CANADA RELEASES NEW COMFORT LETTER

Finance Canada released a new Comfort Letter, Re: Siemens AG — Spin-off of Common Shares of OSRAM Licht AG, dated February 26, 2015. In short, the Comfort Letter confirms that Siemens' distribution of Osram shares to shareholders satisfied the technical requirements of the Canadian spin-off rules in section 86.1 of the *Income Tax Act*.

MINISTER OF NATIONAL REVENUE ANNOUNCES APPOINTMENT OF NEW TAXPAYERS' OMBUDSMAN

On April 10, 2015, The Minister of National Revenue, Kerry-Lynne D. Findlay, announced that Ms. Sherra Profit has become the new Taxpayers' Ombudsman. The Ombudsman's role is to uphold the *Taxpayer Bill of Rights* and to provide an impartial review of taxpayers' service complaints. She becomes the second such Ombudsman since the position was created in 2008, replacing Mr. Paul Dubé, who resigned last year.

NEW INCOME TAX FOLIO S2-F3-C1: PAYMENTS FROM EMPLOYER TO EMPLOYEE

New Income Tax Folio S2-F3-C1: Payments from Employer to Employee, effective April 14, 2015, replaces and cancels Interpretation Bulletins IT-196R2, Payments by Employer to Employee, dated November 23, 1981, and IT-196R2SR, Payments by Employer to Employee, dated May 25, 1984. This Folio discusses and provides useful examples regarding the tax treatment of amounts received by employees:

- as inducement payments;
- as non-competition payments; and
- with respect to a covenant.

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.

Employee Stock Option Surrender Payment

***Rogers Estate v. The Queen*, 2015 DTC 1029 (Tax Court of Canada)**

The *Rogers Estate* case deals with the characterization of an amount (referred to in the judgment as the "Surrender Payment") received in 2007 by Ted Rogers from Rogers Communications Inc. ("RCI") in exchange for the surrender of stock options held by him. Following the grant of the stock options in question, the RCI stock option plan had been amended to add a stock appreciation cash-out feature, which permitted option holders, in lieu of exercising their options in the normal course, to dispose of their options to the company in exchange for cash payments equal to the in-the-money amounts (i.e., the Surrender Payments). Mr. Rogers did just that, and reported the Surrender Payment received for his options as a capital gain.

The Minister reassessed, including the full amount of the Surrender Payment in income and, as part of the appeal to the Court, made three alternative arguments in support of the reassessment:

(1) the amount was income from employment or an employment benefit under either section 5 or paragraph 6(1)(*a*) of the *Income Tax Act* (the "Act");

(2) the amount was a shareholder benefit under subsection 15(1) of the Act; or

(3) the amount was a profit from an adventure in the nature of trade and taxable under subsection 9(1) of the Act.

The decision of Hogan J begins with a discussion of a rather interesting procedural issue that had arisen subsequent to the hearing of the case. Namely, the last of the three arguments — the "Section 9 Argument"— had been abandoned by the Crown at trial when the Crown concluded that there was insufficient evidence to support the argument. However, notwithstanding this (and arguments from the Appellant to the contrary), the Court requested written submissions on the matter following the hearing and elected to analyze the issue in its judgment. The reason for this, according to Hogan J, was that the Crown's decision to abandon the Section 9 Argument amounted to a conclusion by counsel for the Crown of mixed fact and law, and that a court is not bound by the parties' interpretation of a point of law. Accordingly, the Court was not bound by the Crown's concession.

On the substance of the case, the issues to be decided were framed by the Court as follows:

(1) Does the carve-out in paragraph 7(3)(*a*) of the Act apply to preclude the Surrender Payment from being a benefit taxable under section 6, notwithstanding the fact that the Surrender Payment is not taxable under section 7 because of Mr. Rogers's non-arm's length relationship with RCI?[1]

(2) Alternatively, can the Surrender Payment be characterized as "salary, wages and other remuneration" under section 5 of the Act, as a shareholder benefit under subsection 15(1) of the Act, or as profit under subsection 9(1) of the Act?

