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IS A 93% TAX RATE FAIR TO CANADIAN SMALL BUSINESS OWNERS?

— By: Michael Goldberg, with Mac Killoran and Jay Goodis

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The new tax policies introduced by the Canadian Federal Government on July 18, 2017 (we'll refer to these policies as the "Fair Tax Plan")[1] appear likely to materially harm the Canadian economy including, as will be discussed below, by exposing Canadian small business owners to tax rates of 93% or even more.[2]

The Fair Tax Plan

In Finance Minister Bill Morneau's letter to all Canadians introducing the Fair Tax Plan he states:

> And it starts by making sure that we all pay our fair share of taxes — with no exceptions.

We don't think that exposing Canadian small business owners to tax rates of 93% or more is fair, and we trust that Canadians would agree.

The measures in the Fair Tax Plan do not just impact the "1%". In fact, the Fair Tax Plan undermines all Canadian small business owners, which, according to the Federal Government's own statistics, comprised over 97% of Canadian businesses in 2015 and include restaurant owners, franchisees, real estate agents, plumbing contractors and a broad range of other small businesses.[3]

The mere proposal of these changes has already thrown the Canadian private business owner tax system into turmoil, and, unfortunately, the Government and the Department of Finance do not seem to appreciate and possibly do not understand the extent of the damage that the Fair Tax Plan will cause to Canadian business owners, employees of their businesses, and the economy as a whole.

Combined with rising labour costs,[4] among other things, the interaction of the changes in the Fair Tax Plan (some of which took effect as of July 18, 2017) will (a) undermine

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[1] The "Related Products" section using the Department of Finance link http://www.fin.gc.ca/n17/17-066-eng.asp includes the "Fair Tax Plan" documents referred to in this article.

[2] Although not dealt with in this article, Mac Killoran has run other examples that show the total tax payable can actually exceed 100% of the taxable income earned in certain situations.

[3] For more on this statistic please click the link https://www.ic.gc.ca/eic/site/061.nsf/vwapj/KSBS-PSRPE_June-Juin_2016_eng.pdf/$FILE/KSBS-PSRPE_June-Juin_2016_eng.pdf.

[4] Minimum wage rates are rising in many jurisdictions across Canada and are set to rise dramatically in Ontario where the provincial government has controversially announced hikes in the minimum wage from to $11.40 to $14.00 on January 1, 2017 and to $15.00 an hour (indexed for inflation) on January 1, 2019.

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retirement and succession planning in ways that are often retroactive, punitive and could result in an effective confiscation of a small business owner's property; (b) burden estates with double or more levels of taxation; (c) negatively distort the market for private business owners seeking to sell their businesses, including in ways that may effectively take away their capital gains exemptions; and (d) create a new crushing compliance burden for any person or entity carrying on anything but a public or foreign business. The result is that many businesses will likely close and take with them the jobs they had created for the people whom the Liberal Government is trying to help.

There are some policy measures in the Fair Tax Plan that are fair and difficult to argue against, such as curbing planning that can allow the capital gains exemption to be enjoyed by taxpayers in ways far beyond the intent of the legislation. However, there are better ways to address such issues than through the wide net of the Fair Tax Plan.

Some may suspect that we are exaggerating the impact of the Fair Tax Plan. To them, we would ask if a tax system that can confiscate the hard-earned income of a business owner at a tax rate of over 93% is fair? This could be the result if the Fair Tax Plan is implemented.

For more detail as to how the 93% tax rate has been calculated, we encourage you to review the example in Annex I to this article. We also invite you to read through the discussion that suggests that the Fair Tax Plan may jeopardize the ability for private business owners to sell their shares and use their capital gains exemption found in Annex II to this article.

Conclusions

The individual proposals in the Fair Tax Plan are extremely complicated and their complexity increases as the interactions between the proposals and the rest of the *Income Tax Act*,[5] are considered. The Department of Finance has invited Canadians to provide comments and allowed only 75 days to do so. Given that these proposals collectively are perhaps the most transformational changes in over 50 years, this amount of time to respond is wholly inadequate.

Regardless of the time provided for comments, as illustrated in the examples in the Annexes to this article, we believe that there is no way to work with the Fair Tax Plan and that it should simply be abandoned before any of it is enacted into law.[6]

Even though our proposal is to abandon the Fair Tax Plan, there are elements of the Canadian income tax system that do need to be improved and made more fair for all Canadian taxpayers. Hopefully, the Government will restart the process of making those changes by first better-defining its legitimate tax objectives and then spending time to properly consult with the tax community and affected constituents. We believe that it is possible to build a legislative plan that will be fair to all Canadians and will ensure the ongoing success of our economy.

With what we know today of the Fair Tax Plan, it seems very likely that it will materially harm the Canadian economy. We can only imagine what other tax implications will be discovered once the greater tax community has had the time to fully review and understand the interaction of the proposed changes being made by the Fair Tax Plan with the rest of the Act. Provided the Fair Tax Plan is abandoned, we hope to never find out.

If you would like to weigh in on these proposed changes, please contact your local MP or respond to the consultation request email at fin.consultation.fin@canada.ca.

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[5] Unless otherwise noted in this article and the Annexes, all statutory references are to the *Income Tax Act* (Canada) R.S.C. 1985, as amended ("Act").

[6] There is past Canadian precedent for our Federal Government abandoning a major tax overhaul: in 1981, then Liberal Finance Minister Alan MacEachen introduced an "ambitious" overhaul of the Canadian income tax system, which was ultimately abandoned. Interestingly, the Prime Minister at that time was Pierre Elliot Trudeau.

Annex I — THE FAIR TAX PLAN — AN EXAMPLE[7]

Stage 1 — Building Value

Imagine a situation involving Marie, the owner of an incorporated small business that provides landscaping services ("Gardenco"), who took legitimate steps to allow her only child, Justice, who is not active in the business carried on by Gardenco to acquire nominal value common shares of Gardenco.[8] Now let's fast forward 10 years. Over that time, Justice's shares of Gardenco have become valuable, because Marie successfully ran the business (and employed her friends and neighbours).

Let's say that during the 10-year period, Gardenco earned taxable profits totaling $5,000,000 ($500,000 per year). As the profits qualified for the combined federal and Ontario 15.00% small business rate (provided to create an incentive to entrepreneurs to create businesses and jobs), Gardenco paid tax of $750,000.[9]

Gardenco paid Marie a reasonable salary over those 10 years (Marie paid tax at top Ontario tax rates of 55.48%, including Ontario employer health taxes). Gardenco was also able to retain after-tax profits of $4,250,000 for reinvestment. Over the 10-year period, those investments generated $3,000,000 of income and Gardenco paid $1,505,000 in taxes on this income.

A portion of Gardenco's investment taxes ($920,000) are eligible to be refunded, provided sufficient dividends are later paid by Gardenco.[10] However, because it is assumed that the recipients of such dividends will be taxed at the highest tax rates and will pay more than $920,000 in personal taxes in connection with such dividends, it has been decided to defer the corporate refund as the funds are being continuously invested.

As a result of its success, the value of Gardenco has increased by $6,665,000 (this value includes the $920,000 refundable tax asset in Gardenco) over the 10-year period,[11] which has also increased the value of Justice's shares to $6,665,000. In addition, Gardenco has paid $2,255,000[12] in income taxes on $8,000,000 of net taxable income for an effective corporate tax rate of about 28.19%.

So far it's looking pretty good for Marie and her family — but it should be kept in mind that before Gardenco became a success, Gardenco could not afford to pay Marie. Therefore, she drew out her RRSP savings, she mortgaged her house, and she even drew on her spouse's assets. Marie had no pension fund or savings to provide her with a safety net. Her efforts also enabled Gardenco to employ multiple employees. Regardless of Marie's personal situation, the salaries and source deductions of Gardenco's employees were paid, as were numerous other business fees and taxes.

Stage 2 — Death — Pre-Fair Tax Plan

As part of succession planning, we always have to assume someone will die (as we all will) to determine the tax consequences that will occur on death. For the purpose of this example, we will assume that Justice is no longer alive.

Subject to limited exceptions, under Canadian tax law, the death of a taxpayer causes a deemed disposition of the taxpayer's assets at fair market value, giving rise to income tax on the previously unrealized capital gains.[13] In this case, in the absence of changes and proposed changes under the Fair Tax Plan, the deemed capital gains on Justice's nearly $6,665,000 of Gardenco shares would typically be expected to give rise to taxes of nearly $1,784,000 and to increase the cost base in Justice's shares of $6,665,000.[14]

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[7] See Annex I.1 for a breakdown of all of the numbers in this example.

[8] These steps are sometimes referred to as an estate freeze.

[9] All tax rates utilized in this article are based on combined Federal and Ontario tax rates. It is assumed that top combined Federal and Ontario marginal tax rates apply to all personal income tax amounts.

[10] The refundable tax regime in the Act is intended to ensure tax fairness so that investment income earned in a corporation is taxed at approximately the same rate that it would be if it were earned directly by an individual.

[11] The increase is due to $1,495,000 of after-tax investment profits plus $4,225,000 of after-tax operating profits plus just over $920,000 of refundable taxes.

[12] An aggregate of $750,000 of active small business corporation taxes and $1,505,000 of corporate investment taxes.

[13] See subsection 70(5).

[14] As the Gardenco shares will not qualify for the lifetime capital gains exemption under the Fair Tax Plan or under the pre-Fair Tax Plan regimes, we have assumed that the full amount of the increase in value will be treated as a capital gain and that the full gain would be taxable at capital gains tax rates of 26.76%.

If this were the end of the story — and under the pre-Fair Tax Plan system, it might be[15] — the total income taxes paid by Justice and Gardenco on the $8,000,000 of net taxable income would have been almost $4,039,000[16] for an effective combined corporate and personal income tax rate of 50.49%. While this tax rate is approximately what the average top-tax-rate employee would pay, the ability to defer almost $1,784,000 of this tax until Justice's death is a tax advantage enjoyed by Marie and her family when compared to an employee — but, again we mustn't forget that Gardenco has paid a host of other business taxes, created jobs for Canadians and that Marie and her family have faced more than their fair share of risk and adversity to build a successful small business.

Stage 2.1 — Death under the Fair Tax Plan

Now let's add in the impact of the Fair Tax Plan. Instead of the just under $1,784,000 of tax payable on Justice's death, the taxes will increase to more than $2,602,500,[17] increasing the total taxes payable by Gardenco and Justice on that $8,000,000 of net taxable income to just over $4,857,500[18] — or an effective tax rate of nearly 60.72%.

It's beginning to look pretty bad for Marie and her family and we wish this was the end of the story, but it's not. To pay for this additional nearly $2,602,500 of income tax, the executors of Justice's estate will need to come up with money. However, the money is still in Gardenco and the Fair Tax Plan may have eliminated the ability for Justice's executors to remove the money from Gardenco without additional tax becoming payable.[19]

If the executors can sell the shares to an arm's length party, they could come up with the money. But that means the end of the next generation's involvement in the business — not a great policy result. We'll say a few words about the distortion of the sale market for private company shares below in Annex II to this article.

You may be asking yourself how the executors can get the cash to pay this approximately $2,602,500 additional tax liability. The answer is that they will need to cause Gardenco to pay taxable dividends on the shares to the estate. Assuming that the $5,745,000 of cash in Gardenco is distributed by way of taxable dividends to the estate, the estate will be liable for over $2,602,500 of additional taxes.[20]

In the pre-Fair Tax Plan discussion, we mentioned that Gardenco would have a refundable tax asset of just over $920,000. However, the Fair Tax Plan proposes to eliminate this tax refund for private corporations that use their active business income profits to earn income from passive investments. As a result, this refund will not be available to Gardenco.[21]

What is the total tax bill for Gardenco, Justice, and the estate as proposed? You may recall that Gardenco paid a total of $2,255,000 in income taxes on the $8,000,000 of net taxable income it earned. On Justice's death, further taxes of more than $2,602,500 will be payable and, to access the money in Gardenco, Justice's estate will also be required to

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[15] Using a technique that is often referred to as "pipeline planning," it might be possible for Justice's estate and/or heirs to use the cost base in the shares Justice owned, to remove up to $6,665,000 of cash from the corporation without additional tax being paid. Other approaches could be used and different tax results would arise. Such other approaches are ignored in this article.

Steps to refund the $920,000 of refundable tax should also be considered as there may be tax advantages to doing so. Such planning and any attempt to value such tax advantages is beyond the scope of this article.

[16] An aggregate of $2,255,000 of corporate taxes and nearly $1,784,000 of personal taxes.

[17] Changes to the rules relating to sprinkling of income using private corporations will cause the deemed gain to be taxed as if it was a dividend (see draft section 120.4 changes and, in particular, changes to section 120.4(4)), which for purposes of this example will be taxed to Justice at a tax rate of 45.30%. We have assumed that the changes to the taxation of holding private investments inside a private corporation have also been implemented such that there is no refundable tax in Gardenco. As a result, the value of Gardenco for purposes of determining Justice's dividend tax liability will only be $5,745,000 and not $6,665,000 under the prior regime.

If Justice had inherited the Gardenco shares from Marie certain exceptions to these rules might apply so that tax of nearly $1,784,000 would have been payable (draft clause 120.4(1.1)(e)(ii)(C)). However, this tax would have been payable at the time of Marie's death.

[18] An aggregate of $2,255,000 of corporate taxes and over $2,602,500 of personal taxes.

[19] Changes to the rules converting a private corporation's regular income into capital gains (see proposed changes to section 84.1 and new section 246.1) may have eliminated pipeline planning effective July 18, 2017. These changes will have far ranging consequences on many taxpayers — many of them retroactively exposing taxpayers to double or triple taxation.

[20] We have assumed that the dividend tax rate would be 45.30%. It would appear that if certain post-mortem planning under subsection 164(6) is employed that it could be possible to effectively reduce the deemed dividend tax under subsection 120.4(4) from about $2,602,500 to a bit more than $1,060,000 (the amount of the reduction could be more depending on the sources of other income earned by Justice in his terminal taxation year). However, for reasons noted when discussing the pre-Fair Tax Plan regime, it is assumed that subsection 164(6) planning is unavailable in this situation.

[21] Changes to the rules regarding holding a passive investment portfolio inside a private corporation. A consequence of this change will be to tax such income when it is distributed from certain private corporations at a 72.74% effective tax rate.

pay more than $2,602,500 in taxes. Based on these calculations, the total tax payable by Gardenco, Justice and his estate to earn $8,000,000 of taxable income in Gardenco is a staggering amount of just over $7,460,000 — or 93.26% of the income earned by Gardenco!

One would have to wonder why Marie even bothered to go into business at all. Quite frankly, given the risks she and her family have taken and the sacrifices they have made, her family would likely have been better off if she'd gone to work for someone else. Unfortunately, her community, her province and Canada as a whole would be far worse off in almost every way imaginable (fewer jobs; fewer source deductions, business fees and taxes; spin-off benefits, etc.).

Annex I.1 — THE FAIR TAX PLAN — AN EXAMPLE

	Current Rules	New Fair Action Plan
Gardenco - Tax on Income		
Active business income	5,000,000	5,000,000
Tax @ 15%	(750,000)	(750,000)
Net available for investment	4,250,000	4,250,000
Investment income	3,000,000	3,000,000
Tax @ 50.17%	(1,505,000)	(1,505,000)
Net after tax on investment income	1,495,000	1,495,000
Total income earned	8,000,000	8,000,000
Total taxes paid by Gardenco	(2,255,000)	(2,255,000)
RDTOH balance	920,000	-
Net assets in Gardenco	6,665,000	5,745,000
Effective Gardenco tax rate	*28.19%*	*28.19%*
Justice - Tax on Death		
Value of shares on death	6,665,000	5,745,000
Tax @ 26.76%	(1,783,874)	-
Tax @ 45.30%	-	(2,602,730)
RDTOH balance*	(920,000)	-
Net value available to Justice's heirs	3,961,126	3,142,270
Total income earned	8,000,000	8,000,000
Total taxes paid by Gardenco & Justice	(4,038,874)	(4,857,730)
Net value available to Justice's heirs	3,961,126	3,142,270
Effective Gardenco + Justice tax rate	*50.49%*	*60.72%*
Estate - Tax to Remove Funds from Gardenco		
Value of shares on death	6,665,000	5,745,000
Tax at 45.30%	-	(2,602,730)
Net assets available to fund Justice's tax on death and his heirs	6,665,000	3,142,270
Total income earned	8,000,000	8,000,000
Total taxes paid by Gardenco, Justice and estate	(4,038,874)	(7,460,461)
Net after tax cash available for heirs	3,961,126	539,539
Effective tax rate	*50.49%*	*93.26%*

**This example assumes that loss carryback planning under s.164(6) is unavailable.*

**As the cost to pay out RDTOH will exceed the value of RDTOH, no effort will be taken to try and obtain an RDTOH refund in using the "Current Rules" analysis.*

Annex II — DISTORTION OF THE SALE MARKET FOR SHARES

Even if a sale can be completed, will it be possible to find a purchaser who is willing to buy shares?

Unfortunately, other changes introduced in the Fair Tax Plan may result in buyers avoiding the purchase of shares.[22] This is because if buyers use their after-tax dollars to buy shares, they might not be able to extract the purchase price from Gardenco without tax.

Assume that Wylie, an individual who deals at arm's length with Justice, is considering buying Justice's estate's shares of Gardenco for $5,745,000. It would appear that if Wylie purchased the Gardenco shares with his own after-tax dollars, he may need to pay taxes of over $2,602,500 to be able to extract the money back from Gardenco.[23] Therefore, Wylie would instead offer to purchase Gardenco's assets for $5,745,000,[24] unless the estate offered to sell its shares with a substantial discount.[25]

An unintended consequence of the Fair Tax Plan is that individual shareholders may have difficulty claiming their capital exemptions. Purchasers, such as Wylie, will be further incentivized to purchase assets, in lieu of shares, since they may no longer be able to monetize the cost base of purchased shares. Furthermore, even if the seller offered a price reduction on the shares in order to claim the capital gains exemption, the discount required to compensate the potential inability to monetize the cost base of a purchaser, such as Wylie, will outweigh the savings from utilizing the capital gains exemption.

Please note, this article is intended to provide general information only and not legal advice. This information should not be acted upon without prior consultation with legal advisors.

WHAT'S NEW

Government Releases Proposals Regarding Tax Planning Using Private Corporations

The Department of Finance Canada fulfilled its Budget 2017 promise by launching a consultation on tax planning using private corporations. Draft legislation (with explanatory notes and a white paper) has been released. In brief, the following changes have been proposed:

- The tax on split income will be extended to include adult individuals where the amount received is unreasonable (a test based on the extent of the individual's capital and labour contributions). The types of income subject to the tax will also be extended to include income from debt, gains from the disposition of property from which the income is split income, and second-generation income on amounts that were previously subject to split income tax.

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[22] Changes to the rules converting a private corporation's regular income into capital gains (see proposed changes to section 84.1 and new section 246.1).

[23] Due to the application of section 246.1, Wylie would appear to be unable to use pipeline planning to remove funds from Gardenco without giving rise to deemed dividends. Arguments might be made that this result could be avoided through careful planning if Wylie were to buy the shares through a corporation owned by him. However, there appears to be no certainty that such planning will be successful since in applying the rules in section 246.1, Finance's comparative norm to determine if the rules are engaged is that tax should be paid as a dividend. We have applied a dividend tax rate of 45.30% to calculate this tax liability.

[24] A sale of assets won't help Justice's estate to fund its tax liability as the money will still be in Gardenco. Also, depending on the assets in Gardenco, a sale of the assets could give rise to a further level of taxation — that is a further subject that we will ignore for purposes of this article.

[25] In general, purchasers prefer to buy assets to avoid a number of legal and tax complications when shares are purchased and will request a discount off the price that would otherwise be offered to purchase assets when acquiring shares. The additional tax issues raised by draft section 246.1 appears likely to severely increase the discount that purchasers will request.

The rules in section 246.1 appear to have been written broadly enough to apply to any type of purchaser. However, by virtue of the purpose test in paragraph 246.1(2)(*d*), it appears to be more likely that section 246.1 will apply to smaller more unsophisticated purchasers, like Wylie, than to larger and more sophisticated purchasers, such as a public company. While it may still be too early to definitively conclude on this point, it would appear that the rules in section 246.1 could place such smaller unsophisticated purchasers at a disproportionate disadvantage in their ability to compete on an even playing field with some larger purchasers.

- New rules will crack down on strategies that multiply access to the lifetime capital gains exemption ("LCGE"). Minors will no longer be able to claim the LCGE. Gains that are subject to the extended split income tax are also ineligible for the LCGE, so an individual's eligibility for the LCGE is based upon the labour and capital contribution tests mentioned above. Last, gains accrued while the property was held by a trust are no longer eligible for the LCGE, with some minor exceptions. Regardless of whether the trust flows out the capital gains, or rolls out the property to the beneficiaries who then dispose of it, using a family trust to own a business will disqualify access to the LCGE — this will no doubt disrupt many plans and structures currently in place, including "garden-variety" estate freezes.
- Although no specific amendments have been proposed, the government plans on eliminating a perceived tax deferral advantage from holding passive investments within a private corporation. The government is asking for input from the tax community on how best to achieve this. The white paper provided by Finance suggests making changes to the current system, or replacing it with a new system. Potential replacement systems are also discussed in the white paper.
- Section 84.1 will be amended, and a new section of the Act will be introduced to prevent certain strategies that allow a corporation to convert its regular income into capital gains. If implemented, it appears that these changes will put an end to the so-called "pipeline" arrangements that are currently used to avoid the double taxation that otherwise can arise during the administration of an estate of a small business owner.

Most of the provisions will apply to 2018 and subsequent years. However, the measures targeting conversion of income into capital gains apply to amounts received on or after July 18, 2017. Submissions regarding these proposed rules will be accepted until October 2, 2017, which leaves tax professionals less than 70 days to comprehend the implications of the proposed changes and submit feedback to the government.

Interest and Penalties Relief for Taxpayers Affected by Flooding

Both the CRA and Revenu Québec have announced relief for taxpayers affected by the recent flooding in parts of the country. The CRA is encouraging individuals, businesses, and first-responders to file a request for taxpayer relief from penalties and interest (Form RC4288) or to call the CRA directly. Revenu Québec will likewise waive interest or penalties for taxpayers unable to meet their compliance obligations due to the flooding.

CRA Makes Statement Regarding BP Canada Decision

Tax Topics no. 2354 contained a summary of the Federal Court of Appeal's decision in *BP Canada Energy Company v. MNR* (2017 DTC 5028). The court found that BP Canada was not obligated to provide a list of its uncertain tax positions pursuant to a requirement to provide information issued by the CRA. The CRA has decided not to appeal this case to the Supreme Court of Canada. Rather, the CRA will update its audit procedures to clarify where such information may be requested from taxpayers.

Minister of National Revenue Provides Update on Tax Compliance Improvements

Diane Lebouthillier, Minister of National Revenue, issued a progress update on the government's commitments made in response to a report made by the Standing Committee on Finance. This report, issued on February 22, 2017, recommended various actions that the government should make with respect to offshore tax avoidance. The progress update contained a few interesting points.

The CRA has identified several areas to improve with respect to the advance income tax ruling process. Improvements will include:

- stronger communications with taxpayers,
- increased awareness and education for tax professionals,
- retaining and meeting the current 90-day service target, and
- guidelines for advance rulings on issues that are questions of fact.

The CRA has also completed a review of its voluntary disclosure program ("VDP") in response to one of the report's recommendations. Within the next week or so, the CRA will release its revised VDP policies, which will be finalized in the Fall after external consultation. It is expected that these revisions will reduce the relief available where certain factors are present (e.g., taxpayer has a history of avoidance, taxpayer is sophisticated, the amount of tax avoided is large, etc.).

Joint CBA/CPAC Submission on Taxation of WIP for Professionals

On May 31, 2017, the Joint Committee on Taxation of the Canadian Bar Association ("CBA") and Chartered Professional Accountants of Canada ("CPAC") filed a submission with Finance Canada regarding the 2017 Federal Budget proposal to prevent professional businesses from excluding their year-end work in progress ("WIP") from their income. Under the proposal, they would have to include WIP in their income at its fair market value ("FMV") or at the lower of its cost or FMV. The committee understands the policy rationale to match income with related expenses but is concerned with the uncertainty and compliance burden that could result from the proposal.

Joint CBA/CPAC Submission on New Small Business Deduction Rules

On June 2, 2017, the Joint Committee on Taxation of the Canadian Bar Association ("CBA") and Chartered Professional Accountants of Canada ("CPAC") filed a submission with Finance Canada (previously filed with the Canada Revenue Agency on February 14, 2017) concerning the small business deduction ("SBD") rules announced under the 2016 Federal Budget. The committee was concerned with the new rules, especially with their impact on structures and transactions that were never undertaken for the purpose of multiplying SBD claims. The committee agrees with the policy rationale to make sure that any single business only had access to a single SBD limit. However, the new specified partnership income or specified corporate income provisions, and the new carve-out rules applicable to certain structures, would fall outside and go well beyond the proposed policy of simply preventing taxpayers from making unwarranted multiple SBD claims.

Interest Rates for Third Quarter of 2017

The CRA announced the prescribed annual interest rate that applies to amounts owed to/by the CRA to individuals and corporations for the third quarter of 2017 (July 1 to September 30). There are no changes since the previous quarter, except for the rate applicable to corporate taxpayers' pertinent loans or indebtedness, which increased to 4.55%.

Standing Committee on Public Accounts Report on Income Tax Objections

On June 21, 2017, the Minister of National Revenue tabled the Government of Canada's response to the report of the House of Commons Standing Committee on Public Accounts on income tax objections. The CRA accepted all of the recommendations in the report and reiterated their commitment to improving the objections process and better serving Canadians. Since fall 2016, the CRA implemented an action plan to address the delays in processing objections. To improve the timeliness of the CRA's decisions and keep taxpayers informed of the status of their objections, the following standards were implemented for low-complexity objections:

- Contacting taxpayer or representative within 30 days from receiving the objection.
- Publishing a new service standard of 180 days 80% of the time.

Bill C-44 Receives Royal Assent

On Thursday, June 22, 2017, Bill C-44, *An Act to implement certain provisions of the budget tabled in Parliament on March 22, 2017 and other measures*, received Royal Assent. The Senate passed the bill on Thursday morning after a contentious previous day, where the Senate introduced amendments to the proposed increases on wine, beer, and alcohol. The House rejected those changes on the basis that the Senate did not have the authority to make changes relating to financial matters. The Senate maintained that it did have the power to amend any bill, but still passed Bill C-44 without the amendments. From a practical perspective, with the House adjourned for the summer, if Bill C-44

hadn't passed it would have been on hold until the House returned in September, unless MPs had returned to push it through. This may foreshadow an interesting constitutional issue at some point in the future.

The bill will allow the government to implement the following priorities:

- Funding for home care and mental health services to provinces and territories.
- Establishment of the Canada Infrastructure Bank to fund various infrastructure projects.
- Expansion of Employment Insurance benefits to help families with different needs.
- Support Canadian veterans and their families in transition from military to civilian life.
- Simplification of disability tax relief system for caregivers of infirm dependants.
- Allow students enrolled in occupational skill courses to qualify for a tuition tax credit.
- Support a Pan-Canadian Artificial Intelligence Strategy to retain and attract top talent.
- Strengthen the Parliamentary Budget Office to make it truly independent.

CRA Announces Service Improvements for SMBs

Last week, the CRA announced a series of service improvements targeting small and medium businesses ("SMBs") as a result of the *Serving You Better Consultations* conducted in 2016. Over 50 action items were announced, but the most noteworthy changes include:

- Taxpayers will be able to receive security codes via email by obtaining telephone authorization (as opposed to waiting to receive a code in the mail).
- A new mobile app will be created to assist businesses in managing their interactions with the CRA.
- Employers will be allowed to provide T4 slips to their employees in electronic format.
- New businesses will be able to sign up for *My Business Account* and online mail when registering for CRA accounts such as GST/HST and payroll.
- A dedicated telephone service for tax preparers will be launched as a pilot. Calls to this service will be directed to more experienced CRA staff who can address more complex issues.
- Corporations will be able to view the assessed value of their T2 returns and schedules and the CRA-verified capital dividend account balance in *My Business Account*.
- Certain auto-fill functionality will be added to T2 tax return software.
- As previously announced, the time it takes to resolve an objection will be improved.
- A post-audit survey will be launched in order to gather feedback from small businesses regarding their audit experience.