On the first issue, the Court considered the effect of paragraph 7(3)(*a*), which essentially provides that, except as provided by section 7, an employee is deemed to have neither received nor enjoyed any benefit under or because of an agreement to issue securities covered by subsection 7(1). Notwithstanding the fairly clear wording of paragraph 7(3)(*a*), the Crown urged the Court to adopt a reading of the provision such that it would apply only if one of the enumerated circumstances in subsection 7(1) exists. In other words, the Crown maintained that any portion of an employment benefit relating to a section 7 agreement that is not included in income pursuant to section 7 should be included in income under section 6 of the Act.

[1] The reason the question is framed this way is that the payment was received prior to the addition of paragraph 7(1)(*b*.1) to the Act, which essentially closed the "loophole" that gave rise to the issues in this case. At the time, paragraph 7(1)(*b*) was the only provision that dealt with the treatment of proceeds of disposition of rights under a section 7 agreement, which provided that such proceeds were taxable only "if the employee has transferred or otherwise disposed of rights under the agreement [. . .] to a person with whom the employee was dealing at arm's length". This wording did not capture situations in which an employee disposes of rights to an employer with whom he or she *does not* deal at arm's length, and in the case at hand, the taxpayer owned approximately 91% of the voting shares of the employer corporation at the relevant time and, thus, was deemed to be non-arm's length.

The Appellant, on the other hand, pointed to the rule of statutory interpretation providing that specific provisions take priority over general ones (*generalia specialibus non derogant*) in support of the proposition that section 7 (a specific provision) trumps sections 5 and 6 (general provisions), relying on *Chrysler Canada Ltd.* (92 DTC 6346 (FCTD)) and *Bowens* (94 DTC 1853 (TCC)). The Court agreed, holding as follows:

> A textual, contextual and purposive reading of section 7 of the Act leads me to conclude that this provision is meant to provide a complete code for the taxing of benefits arising under or because of a stock option agreement. The text of paragraph 7(3)(*a*) is clear and unambiguous: it deems an employee to have neither received nor enjoyed any benefit under or because of a stock option agreement, except as provided by that section.

On the foregoing basis, the Court found that section 6 of the Act did not apply to the Surrender Payment, but it did not conclude, by the same reasoning, that section 5 would not apply, presumably on the basis that even though there was no benefit, as per paragraph 7(3)(*a*), it still needed to be considered whether there was "salary, wages and other remuneration", as contemplated by section 5. The Court concluded that the Surrender Payment was not salary, wages, or other remuneration, however, such that section 5 did not apply.

The Court went on to consider whether the Surrender Payment was a shareholder benefit pursuant to subsection 15(1) or profit pursuant to subsection 9(1), apparently given: (i) its suggestion that an employee could receive stock options "in his capacity as an employee [. . . but] it does not logically follow from this that the Surrender Payment was likewise received by him qua employee"; and (ii) that paragraph 7(3)(*a*) applies only for the purposes of section 6.

In respect of the Court's reading of paragraph 7(3)(*a*) as applicable only for the purposes of section 6, it appears that this narrow reading is without precedent and, arguably, runs counter to what many practitioners consider to be the policy underlying subsection 7(3): that inclusions in income in respect of a section 7 agreement are determined exclusively under section 7. This reading also ignores the fact that prior to 1998, paragraph 7(3)(*a*) specifically referred to an employee being deemed not to have received any benefit "for the purpose of this Part", meaning Part I. In 1998, Parliament deleted the reference to Part I, presumably to make the provision *broader*. However, the Court implies in this case that the deletion significantly narrowed the effect of paragraph 7(3)(*a*).

On the question of whether the Surrender Payment was a subsection 15(1) shareholder benefit, the Court held that Mr. Rogers had given up "something of equal value" to receive the payment because it reflected the "in-the-money value" of the options disposed of. In other words, the payment was "consideration for the cancellation of the unexercised Options" and, viewed in this light, "can hardly be described as a 'benefit' taxable under subsection 15(1) of the Act".