CRA FOLIOS AND FORMS

Form RC59 No Longer Used To Obtain Online Access

As of May 15, 2017, Form RC59, *Business Consent*, will no longer be used to get **online access** to a business client's information. Rather, representatives will need to complete the request in *Represent a Client* online. Upon completing the request, access will be granted in 5 days or less. Note that Form RC59 may still be used to request client information by mail or telephone.

INTERNATIONAL NEWS

The Tax Proposals of French President-Elect Macron

This article originally appeared in Wolters Kluwer's Global Tax Weekly Issue 235.

French centrist independent candidate Emmanuel Macron was elected to the presidency of France on May 7, after pledging significant tax cuts for businesses and individuals.

Macron won the contest by a comfortable margin, gaining more than 66 per cent of the vote in the run-off election against nationalist candidate Marine Le Pen, who had proposed raising taxes on companies employing non-French workers.

While Macron has no previous experience in elected office, the former banker was brought into the Government by current President François Hollande in 2014 to help steer through some pro-business economic and tax reforms. He resigned that post in 2016 and later formed his own centrist party, En Marche! (renamed since the election as La République en Marche!).

On the campaign trail, Macron promised to cut taxes by €20 billion (US$21.9 billion), with the reductions divided equally between businesses and individuals.

The program includes a reduction in corporate tax to 25 per cent from its existing level of 33.33 per cent over five years. This would go beyond the cut to 28 per cent for all firms by 2020 approved by the current Government.

In addition, Macron wants to remove investment income from the scope of the wealth tax, so that it effectively becomes a tax on high-value property, and to raise environmental taxes.

IRS Suspends Preparer Tax Identification Number System

This article originally appeared in Wolters Kluwer's Global Tax Weekly Issue 239.

The US Internal Revenue Service ("IRS") has suspended registration and renewal of Preparer Tax Identification Numbers ("PTINs") following a court ruling that it is unlawful to charge associated fees.

The IRS's decision follows a ruling from the US District Court of Columbia in *Steele v. The United States of America* (Case No. 14-cv-1523-RCL), which ruled that while the IRS was entitled to require the adoption of PTINs, it may not charge fees for allocating such. The IRS was ordered to repay PTIN fees to all of the members of the class action in the court case.

Since 2011, tax return preparers are required to have a PTIN, and the IRS has charged fees (currently US$33) for applications and renewals.

The IRS has stated it is considering how to proceed with regards to issuing PTINs, and said it will provide additional information when it becomes available.

ICC Warns of Double Tax Risks Surrounding ' Substance' Tests

This article originally appeared in Wolters Kluwer's Global Tax Weekly Issue 240.

The International Chamber of Commerce ("ICC") has called on governments to adopt uniform, predictable rules to determine the location of economic activity when applying new international tax rules centered on substance.

The ICC noted that in light of recent international tax developments, namely the OECD's BEPS project, the notion of economic substance has attracted attention in a number of countries, especially given the lack of standards on how it can be understood in the context of BEPS. This, it said, is likely to result in double taxation for companies with respect to their international tax and transfer pricing arrangements.

It said: "The concept of economic substance serves as a key criterion for determining whether an economic activity is established only legally or whether there is personnel and an organizational structure. The challenge with any economic substance requirements is their factual nature and the wide leeway for varying interpretations of their content."

"The absence of clear standards on how economic substance can be understood in the context of BEPS; different perspectives, compounded by a lack of experience due to limited guidance; as well as a potentially increasing number of additional sources will most likely create new conflicts in the near future with evident risks of uncertainty and interpretation."

In order to provide certainty to businesses, the ICC said that governments must look at a multinational company's affairs holistically so that they can recognize the different perspectives of the parent country state, the source state, and any intermediary company state.

AICPA Supports US Bill To Ease Tax Burden on SMEs

This article originally appeared in Wolters Kluwer's Global Tax Weekly Issue 243.

The American Institute of Certified Public Accountants ("AICPA") has voiced support for a bill that would enhance reliefs available to small and medium-sized businesses, and simplify certain accounting and tax rules.

AICPA published a letter of support to the sponsor of the Investment in New Ventures and Economic Success Today ("INVEST") Act of 2017, Senator John Thune (R–SD). Thune introduced the standalone bill in the Senate but proposes that the legislation should form part of the broader tax reform agenda.

The INVEST Act would extend the cash basis method of accounting to businesses with gross receipts of US$15 million or less over the last three years; simplify inventory accounting for small and medium-sized companies; and allow more small construction companies to use the simplified completed-contract method of accounting.

As well as welcoming proposals to expand cash basis accounting, AICPA praised his proposals to update the types of property that can be expensed for tax purposes. It said that "updating the schedule of depreciable property under Revenue Procedure 87-56 to include a range of technology and other types of property that did not exist in 1987 would provide clarity, eliminate controversy, and provide a more accurate reflection of depreciation."

The bill makes a number of other changes, including increasing the Section 179 expensing limit for capital investments, reducing depreciation periods for farm machinery and equipment, increasing the amount that a company can deduct for passenger vehicles, and reducing the time taken to recover investment on acquired intangible property.

The INVEST Act bill has been referred to the Senate's Committee on Finance, of which Thune is a member.

Canada, EU Set Provisional Date for CETA Implementation

This article originally appeared in Wolters Kluwer's Global Tax Weekly Issue 244.

Canada and the EU will provisionally apply their Comprehensive Economic and Trade Agreement ("CETA") from September 21, 2017.

Canadian Prime Minister Justin Trudeau met with Jean-Claude Juncker, the President of the European Commission, during [early July's] G20 Summit.

According to a joint statement issued on July 8, the two sides "agreed to set the date of September 21, 2017, to start the provisional application of the agreement, thus allowing for all the necessary implementing measures to be taken before that date."

For CETA to definitively enter into force, the parliaments in all EU member states must ratify the text.

The statement said: "It is by opening up to each other, by working closely with those who share the same values that we will shape and harness globalization. It is important that our companies and citizens, the real winners with this agreement, start reaping its benefits without further ado."

Upon CETA's entry into force, Canada will eliminate duties worth €400 million (US$456.1 million) each year for goods originating in the EU. Once the agreement is fully implemented, that figure will rise to more than €500 million a year.

The EU will immediately remove tariffs on 98 per cent of its tariff lines, rising to 99 per cent upon full implementation.

Hong Kong Mulls New Tax Breaks for SMEs, Innovators

This article originally appeared in Wolters Kluwer's Global Tax Weekly Issue 244.

Hong Kong is considering introducing tax relief for small and medium enterprises ("SMEs") and providing additional tax deductions for research and development ("R&D").

The Government has confirmed that a new "tax policy unit" has been instructed to consider the proposals of Hong Kong's new Chief Executive, Carrie Lam, who took office on July 1, to: introduce a two-tier profits tax rate system and lower the profits tax rate for the first HK$2 million (US$256,000) of profit from the current 16.5 per cent to 10 per cent; and provide additional tax deductions for business spending on R&D activities.

James Lau, the Secretary for Financial Services and the Treasury, told the Legislative Council that "once specific proposals have been drawn up, the Government will consult the stakeholders concerned."

In addition, he ruled out a change to anti-avoidance provisions on the leasing of plants and machinery contained in Section 39E of the Inland Revenue Ordinance, and told lawmakers that Hong Kong and Mainland China continue to discuss the taxation of individuals to simplify arrangements for expatriates and cross-border workers.

China's Recent Business Tax Cuts Worth US$147 Billion This Year

This article originally appeared in Wolters Kluwer's Global Tax Weekly Issue 244.

Recent tax cuts have reduced the corporate tax burden by ¥1 trillion (US$147 billion) this year in China, Chinese Premier Li Keqiang said.

This is considerably more than in recent years, with the tax reduction most notably due to the introduction of China's new value-added tax regime. Businesses saw savings worth ¥2 trillion during the four years between 2013 and 2016.

China has also introduced tax breaks for small and micro-enterprises and increased tax relief for innovation.

Further reforms are planned, Li said. These will reduce discretion in the administration of taxes and prevent arbitrary taxation. China will improve tax services for taxpayers and simplify and improve the structure of the VAT regime, he said.

TECHNICAL INTERPRETATIONS

Section 55(2) — Part IV Tax Exception

The CRA was asked to consider the following situation:

- "Holdco" owns all the shares of "Opco", which is therefore connected to Holdco.
- All transactions occur in Holdco's and Opco's taxation years beginning after Year 1.
- Taking into account its refundable dividend tax on hand ("RDTOH"), Opco pays a taxable dividend to Holdco and expects to receive a dividend refund.
- Holdco then pays a taxable dividend of the same amount to an individual shareholder.
- Holdco pays Part IV tax and is eligible for an offsetting dividend refund.

The taxpayer assumed that all the steps above were part of the same series of transactions since they were all related to the distribution of cash to a shareholder.

The CRA was asked if the Part IV tax exception to s. 55(2) of the Act would apply to the taxable dividend received by Holdco even if the Part IV tax was refunded because of the dividend paid to the individual. The CRA was also asked, assuming that s. 55(2) would apply because of the Part IV tax refund, if an election could be made on the portion of the taxable dividend that generated the refund to be a capital dividend, therefore giving a retroactive effect to s. 55(2).

The answer was in both cases in the negative. Regarding the first question, the CRA confirmed that s. 55(2) would be applicable whenever the Part IV tax is refunded as a result of the payment of a dividend by the corporation regardless of who received the dividend. The fact that the dividend is paid to an individual instead of a corporation is not relevant for the purpose of applying s. 55(2) of the Act. Regarding the second question, the CRA confirmed that s. 55(2) of the Act would be applicable only if Part IV tax was actually paid on the dividend received and if a dividend refund was actually received. Section 55(2) of the Act would always require the prior application of s. 129 and 186 of the Act. The payment of a capital dividend and resulting reduction of the taxable dividend paid by the recipient corporation would not cause a full refund of Part IV tax, resulting in a circular calculation. No capital dividends could be paid before all taxable dividends are paid to generate a full Part IV tax refund if you want to make a full application of the rule in s. 55(2) to the dividend received.

External Technical Interpretation, Reorganizations Division, October 11, 2016

Automobile Standby Charge — Provincial Sales Tax and Automobile Cost

The CRA was asked if the cost of an automobile used to calculate a standby charge benefit under s. 6(2) of the *Income Tax Act* (the "Act") should include: (1) the actual provincial sales tax ("PST") calculated on the cost of the automobile purchased less the trade-in value; or (2) the PST payable on the cost of the automobile purchased without consideration for the trade-in value.

The CRA confirmed that the actual PST paid on the cost of the automobile purchased net of the trade-in value should normally be included in the automobile cost used to calculate the standby charge benefit under s. 6(2) of the Act. The Goods and Services Tax ("GST"), Harmonized Sales Tax ("HST"), and PST are normally calculated on the net value of the purchase transaction which includes the price of automobile purchased less the trade-in value. The result could be different if a province calculated its PST on the cost of the automobile purchased without taking into account the trade-in value. If this was the case, the full PST on the cost of the automobile acquired would be used to calculate the standby charge benefit without consideration for any trade-in value.

Internal Technical Interpretation, Business and Employment Division, January 12, 2017

T4A Reporting — Payment of Rent

The CRA was asked to consider a situation where an organization uses independent contractors for the provision of teaching and supervising services. Both the organization and the contractors are resident in Canada. One of the contractors is paid rent for the use of his property. The CRA was asked if the rent amount was reportable on a T4A. Even if payments of fees, commissions, or similar amounts for services are subject to Canadian withholding tax under s. 153(1)(*g*) of the *Income Tax Act* and are reportable on Form T4A under Regulation 200(1) of the *Income Tax Regulations* (the "Regulations"), the CRA did not consider the rent paid to the contractor as a fee, commission, or similar amount paid for services. The rent payments are not subject to reporting on Form T4A under Regulation 200(1) of the Regulations. However, the question of whether a rent payment is a fee, commission, or similar amount is essentially one of fact.

External Technical Interpretation, International Division, March 31, 2017

Eligible Capital Expenditures — Transitional Rules

The CRA was asked to review the following situation:

- "ACO" sold its internally-generated goodwill to an arm's length buyer in December 2016.
- ACO incurred eligible capital expenditures like incorporation costs for a business before 2017.
- ACO's taxation year ended on April 30, 2017.

More specifically, the CRA was asked if the election available under s. 13(38)(*d*)(iii) of the *Income Tax Act* (the "Act") could be exercised by ACO in this situation.

After noting that s. 33(8) of the Act contained the transitional rules applicable to the repeal of the eligible capital property rules and their replacement by the new capital cost allowance class 14.1, the CRA noted that the provision applied only if the following two conditions were met:

- No taxation year of ACO ended immediately before January 1, 2017.
- ACO would have had an amount included in its business income (because of s. 14(1)(*b*) of the Act) for the particular taxation year including January 1, 2017, if the particular year had ended immediately before that day.

ACO could elect under s. 13(38)(*d*)(iii) of the Act to treat the capital gain under s. 13(38)(*d*)(ii) of the Act as an income inclusion for the business under s. 14(1)(*b*) but only if ACO also incurred an eligible capital expenditure before 2017 in respect of a business. Therefore, provided all other conditions in s. 33(8) of the Act were also met, ACO could file the election under s. 13(38)(*d*)(iii).

External Technical Interpretation, Business and Employment Division, March 27, 2017

Small Business Deduction

The CRA was asked to consider the following two situations:

Situation #1:

- An individual owns the following percentages of the following Canadian-controlled private corporations ("CCPCs") carrying on a fishing business: 30% of Buyco 1, 100% of Sellco A, and under 50% of Sellco B.
- The corporations are not associated and their taxation year begins after March 21, 2016.
- Sellco A and Sellco B sell 100% of their catch to Buyco 1, meaning that all their income is derived from sales to Buyco 1.
- Buyco 1 buys most of its fish from non-related parties.

Situation #2:

- The following individuals own the following percentages of following CCPCs carrying on a fishing business: K owns 65% of Buyco 2, K's brother owns 100% of Sellco A, and K's son owns 100% of Sellco B.
- The corporations are not associated and their taxation year begins after March 21, 2016.
- Sellco A and Sellco B sell 100% of their catch to Buyco 2, meaning that all their income is derived from sales to Buyco 2.
- Buyco 2 buys most of its fish from non-related parties.

The CRA was asked how the changes to the small business deduction ("SBD") rules described in the recently enacted Bill C-29 could apply to those two situations.