On the question of whether the Surrender Payment was received as part of an adventure or concern in the nature of trade and, thus, taxable under subsection 9(1), the Court applied the test set out in *Friesen* (95 DTC 5551 (SCC)), asking: (i) whether the taxpayer dealt with the property in the same manner as a trader in such property ordinarily would deal with it; (ii) whether the nature of the property was such that the taxpayer could only have disposed of it in a transaction of a trading nature; and (iii) whether the taxpayer intended at the time of the acquisition of the property to resell it at a profit.

Each of the above questions was answered in the Appellant's favour (i.e., the Surrender Payment *was not* received as part of an adventure or concern in the nature of trade). Of note in this regard was the Court's response to a novel argument from the Crown that the stock appreciation cash-out feature (referred to by the Court as the "SAR") added to the RCI stock option plan should be viewed as "a right that is distinct from the Options" such that the disposition of the SAR was on income account. The Court disagreed with this proposition, stating as follows:

> With respect, I disagree with this proposition. As noted earlier, the granting of the SAR did not negate RCI's promise to issue shares under the terms of the Plan. The SAR had no function or force independent of the Options. It was an added feature that allowed Mr. Rogers to elect to surrender the Options for a consideration that was the Surrender Payment.
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> Its sole purpose was to allow for the disposition of the Options instead of their simply being exercised, which latter would have resulted in greater share dilution. For these reasons, the SAR cannot be considered separate property.

Having found in favour of the Appellant on each of the main issues, the Court then addressed whether the Surrender Payment gave rise to a capital gain, which had been the filing position of Mr. Rogers. This became relevant as the Appellant brought a motion before the Court three and a half months after the initial hearing of the appeal to argue that the Surrender Payment should not be taxable at all on the basis of the Tax Court's decision in *Mathieu* (2014 DTC 1165 (TCC)), which was released subsequent to the hearing. The Appellant's motion had previously been dismissed by Hogan J for the reasons set out in *Rogers Estate* (2015 DTC 1084 (TCC)). The Court also noted that, in any event, *Mathieu* did not address the question of whether the surrender of the options by the appellant therein gave rise to a capital gain.

Rather tersely, the Court in *Rogers Estate* found that the Surrender Payment was indeed taxable as a capital gain under subsection 39(1) of the Act, finding that the subsection is drafted such that it applies to a "gain [. . .] from the disposition of *any* property" [emphasis added] (other than excluded property) unless the gain is otherwise included in income under section 3. As discussed above, the Surrender Payment was not included in income under section 3 by virtue of paragraph 7(3)(*a*) and, therefore, in the Court's view, was free to be taxed as a capital gain under subsection 39(1). The Court did not expressly consider the additional language in the subsection requiring the gain to be computed "under this subdivision" (i.e., Subdivision c, Taxable Capital Gains and Allowable Capital Losses), which would seem to suggest that it applies only to dispositions of *capital* property, not *any* property (although the Court did note that options could be capital property depending upon the circumstances surrounding their acquisition and disposition).

The case has been appealed to the Federal Court of Appeal, so this likely will not be the last word on at least some of these issues.

— *Brian O'Neill*

Taxpayer Not Liable As a Director — Taxpayer Neither a *De Jure* Director nor a *De Facto* Director

***MacDonald v. The Queen*, 2014 DTC 1212 (Tax Court of Canada)**

In the *MacDonald* case, the taxpayer was assessed pursuant to the directors' liability provisions in subsection 227.1(1) of the *Income Tax Act* and subsection 228(2) of the *Excise Tax Act* in connection with payroll deductions and GST payable by the Great Canadian Pub Inc. ("GCPI"). The GCPI operated a bar in Moncton, New Brunswick, from October 2007 until December 2009, when it ceased to operate due to financial difficulties.

The taxpayer had become involved with the GCPI on November 7, 2007, when he had invested $10,000, becoming a minority shareholder of the company. He made this investment after having attended a presentation by the company's incorporator, notwithstanding that he had not known any of the GCPI's management personnel. The taxpayer was never employed by the company nor was he involved at the outset in any of GCPI's business operations (although, as a matter of convenience for the company, the taxpayer became an authorized signatory at the company's bank and signed blank cheques for the company about once a week).