The CRA confirmed that the receipt of "specified corporate income" (as defined in s. 125(7) of the Act) by a corporation limited its SBD. More specifically, the income earned by Sellco A or Sellco B would not qualify for the SBD unless Buyco 1 (for situation #1) or Buyco 2 (for situation #2) made an assignment of a portion of its business limit to Sellco A or Sellco B under the new s. 125(3.2) of the Act. The business limit of Buyco 1 or Buyco 2 would be reduced under s. 125(3.1) of the Act for any portion of its limit assigned to Sellco A or Sellco B. The assignment is only valid if each CCPC files prescribed forms T2 and T2SCH7 for their respective taxation years.

External Technical Interpretation, Business and Employment Division, April 20, 2017

Stock Appreciation Rights not Salary Deferral Arrangements

The CRA was asked to rule if two stock appreciation right ("SAR") plans calculated by reference to a company's "earnings before interest, tax, depreciation, and amortization (EBITDA)" constituted "salary deferral arrangements (SDAs)" as defined in s. 248(1) of the *Income Tax Act* (the "Act").

More specifically, the following transactions were considered:

- "ACO1" established "SAR1" and "SAR2" plans for participants "A", "B", "C", "D", and "E" but only on the condition it obtains a ruling and makes any required changes to the plans.
- The plans would have the following characteristics:
  - The board of directors of ACO1 would manage the plans and be allowed at any time to modify, suspend, or eliminate them provided they did not have adverse effects on the rights of the participants in those plans.
  - ACO1 would grant SAR1 and SAR2 shadow shares to each participant entitling them to receive a percentage of the potential capital gain (i.e., excess of fair market value of ACO1 or ACO2 shares on the date of a triggering event over their original value).
  - Before the date of the triggering event, the value of the shadow shares would be nil.
  - After a normal triggering event (without material changes), each participant would be paid a percentage of the potential capital gain on the shadow shares within a certain period of time. The amount paid would be subject to source deductions.
  - Different rules would apply, and the percentage of potential capital gain would be paid earlier in case of material changes (e.g., change of control, liquidation, etc.).
  - Number of granted shares would be adjusted in case of stock splits, payment of stock dividends, share exchanges, etc.
  - The shadow shares would not provide the SAR participants with voting rights or other rights similar to those available to regular shareholders.
  - Participants could not transfer their shadow shares or rights to potential capital gain.
  - ACO1 could not capitalize the SRA plans or set funds aside to pay the percentages of potential capital gain to the participants.
  - SAR plans end in respect of participants when their percentages of potential capital gain owed to them on the shadow shares are paid to them.
  - When a percentage of potential capital gain becomes payable to a participant due to a normal triggering event a new SAR plan is automatically established.

There are three purposes to the proposed transactions:

- Encourage the development and growth of ACO1, ACO2, and their subsidiaries.
- Retain the participants and lead them to promote the growth of the corporations.
- Link their remuneration to the growth in value of the ACO1 and ACO2 shares.

The CRA issued the following ruling:

- Provided a participant is not yet entitled to receive the portion of the potential capital gain due to him on the shadow shares, the SAR plan is not considered a salary deferral arrangement (as this term is defined in s. 248(1) of the Act). If he is entitled to receive such a portion of the potential capital gain, the facts will determine if the plan is an SDA or not.
- The plans are not considered retirement compensation arrangements under s. 248(1) of the Act or investment contracts under s. 12(11) of the Act. The allocation of shadow shares by itself is not considered an interest income on an investment contract.
- The allocation of shadow shares in itself would not trigger an inclusion of an amount in the participant's income under s. 5(1), 6(1)(*a*), or 115(1)(*a*)(i) of the Act, but such inclusion would be required under those provisions for any amounts paid by ACO1 under SAR1 or SAR2 unless the plans would be considered as SDAs.

- If SAR1 and SAR2 are considered SDAs, any "deferred amount" (see definition in s. 248(1) of the Act) that the participants are entitled to receive under the plans at the end of a taxation year must be included in their income for that year under s. 6(1)(*a*) and 6(11) of the Act provided the amount was not otherwise included in a prior year.
- Subject to s. 18(1)(*a*), 18(1)(*o*.1), and 67 of the Act, any amount payable by ACO1 to the participants under the SAR plans in a particular taxation year would be deductible from income under s. 9 of the Act in that particular taxation year. This will also be the case for expenses incurred to implement or manage those plans.
- In case of death of a participant, any amount payable under the SAR plans to an heir would be considered a right or thing held by the deceased participant at the time of his death for the purpose of s. 70(2) and 70(3) of the Act.

Tax Ruling, Financial Industries and Trusts Division, 2015

Calculation of Earnings for LLCs

In November 2016, the CRA announced a new position on how to calculate the earnings of a disregarded US limited liability company ("LLC") operating an active business. Previously, the LLC had to calculate the earnings under Regulation 5907(1)(*a*)(i) of the *Income Tax Regulations* (the "Regulations"). Now, they must be calculated under Regulation 5907(1)(*a*)(iii). The new calculation is consistent with the entry into force of Regulation 5907(2.03) in 2013. The revised position will apply retroactively to the LLC's first taxation year ending after August 19, 2011. The CRA was asked to reconsider its position to the extent many taxpayers could have completed transactions on the basis of earnings calculated under Regulation 5907(1)(*a*)(i) instead of Regulation 5907(1)(*a*)(iii).

The CRA agreed to provide tax relief to the taxpayers for the following reasons:

- They incurred major compliance costs to calculate their earnings under Regulation 5907(1)(*a*)(i) and would incur additional costs to recalculate them under Regulation 5907(1)(*a*)(iii).
- The recalculation of the earnings could trigger adverse tax consequences unforeseen by the taxpayers when they undertook certain transactions.

If they used Regulation 5907(1)(*a*)(i) instead of Regulation 5907(1)(*a*)(iii) to recalculate the earnings of a foreign affiliate that was a disregarded US LLC for the taxation years ending before November 30, 2016, the CRA would accept their calculation if the taxpayer and all other persons related to the taxpayer used Regulation 5007(1)(*a*)(i) to calculate the earnings of all their foreign affiliates disregarded as US LLCs for taxation years ending before November 30, 2016. Alternatively, they could use Regulation 5907(1)(*a*)(iii) to calculate the earnings of all their foreign affiliates that were disregarded US LLCs for all taxation years of these LLCs that ended after August 19, 2011. On the other hand, earnings of a disregarded US LLC for any taxation year ending after November 29, 2016 should be calculated under Regulation 5907(1)(*a*)(iii).

IFA Conference, CRA Roundtable — Question 9, April 26, 2017

Dividend Refund to Private Corporation

The CRA was asked if a "private corporation" (as this term is defined in s. 89(1) of the *Income Tax Act* (the "Act") could decide not to claim a dividend refund to which it was entitled under s. 129(1) of the Act on its T2 corporate income tax return. The CRA confirmed that the corporation could choose not to claim the refund but that it may not make any difference since the CRA may decide to pay it anyway even if it did not receive any demand from the corporation. Their policy is to automatically refund the dividend to the corporation when all the information necessary to calculate the refund has been filed in the annex 3 of the T2SCH3 in the T2 corporate income tax return.

External Technical Interpretation, Reorganizations Division, May 12, 2017

Eligible Capital property — Transitional Rules

The CRA was asked to consider the following situation:

- In December 2016, the corporation, "ACO", sold its goodwill created over the years to an arm's length person.
- ACO also incurred before 2017 several eligible capital expenditures like incorporation costs or acquisition of trademarks
- ACO's taxation year ends on April 30, 2017

Referring to Question 13 of the CRA Roundtable at the 2016 Canadian Tax Foundation Annual Conference, the taxpayer asked the CRA if it could file the election under s. 13(38)(*d*)(iii) of the *Income Tax Act* for the sale of its goodwill. The CRA confirmed that only the facts would determine if ACO could file the election. To be allowed to file the election, ACO would have to demonstrate that it incurred an eligible capital expenditure in respect of a business before January 1, 2017.

The CRA noted that their answer to Question 13 of the CRA Roundtable was based on a different set of facts confirming that the taxpayer never incurred eligible capital expenditures in respect of a business before 2017. This was not the case for the facts of the above situation.

External Technical Interpretation, Business and Employment Division, March 9, 2017

Life Insurance Policy Transfer by Dividend in Kind

The CRA was asked to consider the following situation:

- "X" is the sole shareholder of the company, Holdco.
- Holdco is the holder and beneficiary of an insurance policy on X's life.
- Holdco wants to transfer its interest in the policy to X.
- Holdco declares an in-kind dividend by transfering the interest to X.
- At the time of declaring the dividend (which was after March 21, 2016), the interest had a $450,000 fair market value ("FMV") and a $240,000 redemption value.
- Immediately before that time, the interest had a $200,000 adjusted cost base ("ACB").

The CRA was asked what proceeds of disposition the transferor of the interest would be deemed to be entitled to receive under s. 148(7) of the *Income Tax Act* (the "Act") in respect of the above transfer. The taxpayer considered that, because X did not pay any consideration to Holdco for the interest, the proceeds of disposition for Holdco would be the greater of the redemption value and ACB of the interest.

The CRA confirmed that, since X did not give any consideration to Holdco for the interest, Holdco would be deemed to become entitled to receive proceeds of disposition equal to the greater the cash surrender value of the interest at the time of its transfer to X and the ACB of that interest to Holdco immediately before the transfer. As a result of the application of s. 148(7)(*a*) of the Act, Holdco would have a gain of $40,000 in respect of the disposition of the interest and X would be deemed to have acquired the interest for $240,000. In accordance with s. 12(1)(*j*) and 82(1) of the Act, X would have to include the fair market value of the interest ($450,000) grossed up under s. 82(1)(*b*). Since the redemption value of the interest at the time of its disposition was inferior to its FMV, the gain on its disposition to be included in Holdco's income is less than the one that would be included if the interest had been transferred to X for its FMV.

The CRA brought the tax results of this situation to the attention of the Department of Finance.

External Technical Interpretation, Financial Industries and Trusts Division, June 7, 2017

Capital Cost Allowance — Class 43.2 — De-Icing Equipment for Solar Panels

The situation considered by the CRA involved an individual taxpayer who had installed solar panels (i.e., photovoltaic equipment) on the roof of his principal residence and was intending to install de-icing equipment (i.e., aluminum shingles connected to an electric cable) beneath those panels. The de-icing equipment is new, attached to the existing

asphalt shingles, and not installed in areas of the roof where there is no panels. The purpose of the de-icing equipment is to melt any snow and ice accumulated on the panels to improve their efficiency.

The CRA was asked if the cost of the equipment could be included in Class 43.2 of Schedule II of the *Income Tax Regulations* (the "Regulations") for the purpose of claiming a 50% capital cost allowance.

The CRA confirmed that the de-icing equipment could be included in Class 43.2, but that this was essentially a question of fact and law. The taxpayer's intention was to resolve a problem caused by the deficient operation of those panels when they were covered with snow or ice in the winter. Since the equipment was necessary for the good operation of the panels during the winter and its main function was to benefit the panels (with negligible benefits to the house), its cost should be included in Class 43.2 provided all the other conditions were also met. Further, the equipment is not installed on the whole roof but only on areas near the existing panels. The CRA added that the cost of the equipment would not be related to the solar panels and would not be included in Class 43.2 if it was installed on the whole roof and not only near the panels.

The cost of the solar panels and de-icing equipment would only qualify for inclusion in Class 43.2 and the 50% capital cost allowance if the panels and equipment are located in Canada and used to earn income from a business carried on in Canada or from a property located in Canada (e.g., income from sale of excess electricity or income from renting the principal residence). Further, the capital cost allowance deduction claimed from the cost of the de-icing equipment would be limited by Regulation 1100(24) to the business or rental income earned from the property.

External Technical Interpretation, Reorganizations Division, May 16, 2017

Principal Residence Exemption — Farm Property

The CRA was asked to review the following situation:

- An individual taxpayer owns a single piece of land used to carry on a farming business.
- The land comprises a farmhouse treated by the taxpayer as his principal residence.
- The farmhouse and the land on which it is located cannot be legally severed from the land used to carry on the farming business.
- The taxpayer wants to retain beneficial ownership of the farmhouse and land on which it is located but transfer the remaining portion to a wholly-owned corporation which would continue to carry on the farming business for him.
- The purpose of the partial disposition of the farmland is to allow the taxpayer to claim a principal residence exemption from the capital gain realized on the sale of the farmhouse and underlying land when the whole farmland is sold by the corporation at a later date.

The CRA confirmed that the individual taxpayer could not claim the principal residence exemption on the future disposition of the farmland (including the farmhouse and land on which it is located) by the corporation. The CRA's long-standing position is that the essential rights of ownership of a property used as principal residence (i.e., whole farmland, not only farmhouse portion) cannot be transferred or retained separately from the rest of the property. If the taxpayer decides to transfer the property to a corporation, he loses the right of alienation (i.e., ability to transfer the property). The rights of possession and alienation are two essential elements of ownership in the context of a principal residence. Without those rights, the taxpayer stops owning the farmhouse after the sale to the corporation and therefore cannot claim a principal residence exemption at a later date.

External Technical Interpretation, Business and Employment Division, June 21, 2017

Capital Gains Exemption — Farm Property

The CRA was asked if the capital gains exemption could be claimed in the following situation:

- An individual's parent owned a piece of land that was actively farmed by him for many years until his death.
- The individual's surviving parent then sold a portion of the land and rented out the rest of the land to another arm's length farmer until a portion of the land was transferred to the individual.
- The individual continued to rent the land to an arm's length farmer until it was sold.

The CRA confirmed that the availability of the capital gains exemption in respect of the sale of a "qualified farm or fishing property (QFFP)" as defined in s. 110.6(1) of the Act) was a question of fact but offered the following general comments:

- S. 110.6(2) and (2.2) of the *Income Tax Act* (the "Act") allow a Canadian resident individual having disposed of a QFFP after April 20, 2015 to claim a maximum capital gains exemption of $500,000.
- A QFFP includes any real or immovable property used by a taxpayer or his or her spouse, common-law partner, child, parent, or grandparent to carry on a Canadian farm business.
- Assuming the land was acquired before June 18, 1987, one of the two conditions listed in s. 110.6(1.3)(*c*) of the Act must be met for the land to be considered used in the course of carrying on a Canadian farming business. First condition: in the year the land was sold or replaced, it was used mainly in a Canadian farming business by the individual or his or her spouse, common-law partner, child, parent, or grandparent. Second condition: the land or land it replaced was used mainly in a Canadian farming business for at least 5 years and owned by any of the above persons. A land is used mainly in a farming business if more than 50% of its use is in respect of the farming business operation.

Therefore, if one of the individual's parents used the land mainly in a Canadian farming business for at least 5 years, the applicable test in s. 110.6(1.3)(*c*) of the Act should be met and the capital gains exemption could be claimed when the land is subsequently sold.

External Technical Interpretation, Business and Employment Division, June 21, 2017

Purpose Tests and Allocation of Safe Income

The CRA was asked to consider the following situation:

- "Opco" was a private corporation held by "A" and "B" and carrying on an active business.
- A and B dealt at arm's length with each other and paid $50 each to acquire 50 Class AA participating and non-voting shares of Opco.
- On January 1, 2016, immediately after Opco's taxation year-end, the Class AA shares had a value of $500,000 and a safe income on hand ("SIOH") of $300,000.
- Each of A and B also held 50 Class A voting and participating shares in Holdco.
- Holdco held 100 voting, non-participating, and redeemable Opco shares subscribed for $100.
- On January 1, 2016, Holdco subscribed $100 for 100 Class X shares which were non-voting but had the right to participate in Opco's annual benefits in proportion to the total number of Class AA and Class X shares issued. The redemption value was based on Opco's after-tax net income in the above proportion and on the issued and paid-up capital.
- Every year, Opco confirmed its after-tax net income allocable to the Class X and AA shares.
- Class X shareholders receive dividends for the benefits accumulated since their shares were issued and their redemption value was reduced by the same amount.
- On December 31, 2016, Opco had $100,000 of after-tax net income and $100,000 of SIOH. For 200 Class AA and Class X shares issued, the Class X shares had a redemption value of $50,100 [$100,000 x 100/200) + $100] on January 1, 2017. The $50,000 capital gain on the Class X shares was completely attributable to the income accumulated in the year and the SIOH was also $50,000. The total value of the shares was $600,000 on December 31, 2016.
- On January 1, 2017, Opco paid a dividend of $50,000 to Holdco first for protecting its assets and second for not keeping excess liquidities to make sure that the Class AA shares always qualified for the capital gains exemption.
- After paying the dividend, the redemption value of the Class X shares was reduced to $100.

The CRA was asked the following questions:

(1) Do we meet the purpose tests of s. 55(2.1)(*b*) of the *Income Tax Act* when a dividend is paid to purify a corporation for capital gain exemption purpose?

(2) How do we allocate Opco's SIOH to Class AA and X shares in the following situation:

- Each Class AA and Class X share authorizes the shareholder to participate each year in the annual profits of the corporation in proportion to the number of shares of the Class AA and Class X shares issued at year-end.
- A dividend is paid on Class X shares for the amount of profit to which it is entitled.
- No dividend is paid on Class AA shares.
- The dividend paid on Class X shares decreases the value of Class X shares but does not decrease the value of Class AA shares.

(3) How is the SIOH allocated between Classes AA and X shares if, in a year, the increase in value of Class AA shares is higher than the increase in value of Class X shares because of an unrealized increase of the value of one asset?

(4) Is it possible to isolate the SIOH in one class of shares?

The CRA offered the following answers to those four questions.

(1) The CRA will have to review all the information (including the purpose of the purification) relevant for this situation to be able to take a position on this situation.

(2) The CRA will apply the "Robertson Rules" issued in 1981 stating that the income will be attributable to a particular class of shares in the same ratio in which each class is entitled if all earnings of Opco, but not the share capital, were distributed. Furthermore, the SIOH is allocated to each class in respect of the shareholder's holding period of the shares. In this situation, the dividend paid on Class X shares would not reduce the SIOH in respect of Class AA shares since the value of those shares is not reduced by such dividend.

(3) Same answer as for Question 2. Since the increase in value of the corporation's assets is unrealized and does not form part of Opco's SIOH, the SIOH would not contribute for that year in the part of the hypothetical capital gain of the Class AA shares.

(4) No, such isolation is not possible. See answer to Question 2.

External Technical Interpretation, Reorganizations Division, April 6, 2017

T4A Reporting — Producer Paying Benefits to an Artist

The CRA has reversed Technical Interpretation No. 2013-0507171I7, released on March 7, 2014. In that interpretation, the CRA had confirmed that a producer, having hired an incorporated artist as a self-employed, had to issue a Form T4A to the artist for amounts paid by the producer to the Union des Artists ("UDA") for the benefit of the artist. The CRA relied on Guide RC4157 stating that a person providing benefits to employees of its subcontractor was a third party payor in respect of the employees. The CRA has now confirmed that the producer did not have to issue a Form T4A to the artist for the amounts paid to the UDA since the UDA, not the producer, was providing the benefits to the artist. The artist must include in his employment income any benefits arising from the contributions made by the UDA unless they are exempted under s. 6(1)(*a*)(i) of the *Income Tax Act*. For more background information, see summary no. 12,430 in Window on Canadian Tax Reporter.

Internal Technical Interpretation, Business and Employment Division, November 21, 2016

Withholding on Remuneration Paid to a Non-Resident

The CRA was asked to consider a situation where a Canadian resident corporation paid a salary and director fees to a US-resident individual who never entered into Canada to perform services. The individual would always use the phone or the internet to participate in meetings from outside Canada. The CRA was asked if the corporation would have to withhold tax from the amounts paid to the US resident and provide him with a Form T4 or other information slip.

Relying on Regulation 104(2) of the *Income Tax Regulations* (the "Regulations") and the definition of the term "employee" in s. 248(1) of the *Income Tax Act* (the "Act"), the CRA confirmed that the corporation would not have to withhold any tax from the amounts paid to the US individual. However, unless the remuneration paid was under $500, the corporation would be required by s. 153(1) of the Act and Regulation 200(1) to report the salary on a Form T4. Such reporting requirement would not be conditional on the US individual being taxable in Canada. The CRA considered that the attendance of meetings from outside Canada by phone or internet would not constitute services performed in Canada and would not be subject to withholding tax.

External Technical Interpretation, International Division, March 9, 2017

RECENT CASES

Taxpayers not entitled to Capital Gains Deduction on their disposition of corporate shares, since corporation not a CCPC

Federal Court of Appeal, November 25, 2016

Gestion Lagarde held all of the shares of Dale Parizeau, which operated an insurance brokerage business. RJCG owned all of the common shares of Gestion Lagarde, and Aviva, an Ontario corporation, owned all of the preferred shares of Gestion Lagarde. Aviva International, a non-resident corporation, was the parent of Aviva. RJCG, Aviva, Gestion Lagarde, and Dale Parizeau were parties to a unanimous shareholders' agreement (the "USA"). Article 6 of the USA recognized that Aviva had been given an option to acquire up to 66.305% of the Class A common shares of Gestion Lagarde. Article 7.3 of the USA granted Aviva the right to purchase from RJCG its Class A shares of Gestion Lagarde. Article 7.3 had undergone several modifications which gave rise to a number of questions, including the effects of a certain letter of December 20, 2005. Relying on paragraph 251(5)(*b*) of the *Income Tax Act* (the "Act"), the minister refused the taxpayers the capital gains deduction claimed by them with respect to their sale of their shares of RJCG, on the ground that RJCG was not a CCPC. (Paragraph 251(5)(*b*) provides that, for certain purposes, the holders of options to purchase shares are to be treated as the owners of those shares). In the minister's view, it could be assumed that the effect of the previously mentioned letter of December 20, 2005, was to accord to Aviva the right to acquire the controlling shares of RJCG, thus conferring on Aviva the control of RJCG, while Aviva itself was controlled by the non-resident corporation Aviva International. On appeal to the Tax Court of Canada, the taxpayers argued that: (a) the options conferred on Aviva under Articles 6 and 7.3 of the USA (the "Options") infringed section 148 of the *Act Respecting the Distribution of Financial Products and Services* (the "DFPSA"), since they conferred on Aviva more than 20% of the shares of Dale Parizeau; (b) under paragraph 251(5)(*b*) Aviva was deemed to have exercised the Options, so that it was the owner of the shares covered by the Options for purposes of section 148; and the Options were therefore void. The Tax Court refused to accept the arguments that the Options were void, and upheld the minister's position accordingly. On the taxpayers' appeal to the Federal Court of Appeal, they chose to limit their presentation to the question of whether the Options were void, admitting that if their arguments on this point failed, their appeals would be dismissed. While supporting the Tax Court judge's findings, the Crown questioned the Tax Court's jurisdiction to determine the issue of whether the Options were void, arguing that this question fell within the exclusive jurisdiction of the Quebec Superior Court.

The taxpayers' appeals were dismissed. As the Tax Court judge correctly pointed out, he had jurisdiction to determine whether the Options were void, and was required to make this determination solely for the purposes of ascertaining the validity of the minister's assessments. The fact remained, however, that Aviva had not exercised the Options. And although the taxpayers' counsel recognized that there was no provision in the DFPSA which was equivalent to paragraph 251(5)(*b*) of the Act, he sought to argue that the words "held directly or indirectly" in section 148 of the DFPSA were intended to encompass not only the holding of shares but the holding of options to acquire those shares as well. The Tax Court judge rejected this argument on the ground that there simply was no provision in the DFPSA which was equivalent to paragraph 251(5)(*b*) of the Act. The Tax Court was correct, since the reality is that a future right to acquire shares is not the same as the actual holding of those shares. As a result of the foregoing analysis, the taxpayers' argument that the Options were void was untenable. The minister's position was affirmed accordingly.

Durocher v. The Queen, 2017 DTC 5050

Taxpayer Successfully Challenges a Demand for Information

***Rosenberg v. MNR*, 2017 DTC 5011 (Federal Court)**

This case was a judicial review application brought by the taxpayer to review an auditor's exercise of power with respect to issuing a demand letter under section 231.1 of the Act. The demand letter at issue was seeking information pertaining to taxation years that had already been reviewed by the CRA, and in respect of which the taxpayer and Minister had already reached an agreement. This case provides insight into the standard of review applicable to the exercise of power under section 231.1, and demonstrates the court's willingness to uphold agreements between taxpayers and the Minister.

In February 2010, the taxpayer and an auditor signed a letter regarding certain straddle transactions in the taxpayer's 2006 and 2007 taxation years. This letter was the "agreement" at issue in this case, specifically its scope and validity. The letter stated that, after review of the relevant transactions and applicable law, the CRA was satisfied with the taxpayer's reporting position. However, the CRA added that its position may change if (1) the taxpayer, the taxpayer's spouse, and/or future executors engaged in similar "straddling transactions" in the future, or (2) if the fact pattern on which the auditor based its conclusions changed.

In January 2013, an auditor who was not a party to the 2010 letter sent a demand letter requesting further information on the 2006 and 2007 returns of the taxpayer. The demand letter specifically stated that the review was in relation to the "straddle loss" in those years. It was not disputed that this "straddle loss" was the same transaction reviewed in 2010.

The taxpayer took the position that the 2010 letter was a binding agreement, which barred the Minister from re-auditing or reassessing the taxpayer's 2006 and 2007 taxation years unless the taxpayer breached the 2010 "agreement". The taxpayer argued that the 2010 letter must be binding in order to bring certainty to arrangements between taxpayers and the CRA. On the other side, the Minister made two key arguments. First, the 2010 letter did not bar an audit, it barred an assessment, and audits and assessments are two different things. Secondly, the Minister argued that if there were an agreement, it would be void as such an agreement would be illegal and contrary to the Act and public order.

The court began its analysis by raising the issue of the standard of review that should apply to this case, an issue that the parties had not raised. The matter under judicial review was the exercise of power by the Minister under section 231.1 of the Act when it issued the demand letter in 2013 despite the "agreement" in 2010. The court stated the default standard of review of a decision by the Minister was reasonableness; however, the court noted that there was a "cogent argument for why reasonableness should not be used". Ultimately, the court decided not to reach a conclusion on the standard of review applicable because, even if the Minister were given a generous standard of review, the Minister's interpretation did not fall "within the range of acceptable and rational solutions".

The court then proceeded to review the subject matter of the dispute, and stated that there were two issues to be determined:

- As a matter of contractual interpretation, what was the scope of the 2010 letter?
- Was the 2010 letter a binding agreement?

On the first issue, the Minister claimed that the interpretation of the "agreement" should be narrow, arguing that it stood only for declining to reassess the 2006 and 2007 taxation years at the point in time of the letter. The court found that this interpretation was unreasonable as the agreement would be valid only on the day it was made, and then invalid the next day. The Minister also tried to argue that in order to determine if the taxpayer had breached the conditions of the "agreement", for example, due to a change in the fact pattern, the Minister should not be precluded from a new review under section 231.1 of the Act.

To determine the scope of the "agreement", the court interpreted the contract using the applicable law, which was the *Quebec Civil Code*. The court found that there was an agreement between the parties whereby the taxpayer benefited from not being reassessed for the 2006 and 2007 tax years if he refrained from conducting business in a way that would create straddling transactions — there was a *quid pro quo*. The court found the agreement to be neither ambiguous nor vague. Further, there was no allegation that the taxpayer's fact pattern had changed or that the taxpayer had engaged in any further straddling transactions.

Lastly, the court determined that the letter clearly stated that the CRA would not proceed with any reassessments of the 2006 and 2007 taxation years regarding the straddling transactions. The court held that based on the following factors the 2013 demand letter was part of the process of proceeding with a reassessment: the 2013 auditor was a member of the Specialty Audit Section of the International and Ottawa Tax Services Office; the 2013 letter stated it was a compliance audit; and the new audit from Ottawa, and not Montreal, had the aim of reassessing the taxpayer.

To address the second issue, whether there was a valid and binding agreement, the court first considered an argument made by the Minister that such an agreement is not valid because an agreement cannot waive the Minister's obligation to enforce the Act. The Minister relied on section 220 of the Act, which states that "[t]he Minister shall administer and enforce this Act". The court interpreted section 220 and the use of the word "shall", and held that in the context of this provision, the word "shall" was simply Parliament vesting the executive branch with certain powers and jurisdiction. The court added that section 220 requires the Minister to administer and enforce the Act, but does not mandate how this is to be done. The Minister did not waive its duty by entering into the 2010 "agreement", but rather chose to enter into the agreement as a means of administering and enforcing the Act.