However, shortly after making his investment, the taxpayer guaranteed a loan to help keep the company afloat, notably because he was told that he would lose his investment if he did not do so. The taxpayer also applied for and co-signed a small business loan to the company from the Bank of Nova Scotia. Unbeknownst to him, the taxpayer was described in the banking documents as a director of the company.

The taxpayer never attended any directors' meetings, nor were there any shareholders' meetings held for the appointment of directors or for any other purpose. Notwithstanding this, over an extended period of time, the taxpayer was identified as a director of the company on various company-related documents, some of which the taxpayer had signed. The taxpayer was adamant, however, that he never intended to be a director but had simply made, and was seeking to protect, a $10,000 investment. The taxpayer maintained that he did not understand the difference between directors, officers, and shareholders.

In September 2009, about two years after the taxpayer made his investment, the taxpayer was informed that one of the company's key shareholders and managers was about to declare personal bankruptcy, which subsequently led the taxpayer to buy her shares for $1.

After the departure of that shareholder and the other manager of the business, the taxpayer tried to find someone else to operate the business, since the taxpayer did not have the necessary time or know-how to do so himself. He did find two individuals interested in running the company, but — demonstrating how uninvolved he had been — was not even able to show them how to turn off the lights, locate the alarm, or find the relevant paperwork.

In December 2009, the business was forced to close. Following this, in January 2010, the taxpayer learned that someone was holding him out as a director of the company and that corporate records had been provided to the Canada Revenue Agency which described the taxpayer as a director.

On May 23, 2012, the Minister assessed the taxpayer for director's liability with respect to the failure by the company to remit payroll deductions and GST. The taxpayer filed notices of objection to the assessments, but the objections were dismissed by the Minister, leading the taxpayer to appeal to the Tax Court.

The issues before the Tax Court were whether the taxpayer had been a *de jure* or *de facto* director of the company and, if so, whether he had exercised due diligence to prevent the failures to remit the payroll deductions and GST, and whether the applicable limitation periods caused the assessments to be statute-barred.

Mr. Justice Rossiter began his analysis by referring to *Mosier* (2002 GTC 28) for the proposition that, for the purposes of director's liability under the *Income Tax Act* and the *Excise Tax Act*, a director could be either a *de jure* or *de facto* director. Rossiter AJC noted that:

> A *de jure* director is an individual who has been appointed as such pursuant to the corporate law of the jurisdiction in which the body corporate was created or continued, as the case may be. But a *de facto* director [. . .] can exist in two forms: (i) one who is ostensibly duly elected but who may lack some qualification under the relevant corporate law, or (ii) one who simply assumes the role of director without any pretence of legal qualification.

In determining that the taxpayer had not been a *de jure* director, the Court noted that there had been no meetings or documentation appointing the taxpayer as a director, the taxpayer had not consented to being a director, and, notwithstanding that he had signed some documents describing him as a director, he had not even known until 2010 that he had been held out as a director.

As for *de facto* directorship, Rossiter AJC referred to *Scavuzzo* (2006 DTC 2136 (TCC)) for the proposition that the concept of *de facto* director can apply only to those who hold themselves out as directors. On the facts in issue in this case, Rossiter AJC found that the taxpayer was only a shareholder. Even though he signed numerous documents as an officer or director, it was clear from the evidence that he did so only at the request of others (lawyers, bankers, accountants). Also, although he was listed as a director of GCPI with the Corporations Division of the Province of New Brunswick, he was not aware of that fact until 2010. Describing the taxpayer as "somewhat naive", the Court stated that the taxpayer's conduct demonstrated that he was only trying to protect his investment (i.e., he was not seeking to hold himself out as a director).

Accordingly, the Tax Court found that the taxpayer was not a *de facto* director and, therefore, that the taxpayer was not liable under the directors' liability provisions. In light of this determination, the Tax Court did not find it necessary to address the other issues.

The *MacDonald* decision is of interest as it shows that, in a director's liability matter, even a taxpayer who has signed documents as a director may in some cases be able to persuade a court that he or she is neither a *de jure* director nor a *de facto* director.