The court then considered whether the agreement was valid. The Minister argued that, based on the *Galway* (74 DTC 6247) line of cases, it cannot be bound by an agreement where, if the facts are known and the law is understood, the agreement is to assess an amount that is less than the amount that the Act provides. The court held that this proposition from the *Galway* line of cases was correct but was limited in scope and only stands for the position that once the facts are determined, the law is applied and there is one result, an agreement cannot depart from that. The court went on to add that, from a policy standpoint, tax disputes are settled every day and settlement should be encouraged. An agreement that does not encroach on the *Galway* line of cases will be enforceable. In this case, the assessment of the taxpayer's liability had already taken place in 2010 and no evidence was provided to suggest that it was not justifiable on the facts and law. In fact, the agreement stipulated that if the facts changed, the Minister could proceed with a reassessment.

Lastly, in considering the second issue of the validity of the contract, the court considered whether or not it would be contrary to public order to find an agreement that limited the Minister's powers to be valid. The Minister put forward a bold proposition that the "law is clear, no agreement between the Minister and taxpayers can interfere with the Minister's powers to conduct audits". The court held that legislative power cannot be fettered, but there was no such fettering in this case. The real question is whether or not a contract is compatible with the objectives of the legislation. In conclusion, the court held that the Minister was not fettering its discretion, and that the agreement was in furtherance of the legislative goals as it allowed the matter to be settled.

— Andrea Schneider, Articling Student

Minister Unable To Discharge Onus To Allow Reassessment Beyond Normal Reassessment Period

***Kotilainen v. R.*, 2017 DTC 1006 (Tax Court of Canada)**

This case is an interesting example of a situation where the Minister was unable to discharge the onus of proving that the taxpayer made a misrepresentation in circumstances that would allow the Minister to reassess the taxpayer beyond the normal reassessment period. More particularly, the Minister was unable to show that the amounts alleged to be shareholder benefits were not repayments of shareholder advances, as asserted by the taxpayer.

In the 1980s, the taxpayer invested in a rundown and unprofitable motel with some co-investors. The venture was not successful and, at some point, the taxpayer formed a corporation and became its sole shareholder to buy out the interests of the co-owners and have the corporation own and operate the motel. From 1991 to 2002 the corporation declared $425,000 in tax losses, and the taxpayer had to fund these losses using his personal funds. In 2002, the taxpayer refinanced the mortgage of his personal residence and used more than 50% of the loan proceeds to fund the corporation's operations.

In 2003, the corporation received proceeds of $235,000 from mortgaging the motel property and the taxpayer received $96,451 and $70,701 of those funds in 2003 and 2004, respectively. Since no amounts were recorded in the relevant company balance sheets as loans from the shareholder, the Minister reassessed the taxpayer to include the amounts in income as shareholder benefits. The Minister also imposed gross negligence penalties. By the time the matter reached

the Tax Court, the Minister had agreed to withdraw the gross negligence penalties and reduce the alleged shareholder benefit by more than half.

The CRA's audit of the taxpayer began in November 2008 and was not completed until April 2011. Since the normal three-year limitation period for 2003 and 2004 had expired before 2011 without a waiver being requested by the CRA, the Minister was only entitled to reassess if the taxpayer had made a misrepresentation attributable to neglect, carelessness, or wilful default in connection with the reassessed amounts.

When the Minister seeks to rely on subparagraph 152(4)(*a*)(i) to reassess a taxpayer beyond the normal reassessment period, the jurisprudence establishes that the Minister has the onus of proving that the taxpayer made a misrepresentation and that the misrepresentation was attributable to neglect, carelessness, or wilful default. In this case, there was an issue as to whether the taxpayer had made a misrepresentation at all in his 2003 and 2004 tax returns since the taxpayer's explanation for those amounts was that they were repayments of unrecorded shareholder advances to the corporation.

From an evidentiary standpoint, it seems that the Minister was relying on the fact that the corporation's balance sheets for the relevant years did not show any recorded liabilities to shareholders, together with a "deposit" analysis showing that the assessed amounts flowed from the corporation to the taxpayer.

However, in light of the evidentiary burden placed on the Minister in the circumstances, the Tax Court (*per* Hogan J.) decided that the use of the deposit method was an inadequate method in the circumstance for trying to show that the amounts could not be explained away as repayments of shareholder loans, as argued by the taxpayer. The Court indicated that a combined net worth analysis — accounting for the economic inflows and outflows for both the taxpayer and corporation — over a period of years would have likely been required for the Minister to discharge the onus of proof in this type of case. Had the Minister done so, the Court suggested that the outcome of the case may have been different. In the meantime, the Court considered it plausible that the financial statements (prepared by the taxpayer's stepson, who was not a professional) would not accurately reflect the corporation's outstanding liabilities to its sole shareholder, and that the taxpayer's conduct during subsequent years was consistent with a practice of him advancing money to the corporation to fund its operations.

Interestingly, the Appellant was self-represented and was under the mistaken belief that his documentary evidence would be entered into the Court's record by the Minister. The Court commended the Minister's counsel for his assistance in ensuring that the taxpayer's documentary evidence and his case in general were properly presented to the Court. Thus, despite the fact the Minister lost this appeal and that costs normally follow the cause, the Court found that the taxpayer greatly benefited from the assistance provided to him by the Minister in presenting his case and the Court ruled that it is only fair that each party bear its own costs (although the taxpayer's out-of-pocket costs in this case would likely have been nominal, if the taxpayer did not engage legal counsel to assist him with any stage of the Tax Court proceedings).

— Dean Xiao, Articling Student

Minister's denial of business expenses upheld where taxpayer having no source of income

Tax Court of Canada, April 12, 2017

During the 2011 taxation year the taxpayer operated a corporation offering financial consulting services, and was the sole shareholder of that corporation. For that year, the taxpayer reported registered retirement savings plan income of $129,075, gross business income of $0 and business expenses of $46,003. The business losses claimed were denied by the Minister on assessment. The Minister alleged that the taxpayer did not carry on a business on his own and had no source of business income, and that the expenses claimed were not incurred in order to gain or produce income from a business. The taxpayer appealed to the Tax Court of Canada, taking the position that he earned consulting fees for the work he did for his corporation as a sole proprietor and that the expenses claimed were with a view to earn income from the business.

The appeal was dismissed. The Court noted that the burden of proof of deductions and claims rested with the appellant. The jurisprudence with respect to the existence of a source of income requires a two-stage test. The first stage of that test consists in assessing the general question of whether a source of income exists, while the second

stage consists in categorizing the source as either business or property. The Court reviewed the evidence before it and held that it was not clear in what capacity the appellant carried on his activities. The Court was satisfied that the appellant's activities as a financial services consultant could not be considered as a personal endeavour, but that the nature of the relationship between the appellant and his corporation had not been clearly established and no agreement between the appellant and the corporation had been filed as evidence. The Court reviewed the income and expense amounts reported by the appellant and by his corporation for the 2009 through 2013 taxation years. Based on that information, it concluded that the appellant never intended to make a profit from his business activities and that he used his expenses strictly as a means to reduce his income from his RRSP. Despite realizing a loss in 2010, the appellant continued to incur expenses at a very high level. As well, the Court found that the testimony given by the appellant could not be relied upon and that the documentary evidence provided was both redacted and backdated. It concluded that the appellant had no source of income during the 2011 taxation year and that he did not carry on his activities in a commercial manner or with a business-like endeavour.

Peckitt v. The Queen, 2017 DTC 1029

Parking pass provided to employee properly assessed as taxable benefit

Tax Court of Canada, April 21, 2017

The taxpayer was employed as a flight attendant for an airline. As required by the applicable collective agreement, the airline provided the employee with a monthly parking pass which he could use to park at the airport. The Minister of National Revenue assessed the employee as having received a taxable benefit equal to the value of that parking pass and included the amount of $504 in his employment income for the year as a result. The taxpayer appealed from that assessment.

The appeal was dismissed. The only issue for determination was whether the taxpayer received a taxable employment benefit in the amount of $504 for the 2011 taxation year. The applicable rule is that any material acquisition in respect of employment which confers an economic benefit on a taxpayer falls within paragraph 6(1)(a) of the *Income Tax Act* and is therefore a taxable benefit, unless there is an exemption. One such exemption arises where the material acquisition at issue was provided to the employee primarily for the benefit of the employer. In such instances, even if the employee enjoyed a personal benefit from the use of the acquisition, that benefit is not taxable. The Court was therefore required to determine, on a balance of probabilities, if the taxpayer was the primary beneficiary of the parking pass or if the primary beneficiary was his employer. It reviewed the evidence provided by witnesses, including the taxpayer, and concluded that it was not presented with any evidence of a correlation between the use of the airport parking lot by flight attendants and the existence of a benefit to the employer. It could not conclude, therefore, that the employer received any benefit from the taxpayer's use of the parking pass which it provided. With respect to the taxpayer, the Court concluded that he had to use his car and therefore had to have a parking pass in order to work for the airline, and that such would have been the case whether the employer was paying for that pass or not. The Court held that the taxpayer received only one benefit, being the economic benefit that was measurable in monetary terms. The value of the benefit was the total value of the parking pass for the 2011 taxation year, or $504. and the minister properly assessed such benefit.

Smith v. The Queen, 2017 DTC 1031

Appeal from denial of SR&ED tax credits allowed

Tax Court of Canada, April 27, 2017

The corporate taxpayer was owned by two brothers who were the only officers and directors of the corporation and each of whom held 50% of the corporation's shares. Both worked for the corporation and each received a salary and dividend payments during 2010. The corporate taxpayer claimed scientific research and experimental development (SR&ED) tax credits on its return for the 2010 taxation year. That claim was disallowed in part on reassessment, on the basis that only a portion of the salary amounts paid to the two shareholder employees was paid in respect of qualifying SR&ED work. The taxpayer appealed from that reassessment.

The appeal was allowed. The Court held that it was required to determine whether the appellant corporation was entitled to claim 100% of the salary and wages paid to the shareholder employees, or the lower percentages determined by the minister. The Court reviewed the compensation structure of the corporation and the activities

undertaken by the shareholder employees before concluding that the position taken by the respondent was not consistent with the facts before the Court. That evidence showed that the shareholder employees were compensated in the form of dividends in lieu of salary for "director or management activities" undertaken for the appellant corporation. The Court noted that, as controlling shareholders of the appellant, the shareholder employees were entitled to choose the form of compensation received, and were not required to enter into a formal agreement. The appellant corporation had based the total salary and wages paid to the shareholder employees on the hours they worked on specific SR&ED projects, and it properly claimed all such amounts as an expenditure in respect of SR&ED. The minister's assessment was referred back to the minister for reconsideration and reassessment on that basis.

AG Shield Canada Ltd. v. The Queen, 2017 DTC 1034

Expenses claimed for musician fees were properly denied as they were not documented or reasonable

Tax Court of Canada, April 26, 2017

The taxpayer operated a sole proprietorship business as a performing artist and a freelance talent searcher and operated a music studio. He was appealing reassessments for his 2008-2011 taxation years regarding expenses claimed in computing his income. At the beginning of the hearing the minister conceded that all expenses claimed were fully deductible except for telephone and utilities claims which were partly allowed and associate musician fees which were denied. The taxpayer claimed payments of $38,000 to Amy Todd and $13,500 to Scott McManus. He testified that he used Todd as a sounding board to get perspectives on what was popular and retained McManus, an engineer, to mix tracks for him. Both Todd and McManus were friends of the taxpayer. The taxpayer's returns for the 2008-2011 taxation years were filed late in June 2014.

The appeal was allowed on the basis that all expenses claimed in computing business income were fully deductible except for telephone and utility expenses which were partly deductible. The deductions claimed for associate musician fees were denied. The burden of proof is on the taxpayer to prove that expenses were incurred to earn business income and that they were reasonable. As evidence, the taxpayer submitted his tax returns, documents signed by Todd and McManus confirming receipts of the claimed amounts and bank statements for a three month period showing payments to Todd and McManus of $780 and $1300 respectively. Todd testified that she acted as a music consultant, that she was contacted by the taxpayer on a daily basis but that they had no formal arrangements. She did not keep records, had no idea of the value of the services she rendered and testified that the taxpayer decided when and how much to pay her. There were no written contracts with Todd and McManus, no invoices were submitted, no records were kept regarding dates and number of consultations and payments were made by cash or interact transfers. The taxpayer failed to keep proper books and records to substantiate his expenses. He was vague as to what exact services Todd and McManus provided and his returns were filed years late, long after the fees were paid. Although he was carrying on a commercial venture, the minimal documentation he provided was insufficient to justify the deductions. Even if the expenses were incurred, the Court was not satisfied that they were incurred to earn business income nor that they were reasonable.

Costanzo v. The Queen, 2017 DTC 1035

Corporate taxpayer's appeals largely successful; taxpayer awarded costs in excess of Tariff amounts

Tax Court of Canada, November 10, 2016

The corporate taxpayer's two appeals were from assessments in which the minister disallowed all of the expenses claimed as deductions, characterizing them as capital expenditures. The Tax Court of Canada allowed both appeals in part. As a result, the taxpayer was permitted to deduct substantially all of the expenses that it had initially claimed in its returns, which was a significant victory. At its costs hearing, the taxpayer asked for a lump sum costs award of $518,112 in respect of one appeal and $419,377 in respect of the other. This request represented 55% of the taxpayer's solicitor-client costs incurred. The taxpayer also requested reimbursement of its disbursements of $42,553.54.

The taxpayer's request was granted in part. The parties agreed that there is a strong tendency in the case law to find that costs awards should not be distributed on the basis of success achieved on each individual issue but should be based on the overall result of the appeal. Taking into account all of the factors enumerated in subsection 147(3) of the *Tax Court of Canada Rules* (i.e., amounts in issue, importance of the issue, offers of settlement, and volume and complexity of the work involved), and, in the absence of meaningful settlement discussions in this case, the taxpayer should be awarded 30% of its legal fees of $1,704,527.20, which translated into an award of lump sum partial indemnity costs of $511,358 for both appeals. The taxpayer was also entitled to 100% of its disbursements in the amount of $42,553.54.

Rio Tinto v. The Queen, 2017 DTC 1030

Corporate taxpayer not entitled to orders declaring invalid certain SR&ED reassessments, and certain other SR&ED reassessments made beyond normal reassessment period

Tax Court of Canada, April 26, 2017

The corporate taxpayer RTA was a co-owner of AAI, a corporation incorporated in 1989 to manage and exploit the production of aluminum at Sept-Iles in Quebec. In reassessments dated July 14 2011 (for the taxation year ending December 31, 2006), September 22, 2011 (for the taxation year ending October 31, 2007), and November 10, 2011 (for the taxation year ending December 31, 2007), (and collectively referred to as "the Reassessments"), the CRA disallowed a portion of the SR&ED expenses and related investment tax credits ("ITCs") claimed by RTA in respect of the operations of AAI. M, an assessor with the CRA, had prepared the Reassessments in accordance with what she had perceived to be an agreement reached with RTA relating to its own SR&ED and ITC claims. M had also undertaken to issue reassessments for RTA as soon as RTA's audit for 2006 and 2007 was completed by the Quebec tax authorities. During the course of its appeal from the Reassessments to the Tax Court of Canada (the "TCC"), RTA moved for orders: (a) declaring the Reassessments invalid; and (b) declaring invalid, in part, reassessments made beyond the normal reassessment period and dated April 19, 2013 and October 3, 2013 (for the December 31, 2006 and October 31 2007 taxation years respectively), on the ground that they were statute-barred. Some of RTA's concerns were that: (a) for the 2006 and 2007 taxation years in issue, the minister had arbitrarily refused the SR&ED expenses and related ITCs claimed by RTA in respect of AAI, without any verification process by the Quebec tax authorities; (b) the CRA assessor in this case had no awareness of AAI's SR&ED activities, and hence no factual basis upon which to base the Reassessments; (c) these failures on CRA's part were fundamental to the validity of the reassessment process and not merely technical deficiencies in that process. During the hearing RTA brought the following questions before the Court for determination under section 58 of the TCC Rules (General Procedure): QUESTION A: Was the minister authorized under the *Income Tax Act* (the "ITA") to issue the Reassessments without a prior examination of the relevant facts and a prior determination of the amount of tax owing? And, if not, were the Reassessments invalid as they related to the SR&ED and ITC claims disallowed by the minister for the periods in issue? QUESTION B: Was the minister authorized under the ITA to issue the reassessments dated April 19, 2013 and October 3, 2013 which were beyond the normal reassessment period mentioned in paragraph 152(3.1)(a) of the ITA? If not, were these reassessments invalid having regard for the elements forming the object of reassessments which are not mentioned in subsections 152(4) and 152(4.01) of the ITA?

The taxpayer's motion was dismissed. The answer to QUESTION A was: The Reassessments were valid. And the answer to QUESTION B was: the minister was authorized to include in the reassessments dated April 19, 2013 and October 3, 2013 the amount of tax payable, but unchanged from the tax assessed in prior assessments made within the normal reassessment period, and dated July 14, 2011 and May 11, 2012. In support of these answers, some of the Court's observations were that: (a) AAI's conduct in failing to remit to the Quebec taxing authorities promptly the materials requested by them certainly did not assist them in coming to a determination as to whether AAI's activities involved SR&ED; (b) M was thoroughly experienced in the SR&ED field, had been responsible for RTA's file from 2003 to 2013, and had taken a number of steps, including considering taking waivers from RTI (which its advisors rejected), prior to actually proceeding with the Reassessments; (c) it is not for the Court or anyone else to prescribe what the intensity of the examination by the CRA of a taxpayer's return in any given case should be, since that is the prerogative of the minister (see Western Minerals Ltd. v. MNR [1962] SCR 592); (d) according to section 166 of the ITA, "an assessment shall not be vacated or varied on appeal by reason only of any irregularity, informality, omission or error on the part of

any person in the observation of any directory provision of this Act"; (e) in light of the decision in Ginsberg v. The Queen [1996] 3 FC 334 the effect of section 166 is to deem an assessment to be valid despite any failure on the minister's part to meet any of the requirements of subsection 152(1) of the ITA; (f) the minister is not empowered under subsection 152(4.01) of the ITA to produce reassessments or supplementary assessments after the normal reassessment period which change the previous assessment; (g) subsection 152(4.01) provides that the changes that the minister may make by way of reassessment after the normal reassessment period may only relate to the items listed in that subsection; (h) by virtue of subsection 152(4.01) the minister in this case was entitled to proceed by way of reassessment or supplementary assessment; and (i) requiring the minister to make only supplementary assessments in order to preserve prior valid assessments would run counter to the purpose of subsection 152(4.01).

Rio Tinto Alcan Inc. v. The Queen, 2017 DTC 1036

Applications for extension of time to file Notices of Objection dismissed

Tax Court of Canada, May 2, 2017

The taxpayer was the sole shareholder and director of a corporation. Her business was audited and proposed reassessments were issued in November of 2014 for her personally and for the corporation. The taxpayer disagreed with the reassessments and retained the services of an agent to file Notices of Objection to those reassessments. The agent retained did not file a formal Notice of Objection but did, in September of 2015, send a letter to the Canada Revenue Agency in which he indicated that an "appeal process" would be initiated. The CRA undertook collections action, following which the taxpayer and the corporation brought applications, in July 2016, seeking an extension of time in which to file Notices of Objection to the 2014 reassessments.

The applications were dismissed. The Court held that the issues for determination were whether the applications filed by the taxpayers for an extension of time to file Notices of Objection met the requirements of subsection 166.2(1) of the *Income Tax Act* and, in the alternative, whether the letter sent in September 2015 could be characterized as an application for an extension of time to file such Notice of Objection. The applicants had conceded at the conclusion of the hearing that the applications filed in July 2016 were made out of time in that they were filed more than one year "after the expiration of 90 days after the day on which notification of the decision was mailed to the taxpayer". The only issue for determination by the Court was therefore whether the September 2015 letter could be recognized as a valid application for an extension of time. The Court held that such determination must be based on the provisions of subsection 166.2(5), and that, even if the letter was sent within the time period required by the statute, it did not meet the criteria set out in that subsection. In particular, the letter did not reference the statutory time limits and did not mention that the taxpayer was seeking an extension. As well, it did not indicate a reason why the Notices of Objection were not timely filed. The Court concluded that the letter did not constitute an application to extend the time for filing a Notice of Objection and consequently, no such application had been brought within the statutory time limit. While the Court acknowledged that the fault for the failure lay with the taxpayer's representative and not with the taxpayer, the Court was nonetheless required to make its decision based on the specific statutory provisions, and the application was dismissed.

Thangarajah v. The Queen; 1670000 Ontario v. The Queen, 2017 DTC 1038

Following issuance of net worth reassessments, minister ordered to reassess to delete penalties for gross negligence, and to recalculate amounts to be added to taxpayer's reported income

Tax Court of Canada, May 4, 2017

The taxpayer operated a retail flower business as a sole proprietor. In net worth assessments made beyond the normal reassessment period, the minister added to the taxpayer's reported income for 2002 to 2006, for income tax purposes, the respective amounts of $51,842, $77,774, $68,403, $128,090, and $114,140. Penalties for gross negligence were also imposed. Corresponding net worth assessments covering the taxpayer's unreported income for GST purposes were also made, and these also included penalties for gross negligence. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was allowed in part. To justify reassessments made beyond the normal reassessment period, the minister must establish misrepresentation on the taxpayer's part which is attributable to neglect, carelessness, willful

default, or fraud (see clause 152(4)(*a*)(i) of the *Income Tax Act* (the "ITA")). In the present proceedings, there still existed a discrepancy between the income reported by the taxpayer and the income calculated by the minister using the net worth method. In addition, the taxpayer failed to explain this discrepancy adequately. The minister therefore discharged the burden of proof necessary to justify the reassessments in issue being made beyond the normal reassessment period in this case. Conversely, the minister failed to demonstrate the degree of gross negligence on the taxpayer's part needed to justify the imposition of the penalties for gross negligence. "Gross negligence" in this context means greater neglect than simply a failure to use reasonable care (see *Laplante v. The Queen*, 2008 DTC 4822 (TCC)). In addition, the taxpayer managed to demolish some of the minister's assumptions concerning the quantum of the unreported income in issue, and the minister also made some concessions as well. As a result of the foregoing findings, the minister was ordered to reassess, deleting the penalties for gross negligence, but taking into account the concessions made, in addition to giving effect to the evidence produced by the taxpayer concerning the quantum of his unreported income in issue.

Lee v. The Queen, 2017 DTC 1041

Minister Prohibited From Reassessing Taxpayer in a Manner Inconsistent With Agreement Between Tax Authorities Made Pursuant to Treaty

***Sifto Canada Corp. et al v. The Queen*, 2017 DTC 1020 (Tax Court of Canada)**

The *Sifto* case is an interesting decision which considers the Minister's ability to reassess a taxpayer for increased income and penalties where the taxpayer had previously been reassessed and had agreed to increases to its income pursuant to the mutual agreement procedure ("MAP") article of the *Canada-United States Tax Convention* (the "Convention").

Between 2002 and 2006, the taxpayer, a Canadian corporation resident in Canada, sold approximately 50% of its annual rock salt production from its salt mine operations (in Ontario) to a related US corporation. In 2007, the taxpayer made a voluntary disclosure regarding errors made in its 2002 to 2006 taxation years that arose due to incorrect methodology used in a transfer pricing report, resulting in a transfer price that was less than an arm's length price. In March 2008, the Minister advised the taxpayer that the voluntary disclosure had been accepted and, in April 2008, the Minister issued notices of reassessment to the taxpayer for the taxation years in question (collectively, the "2008 Reassessments"), reflecting the additional income disclosed by the taxpayer and reported in the amended T2 income tax returns filed for those years. The Minister did not audit the taxpayer prior to issuing the 2008 Reassessments.

As a result of the 2008 Reassessments, and the economic double taxation that resulted from the adjustment to the transfer price of the rock salt sold by the taxpayer, the taxpayer and its US parent corporation applied to the Canadian Competent Authority ("CCA") and the United States Competent Authority ("USCA"), respectively, for relief, pursuant to Articles IX and XXVI of the Convention. The Minister, acting as the CCA, requested that the IRS, acting as the USCA, allow a deduction in the taxable income of the related US corporation (and therefore in the consolidated US income tax return of the US parent company) in order to prevent economic double taxation.

After exchanging a series of letters, the CCA and the USCA reached an agreement pursuant to the MAP article, Article XXVI, of the Convention. The MAP procedure spelled out in the Convention is available only to taxpayers that believe that they are being taxed in a manner inconsistent with the Convention. In addition, the contracting state of which the taxpayer is resident must agree with the taxpayer in this respect. Pursuant to the MAP article, both authorities agreed with the adjustments made by the Minister, and the IRS therefore provided a corresponding downward adjustment to the consolidated income of the taxpayer's US parent.

Notwithstanding this agreement, the Minister subsequently reassessed the taxpayer for the 2004 to 2006 taxation years to increase the taxpayer's income beyond the amounts giving rise to the 2008 Reassessments. The taxpayer appealed the subsequent reassessments, contending that the Minister and the taxpayer had entered into a binding agreement that established the transfer price of the rock salt sold by the taxpayer to the related US corporation during the taxation years in issue. The Minister responded by denying the existence of an agreement with the taxpayer and, in the alternative, contending that such an agreement (if it existed) did not fix the arm's length transfer price of the salt.

Owen J. of the Tax Court considered:

(1) what the MAP agreements had resolved;

(2) whether the taxpayer's acceptance of the agreements constituted a settlement agreement;

(3) whether the settlement agreement fixed the transfer price of the salt; and

(4) whether the settlement agreement was binding on the Minister.

Owen J. began by rejecting the Minister's argument that the MAP agreements resolved only the issue of double taxation, and did not represent the Minister's agreement to the 2008 Reassessments. Owen J. found that the correspondence between the Minister and the USCA indicated an agreement between the two parties that the adjustments to the taxpayer's income and the income of the taxpayer's US parent were in accordance with Article IX of the Convention.

Furthermore, Owen J. affirmed that the agreements which were accepted by the taxpayer gave rise to a settlement with the taxpayer. Drawing from *Apotex v Allergan* (2016 FCA 155), the Court noted that the legal framework for assessing the existence of a settlement involved consideration of whether the following three factors were in place:

(1) a mutual intention, determined objectively, to create legal relations;

(2) consideration flowing in return for a promise; and

(3) agreement terms that are sufficiently certain.

In affirming that the parties did have the requisite intention to create legal relations, Owen J. pointed to the correspondence between the two parties:

> The CCA had complete control over the wording of the Letters, which were put to the Appellant on a take it or leave it basis. The wording of the Letters was not ambiguous. The language used clearly described the terms of the MAP agreement reached by the CCA and USCA and asked the Appellant to accept or reject those terms.

The Court thus held that the correspondence between the CCA and the taxpayer set out the terms of the settlement based upon the terms reached by the CCA and the USCA regarding the adjustments to be made under paragraphs (1) and (3) of Article IX of the Convention, including related matters such as the repatriation of the profits to Canada. As a result, Owen J. rejected the Minister's argument that there was nothing for the taxpayer to agree to because the adjustments resulting from the MAP agreement were made only to the income of the US parent corporation. As evidence that the taxpayer did indeed have something to agree to, the Court noted that agreeing to the MAP terms provided the taxpayer with certainty regarding the transfer price of the salt and, given the increase in the sale price, allowed it to receive approximately $11,000,000 free of US withholding tax.

With respect to the issue of consideration (i.e., the second factor listed above as relevant in determining whether a settlement exists), the Court held that, in exchange for the CCA's agreement to implement the competent authority settlement, the consideration flowing from the taxpayer was the implicit agreement not to pursue the issue further through other available avenues.

In holding that the third factor — i.e., the existence of sufficiently certain terms — was also met, the Court again pointed to the letter correspondence between the CCA and the taxpayer, and the fact that the terms of the MAP agreements were sufficiently spelled out.

Moving on to consider the issue of whether the settlements determined the transfer price of the rock salt, the Court noted that the MAP agreements between the CCA and the USCA necessarily determined the transfer price of the relevant transactions reflected in the adjustments of the parties' income. The Court determined that neither the voluntary disclosure by the taxpayer, nor the fact that the Minister chose not to audit the adjustments before issuing the 2008 Reassessments altered that conclusion. Further to this point, the Court noted that:

> If the CRA had an issue with the adjustments suggested by the Appellant in its voluntary disclosure it could easily have audited the Appellant before issuing reassessments of the VDP Taxation Years. Instead, the CRA chose to issue the 2008 Reassessments without an audit. Similarly, upon learning of the pending audit of

> some of the years under negotiation with the USCA, the CCA could have chosen to defer or even discontinue those negotiations. Instead, the CCA chose to continue its MAP negotiations with the USCA and concluded those negotiations with two MAP agreements.