— *David Roulx*

RECENT CASES

Swaps to hedge against currency fluctuations protected a capital asset, so proceeds were on capital account

The taxpayer was appealing a reassessment that treated proceeds from the termination of cross-currency basis swap contracts ("swaps") as income. The taxpayer was a large publicly traded Canadian holding company that held direct and indirect subsidiaries in the food processing or food distribution businesses in Canada and the United States. In

2001, it acquired a mainly US-based bakery business, Bestfoods, which increased its net investments in US dollar operations by over 200%. This acquisition was financed completely by debt, causing the taxpayer's debt-to-equity ratio to rise beyond its recommended levels. The acquisition of Bestfoods exposed the taxpayer to an increased US dollar currency risk. To circumvent that risk, the taxpayer entered into a number of swaps in 2001 which were terminated in 2003. The taxpayer reported the proceeds as taxable capital gains but was reassessed on the basis that the gains were on account of income.

The appeal was allowed. In determining whether the proceeds of the termination of the swaps were income or capital, the Court needed to identify whether the risk associated with the derivative transaction was on income or capital account. If the derivative was used to hedge a capital investment, the gain associated with it would be on account of capital. The respondent argued that if the hedge could not be linked to an underlying transaction that was on capital account, the foreign exchange gain was business income. There was no need for the derivative to be linked to a separate transaction as contended by the respondent. There was no intent on the part of the taxpayer to make a profit from the swaps, and there was no speculation involved. The sole purpose of the swaps was to protect the value of the US operations from currency fluctuations. The taxpayer only intended to hedge its US operations while the associated currency risk exceeded acceptable levels. Once the risk declined with the rise of the Canadian dollar in 2003, the swaps were no longer needed. The termination of the swaps was not related to speculation or an intent to profit. The amount of the swaps closely matched the amount of the taxpayer's net investment in the US operations. The swaps were entered into to protect the taxpayer's consolidated group equity and to protect a capital investment. The fluctuating currency would impact the taxpayer's capital investment in the United States and, as such, the swaps were entered into to hedge a capital asset.

George Weston Limited, 2015 DTC 1079

Provisions of family trust varied, but not retroactively

In February 1955, a family trust (the "Trust") was settled by the applicant, who was the mother of E. E was a capital beneficiary but not an income beneficiary of the Trust, although his wife, S, was an income beneficiary. Upon S's death on August 5, 2009, the income from the Trust, as its provisions were then constituted, did not become available to E or his children, which was allegedly an unanticipated result of S's death. Contrary to the provisions of the Trust, however, E did in fact receive income from the Trust from 2008 until 2013. On February 27, 2013, however, the applicant applied to the Manitoba Court of Queen's Bench for an order varying the provisions of the Trust retroactively to the date of S's death on August 5, 2009 to provide for E's entitlement to income from the Trust from that date. The CRA opposed the retroactivity of the proposed order, arguing that the effective date of the variation should be no earlier than the date of the filing of the application on February 27, 2013. The applicant's position, in part, was that the original intention of the settlor was to benefit E and his family upon S's demise, so the proposed variation was justified.

The application was granted in part. Given the fact that there was no objection to the proposed variation by any of the parties holding beneficial interests in the Trust, the variation was "of a justifiable character" within the meaning of paragraph 59(7)(*b*) of the *Trustee Act* (the "Act") and, hence, should be granted at least on a prospective basis. However, although subsection 59(11) of the Act gives the court a discretion to specify an effective date for a trust to be varied, such variation should normally be prospective (see *771225 Ontario Inc. v. Bramco Holdings Co.*). In the present proceedings, the impetus for the variation application arose after 2010 with the advent of a CRA audit. The applicant, therefore, was attempting to rewrite history in an attempt to avoid an adverse tax result, which has been frowned upon in cases such as *The Queen v. Friedberg*. If the result being sought by the applicant was important, the application should have been brought in 2009 rather than in 2013. Accordingly the application should be granted, but with prospective effect only.