With respect to the final issue as to whether the settlements were binding on the Minister, the Court noted that the case relied on by the Minister, *Galway* (72 DTC 6493 (FCC, Trial Division)), did not preclude the possibility that the Minister may agree with a taxpayer to settle a case. The Court further held that, although the Federal Court of Appeal in *CIBC World Markets Inc*. (2011 GTC 2051) held that the Minister cannot agree to an assessment that is indefensible on the facts and the law, there was no basis on which to conclude that this was the case in this instance.

Furthermore, the Court held that, even if the settlements with the taxpayer were not binding on the Minister, the Minister was bound by the agreements between the CCA and the USCA as mutual agreements reached under paragraph (2) of Article XXVI of the Convention. Accordingly, the Court determined that the Minister was not permitted to act in a manner inconsistent with the agreements. In support of this conclusion, the Court pointed to the policy implications that would result if this were not the case:

> The manifest object of Article XXVI of the Convention in the context of transfer pricing is to resolve by mutual agreement issues of juridical and economic taxation. An issue is not resolved if it is open to one state to simply disregard the MAP agreement that resolves the issue. It is also antithetical to the very notion of an agreement between two treaty partners to suggest that either party may simply choose to ignore the agreement. Not only is such a suggestion contrary to common sense but the adoption of such a principle would effectively neuter the mutual agreement procedure not only in the Convention but in all of Canada's tax treaties. After all, why would a treaty party agree to the resolution of a tax treaty issue if Canada could simply ignore that resolution and assess as it sees fit?

These policy implications were held to be entrenched under both the *Canada-United States Tax Convention Act*, 1984, and the *Vienna Convention on the Law of Treaties*.

The Court thus allowed the taxpayer's appeal, requiring the Minister to reassess the income of the taxpayer from the sale of rock salt to the related US corporation in a manner consistent with the MAP agreements. This taxpayer-friendly decision provides useful guidance to taxpayers that wish to rely on agreements or assessments reached pursuant to MAP negotiations. The decision also underscores the obligations that parties to such treaties are subject to.

— *Krupa Kotecha, Articling Student*

Appeal from assessment for shareholder benefits dismissed

Tax Court of Canada, May 29, 2017

The taxpayer and his wholly owned corporation were reassessed to include shareholder benefits in the taxpayer's income and to deny deductions claimed by the corporation for interest payments made and wage expenses. Penalties for gross negligence were assessed against both the taxpayer and corporation. Both appealed from the reassessments and their appeals were heard on common evidence.

The taxpayer's appeal was allowed in part and the corporation's appeal was dismissed. The Court found that the taxpayer, who was the only witness for himself and the corporation, was not a credible witness and that his testimony was not supported by the documentary evidence. On the issue of the shareholder benefits, the Court held that the corporation had conferred a benefit on the taxpayer during the years in issue by paying the mortgage on the taxpayer's personal residence. It held, however, that the amounts assessed by the minister in respect of that shareholder benefit should be reduced. In addition, the Court concluded that the taxpayer had not provided any convincing evidence with respect to his alleged repayment of a shareholder loan and that the shareholder loan balance was correctly included in his income. On the issue of deductions claimed by the corporation, the Court held that there was no credible evidence that mortgage proceeds were used for a business purpose or to finance the corporation's business. Instead, the documentary evidence showed that most or all of the mortgage proceeds were used for personal expenses. Finally, the Court concluded that payments made and reported by the corporation as wage expenses were actually dividend payments, and that the minister had properly denied the deduction of such payments. On the

question of penalties for gross negligence, the Court held that the minister had successfully discharged the onus of proving that both the taxpayer and the corporation were liable for such penalties, and that those penalties were properly imposed.

Struck and 468543 B.C. Ltd. v. The Queen, 2017 DTC 1051

Tax Court correct in upholding minister's assessment of stock option benefit

Federal Court of Appeal, May 17, 2017

The taxpayer received employee stock options as part of his employment compensation and he exercised those options in the 2010 and 2012 taxation years. On reassessment, the minister took the position that the employment benefits received by the taxpayer as a result of the exercise of the employee stock options which were denominated in US dollars were to be calculated by converting the Canadian dollar value of the exercise price and the fair market value of shares at the time of exercise. The exchange rate to be used for such conversion was the one in effect on the date the options were exercised. The taxpayer appealed from that reassessment to the Tax Court of Canada, which dismissed his appeal. He then appealed from that dismissal to the Federal Court of Appeal.

The appeal was dismissed. The appellate Court agreed with the Tax Court judge that section 7 of the *Income Tax Act* constituted a complete code for the taxation of employee stock options. The appellate Court also held that no taxable transaction occurred when the stock options were granted to the appellant, since he did not at that time receive a taxable benefit. Rather, the taxable transactions occurred when the appellant exercised his stock options in 2010 and 2012, as that was the moment when the shares were acquired within the meaning of section 7, and when the value of the appellant's employment benefits could be ascertained under that provision. Only at that time was the appellant required to calculate his reportable benefits by converting at once all relevant amounts, being the exercise price, along with the fair market value of the shares at the time he exercised his options, using the exchange rate applicable on the date of the exercise. The appellate Court concluded that the Tax Court judge had made no error in law in upholding the minister's reassessments by relying on a contextual and purposive interpretation of section 7 of the Act. The Tax Court judge had correctly applied the relevant legal principles and case law relating to the taxation of employee benefits derived from stock options denominated in a foreign currency.

Ferlaino v. The Queen, 2017 DTC 5062

Appeal from decision allowing business losses of limited partnership dismissed

Federal Court of Appeal, May 19, 2017

A motion was brought before the Tax Court for a determination of a question respecting the application of the at-risk rules limiting the availability of losses incurred by a limited partnership. Specifically, the Court was asked to determine whether, in a two-tier partnership structure, where the top-tier partnership had no at-risk amount in respect of the lower tier-partnership at the end of the fiscal period, business losses incurred by the lower tier partnership in that particular fiscal period retained their character as business losses of the top-tier partnership. The Tax Court judge answered the question in the affirmative, meaning that the business losses incurred were available to be allocated to the partners of the top-tier partnership as business losses, and subject to the at-risk rules in their hands. The Crown appealed from that decision.

The appeal was dismissed. The Court held that as the only issue in the appeal raised a question of law, the standard of review was that of correctness. In the Court's view, the statutory provisions which applied to the question before it should not be read in isolation but should be interpreted based on a textual, contextual and purposive analysis. Following such an analysis, the Court concluded that the intention of Parliament was that sources of income (or loss) should be kept separate and retain their identity as income (or loss) from a particular source as they were allocated from one partnership to another partnership, and then to the partners of that second partnership. Consequently, losses from a business incurred by a lower-tier partnership would still be losses from a business in the top-tier partnership and then allocated to the partners of that top-tier partnership as losses from that business. The interpretation put forward by the Crown did not accord with the intent of Parliament as expressed in the relevant statutory provisions, and the Crown's appeal was therefore dismissed.

The Queen v. Green et al., 2017 DTC 5068

Trust liable under the GAAR for dividends received by it, which it had attributed not to all of its beneficiaries, but to one of those beneficiaries under income reversion provisions of subsection 75(2) of the Act

Tax Court of Canada, June 1, 2017

The appellant trust was a revocable trust specifically created by a numbered corporation 9134 (which was one of the appellant trust's beneficiaries) to bring into operation the income reversion provisions of subsection 75(2) of the Act. 9134 made a $100 gift to the appellant trust, which the latter used to acquire Class F shares of another numbered corporation 9163. These Class F shares could revert, under the terms of the trust to 9134, which would bring into operation the income reversion provisions of subsection 75(2). 9163 paid the appellant trust dividends in excess of $6 million during its 2005, 2006, and 2007 taxation years (the "Dividends"). The appellant trust did not redistribute the Dividends to its beneficiaries, and hence should normally have paid tax on them. However, the Dividends were attributed by the appellant trust to 9134, through the operation of subsection 75(2), and 9134 avoided tax on them by deducting them under subsection 112(1) of the Act. As a result the appellant trust retained the full amount of the Dividends received by it from 9163 without paying tax on them, and its beneficiaries were also enabled to avoid paying any eventual tax on them. 9134, therefore, had divested itself of its assets in favour of the appellant trust without any payment of tax. In the minister's view, the non-payment of tax by both the appellant trust and its beneficiaries on the Dividends constituted an avoidance transaction involving the abuse of subsections 75(2) and 112(1) of the Act. The minister therefore assessed the appellant under the GAAR accordingly for 2005 to 2007, by including the Dividends in the appellant trust's income for those taxation years, relying on paragraph 12(1)(j), section 82, and subsection 245(5) of the Act. The appellant trust appealed to the Tax Court of Canada.

The appellant trust's appeal was dismissed. Subsection 75(2) provides, in essence, that income from property transferred to a trust will revert to the transferor if the trust provides that the trust property may revert to the transferor or to his or her designees. The purpose of the subsection is to prevent revenue splitting among the transferees of trust property if that property can revert to the transferor. On the other hand subsection 112(1) seeks to prevent the imposition of tax on inter-corporate dividends. In *Lipson v. The Queen* 2009 SCC 1, the Supreme Court of Canada held that the use of an avoidance provision (in that case the inter-spousal transfer provisions of subsection 74.1(1) of the Act) to reduce the tax otherwise payable by one of the spouses counteracted the anti-avoidance purpose of the subsection. Applying that reasoning to the present proceedings, the conclusion was that the avoidance operations in this case were manifestly abusive of subsections 75(2) and 112(1), and that, as a result, the appellant trust should not be permitted to benefit from those operations. The minister's assessments were affirmed accordingly.

Fiducie Financière Satoma v. The Queen, 2017 DTC 1056

Loss sustained by taxpayer in "value transfer" corporate share transaction disallowed under the GAAR

Tax Court of Canada, June 1, 2017

The corporate taxpayer engaged in a "value transfer" transaction similar to the ones involved in *Triad Gestco Ltd. v. The Queen* 2012 CAF 258, in *1207192 Ontario Ltd. v. The Queen* 2012 CAF 259, and in *Barrasso v. The Queen* 2014 DTC 1130 2014 CCI 156. The taxpayer received shares of a new corporation controlled by it in exchange for valuable consideration. The value of these shares when issued to the taxpayer was equal to the value of the consideration paid by it for them. Shortly afterward the new corporation declared a stock dividend in a different class of shares, and these shares had a high redemption value and a low PUC. This stock dividend had the effect of transferring the value of the shares first issued to the taxpayer to the shares declared as a stock dividend. The taxpayer subsequently sold the shares initially issued to him to a non-arm's length party, thus generating an allowable capital loss which the minister disallowed in reassessing the taxpayer for 2005 under the GAAR. In the *Triad Gesstco*, *1207192* and *Barrasso* cases, the court concluded that this type of value transfer transaction involved an abuse of paragraphs 38(b)39(1)(b) and 40(1)(b)) of the Act. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was dismissed. The taxpayer's attempt to distinguish the three foregoing cases from its own situation in this case was misplaced. In the *Triad Gestco* and *1702192* cases, moreover, the Federal Court of Appeal

concluded that the purpose of paragraphs 38(b), 39(1)(b) and 40(1)(b) is to permit deductions in cases of "economic losses" but not in cases involving "theoretical or artificial losses". The minister's reassessment was affirmed accordingly.

2763478 Canada Inc. v. The Queen, 2017 DTC 1053

Amounts received by taxpayer from his corporation not capital dividends, but shareholder's loans to be included in his income

Tax Court of Canada, June 1, 2017

The taxpayer was the sole shareholder and director of a numbered corporation, 2869, when the latter purported to pay him a capital dividend of $596,881 on February 2, 2008. On or around November 9, 2011, the minister notified 2869 that its capital dividend account balance as at February 2, 2008 was only $146,881, and not $596,881. In a judgment dated January 6, 2014, the Quebec Superior Court, on 2869's application, nullified the resolution declaring the $596,881 capital dividend, and declared that such dividend was nil, and was deemed not to have been declared. The Superior Court also ordered the taxpayer to repay 2869 $596,881, and, by cheque dated October 13, 2015, he paid 2869 $539,157. On October 15, 2015, 2869 declared another capital dividend in the amount of $540,000 in favour of the taxpayer which was payable on or after October 20, 2015. And on October 15, 2015, it produced Form T-2054 electing to treat this dividend as a capital dividend out of its capital dividend account, which at that point totalled $638,539. At no point did the minister decide upon the validity of this election. On December 31, 2008, however, the taxpayer had received $86,567 from 2869 as an alleged capital dividend, and on December 31, 2009 he had also received $381,260 from 2869 as an alleged capital dividend. In a reassessment dated April 30, 2013, the minister included in the taxpayer's income for 2009 $381,260 under the shareholder loan provisions of subsection 15(2) of the Act, and $4,228 under section 80.4 of the Act ($4,228 was the interest on the $86,567 received by the taxpayer from 2869 on December 31, 2008). The minister's position, in essence, was that: (a) when the taxpayer received both the $381,260 and the $86,567 from 2869, he became indebted to it for those amounts; (b) the capital dividend that had been declared on February 2, 2008 was retroactively declared by the Quebec Superior Court never to have been declared, so that the taxpayer improperly received both the $381,260 and the $86,567 from 2869. On appeal to the Tax Court of Canada, the taxpayer argued, in part, that, when the minister's reassessment was issued on April 30, 2013, he had never agreed to borrow from 2869, and thus was not indebted to it in 2009 for the amounts of $381,260 and $4,228.

The taxpayer's appeal was dismissed. The issue was whether the minister was justified in adding $381,260 and $4,228 to the taxpayer's income for 2009 in the reassessment of April 30, 2013. In principle the taxpayer was entitled to receive, in the form of capital dividends, the non-taxed portion of the gains realized by 2869 upon the sale of its goodwill in 2008. Unfortunately, however, he was prevented from doing so due to errors on the part of his advisors in the declaration by 2869 of its alleged capital dividend of February 2, 2008, in the calculation of its capital dividend account balance on that date, and in the production of its Form T-2054 in October 2008. In addition, the taxpayer was indebted to 2869 for the $381,260 and the $4,228 amounts in issue, since he was unjustly enriched by the receipt of these amounts from 2869. Also, the taxpayer failed to explain why his advisors had applied to the Quebec Superior Court for an order stating that the $596,881 dividend had never been declared, rather than asking for an order of rectification from the Court. The minister's reassessment was affirmed accordingly.

St-Pierre v. The Queen, 2017 DTC 1057

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