Shinewald, 2015 DTC 5029

Taxpayer failed to rebut Minister's assumptions — Shareholder benefits and gross negligence penalties affirmed

The taxpayer was appealing reassessments for 2006 to 2008 that included about $125,000 in her income as shareholder benefits. Gross negligence penalties were assessed as well. The taxpayer was the sole shareholder of a corporation operating a restaurant that was incorporated in October 2005. She claimed she used personal savings, a line of credit, and loans from her family and friends to open her business. The restaurant opened in March 2006, and the taxpayer argued that the money she spent on the restaurant prior to its opening was entered into a shareholder loan account as a credit and she should be allowed to take it out tax-free. She submitted documents that she had prepared as part of the accounting records for the corporation in support of her allegations. They included a summary of the shareholder loan account showing funds she injected and withdrew, a summary of cash disbursements, a cash expense reconciliation, and a summary of disbursements.

The appeal was dismissed. The onus is on the taxpayer to disprove the Minister's assumptions. The taxpayer argued that she commingled personal and restaurant expenses, debiting her shareholder account for personal expenses and depositing the balance in the corporate account. She argued the amounts included in her income included wages that her husband had declared and those amounts should be excluded. The taxpayer provided bank statements for her line of credit but failed to submit source documents to show that withdrawals from her line of credit were invested in the corporation. Her only evidence was accounting records she prepared which could not be verified. There were no records of any loans she may have received. She argued that all the money spent on the restaurant before it opened was hers, but she had received a small business financing loan for about $125,000 in 2005. There was no evidence to show she had earnings or savings to make the investments in the corporation as she alleged. The taxpayer had an accounting designation, worked in accounting firms for eight years, and was aware of the importance of keeping proper records. Her failure to do so, the commingling of personal and corporate expenses, and the failure to verify amounts credited to her justified the imposition of gross negligence penalties.

Nguyen, 2015 DTC 1064

Reassessments beyond normal reassessment period that included RRSP withdrawals in taxpayers' income affirmed

The two taxpayers transferred all of their funds in their employer's pension plan to RRSPs, and these funds were then withdrawn by them from their RRSPs and invested by certain Promoters (the "Promoters"). The Promoters undertook to make extremely profitable investments (the "Investments"), although the investments were not as profitable as expected. In an action subsequently instituted by the taxpayers and other investors against the Promoters, the Investments were all set aside by the Quebec Superior Court, and the Promoters were ordered to pay damages. In reassessments for 2002 made beyond the normal reassessment period, the Minister's position was that the taxpayers withdrew respective sums of $80,000 and $148,000 from their RRSPs for investment by the Promoters, and that these amounts should be included in their respective incomes in the normal way as RRSP withdrawals under paragraph 56(1)(*h*) and subsection 146(8) of the *Income Tax Act*. On appeal to the Tax Court of Canada, the taxpayers argued, in part, that (a) since the Investments had been set aside by the Quebec Superior Court, each of the taxpayers should be restored to the position in which they were prior to the making of the Investments; and (b) the $80,000 and $148,000 amounts, therefore, should not be included in the taxpayers' income, but should be treated as if they had never been withdrawn from their RRSPs at all.

The taxpayers' appeals were dismissed. The fact that the Investments were set aside by the Quebec Superior Court did not change the fact that the $80,000 and $148,000 were withdrawn from the taxpayers' RRSPs and were in fact received by them. Therefore, these amounts had to be included in the taxpayer's income as the Minister contended. To justify the reassessments made beyond the normal reassessment period, the Minister had to establish, under subparagraph 152(4)(*a*)(i), that the taxpayers had made misrepresentations ". . . attributable to neglect, carelessness or wilful default . . .". Misrepresentations by the taxpayers were clearly made. Whether the taxpayers evidenced neglect or carelessness, however, depended upon whether their conduct involved the exercise of due diligence (see *Gebhart Estate v. Canada*). Both taxpayers were content to rely on advice from the Promoters without further inquiries, and one did not even examine his tax return (prepared by a third party) before signing it. Therefore, neither taxpayer exercised due diligence, so the reassessments made beyond the normal reassessment period were justified.

Demers, 2015 DTC 1066

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