CANADIAN TAX focus

Editor: Alan Macnaughton, University of Waterloo
(amacnaughton@uwaterloo.ca)

Volume 9, Number 1, February 2019

Post Mortem Pipeline Fails for Non-Resident Beneficiaries

On the death of the owner of a private company, taxes are payable on the deemed disposition of shares, and taxes are payable again on funds being withdrawn from the company. Pipeline transactions seek to avoid this second level of tax; however, where a non-resident beneficiary is involved, pipeline transactions no longer seem to work after the enactment of amendments to section 212.1 on December 13, 2018 (Bill C-86). The stated purpose of these amendments is far different, so this effect may be unintended. There may be reason to hope for a fix through corrective legislation or CRA interpretation.

In the 2018 Budget, the Department of Finance expressed concerns about cross-border surplus-stripping practices that circumvent section 212.1 (which is roughly the equivalent of section 84.1 for non-residents). Specifically, the concern centred around sophisticated transactions involving multinational companies whereby the application of section 212.1 was avoided through the use of trust and partnership intermediaries between the corporation and the non-resident. The enacted legislation introduces lookthrough rules on tiered partnerships and trusts: a non-resident person who is a member of a partnership or beneficiary of a trust is deemed to own the intermediary's shares on the basis of that person's relative FMV interest in those shares (subsections 212.1(5) to (7)).

Suppose that an estate has three beneficiaries—two are Canadian residents and one is a non-resident—and the will provides that the residue (the amount remaining after other claims are settled) is to be divided equally among the three beneficiaries. The estate owns shares of Opco with an ACB of $100,000 (from the deemed disposition at death) and PUC of $100. One-third of the shares are to go to each beneficiary. If a regular pipeline transaction is performed by the estate—involving the sale of the shares of Opco to a newly incorporated Holdco in exchange for a promissory note—there is a deemed dividend equal to $33,300 (one-third of the difference between the value and the PUC) to the non-resident beneficiary. This defeats the purpose of the pipeline transaction.

The deemed dividend occurs because the transaction satisfies the two conditions below (of which the latter results from the new amendments):

- For section 212.1 to apply, the non-resident person and Holdco must not deal at arm's length. This result is deemed by paragraph 212.1(3)(a) if the non-resident person is part of a group of fewer than six persons that controls both Opco and Holdco. At first, it seems that this condition is not met: the estate controls these two companies, and the non-resident person is not even a shareholder of either company; however, paragraph 212.1(3)(b) deems a beneficiary of a trust to own the shares that the trust actually owns. (An estate is a trust according to subsection 248(1).) Thus, paragraph 212.1(3)(a) applies after all, and the non-arm's-length relationship of the non-resident person and Holdco is established.
- Another requirement for section 212.1 to apply is that the non-resident has disposed of Opco shares to Holdco. The new lookthrough provisions of subsections 212.1(5) to (7) put the non-resident person in the place of the estate, and hence this condition is satisfied.

Different results may occur for more complex provisions in the will concerning the distribution of shares to beneficiaries, as the following examples illustrate:

- Under a "hotchpot" clause the executor has the power to choose which assets go to each beneficiary under the will, taking into account the distribution of assets both inside and outside the estate. In this situation, the effect of subsection 212.1(7) (where its purpose test is satisfied) is that the non-resident beneficiary is deemed to have a 100 percent interest in the estate assets, tripling the deemed dividend to $99,900. This occurs even if that person does

IN THIS ISSUE

CTF FCF CANADIAN TAX FOUNDATION FONDATION CANADIENNE DE FISCALITÉ

not receive the shares on which the dividend arises (the Holdco shares) and receives other property instead.

- There may be a provision in which the executor has the power to choose which assets go to each beneficiary, as long as assets are distributed under the will in certain proportions of value. (The purpose of such a clause might be, for example, to pass on the interest in the family business to the person who is actively involved in it.) In that case, subsection 212.1(7) does not apply but there is still a deemed dividend to the non-resident beneficiary of $33,300. Again, this applies regardless of whether that person receives the shares on which the dividend arises.

Henry Shew
Cadesky Tax, Toronto
hshew@cadesky.com

TOSI and Valuing a Discretionary Interest in a Trust

Consider a common corporate structure that entails shares of Opco being wholly owned by a discretionary family trust with beneficiaries who are all related to one another. Dividends paid by the corporation to the trust and allocated to beneficiaries who have attained the age of 17 years before the year starts may be subject to TOSI unless the dividends are not derived directly or indirectly from a related business. Practitioners may be surprised that it is unclear whether a related business exists in this circumstance. The answer may depend in part on whether a discretionary interest in a trust has a nominal value. It is hoped that the CRA will provide guidance on this question.

A related business, in the context of a corporation, may exist if a source individual is actively engaged on a regular basis in the activities of the corporation (subparagraph 120.4(1)(a)(ii)). If that is not the case, such as for a corporation with only passive investments, a related business might still exist. One must make the determination using a further two-part test under which both parts must be satisfied for TOSI to apply (paragraph 120.4(1)(c)).

Part 1

This part of the test is satisfied where a source individual owns either

1) shares of the capital stock of the corporation; or
2) property that derives, directly or indirectly, all or part of its fair market value from shares of the capital stock of the corporation.

Where the corporation is wholly owned by a trust, condition (1) cannot be satisfied since trusts are specifically excluded from the definition of "source individual." However, condition (2) may be satisfied if the beneficiaries are considered to hold property that derives, directly or indirectly, all or part of its FMV from the underlying property of the trust.

The CRA's view is that a discretionary interest in a trust is property (APFF CRA round table, question 10, October 5, 2018) and thus condition (2) is satisfied. This argument is particularly persuasive if the trust assets consist only of shares of the corporation; in that case, there are no other assets that would contribute to the value of the discretionary interest.

Part 2

The second part of the test is satisfied where the FMV of a source individual's discretionary interest in the trust constitutes at least 10 percent of the FMV of all of the issued and outstanding shares of the corporation. However, a difficult exercise must be undertaken to ascertain the FMV of a discretionary interest in a trust. If a nominal valuation is supported, this condition will not be met. The CRA takes no position on this point in the APFF round table, noting only that the valuation of a discretionary interest in a trust is a question of fact. However, in a different context, the CRA has taken issue with the nominal valuation and supported instead an even-handed principle (CRA ruling 2001-0111303, 2002), which would allow this condition to be met:

> It would be unreasonable to conclude that the FMV of an interest [in] a discretionary trust holding property with significant value has no value simply because it is difficult to measure. In absence of any term of the trust that would direct the trustees to favour one beneficiary over another, the even handed principle would suggest that value of each beneficiary's interest was approximately equal.

Martin Lee
Kakkar CPA Professional Corporation, Vaughan, ON
martin@kakkar.com

FCA Applies GAAR to Loss Transfer by Partnership Allocations

In *Canada v. 594710 British Columbia Ltd.* (2018 FCA 166; leave sought to appeal to the SCC), the FCA overturned a TCC decision (2016 TCC 288) and applied GAAR on the basis that the taxpayer abused section 160. This section is intended to prohibit a person with a tax liability from avoiding the collection of tax by transferring property to a non-arm's-length person for inadequate consideration. Although the situation concerned a partnership loss transaction, the court disposed of the appeal without commenting on the wider issue of whether there is a general scheme in the Act against transferring losses, as suggested by the Crown.

The case involved a partnership structure that consisted of four Partnercos (incorporated for real estate construction projects) that were indirectly owned (99.9 percent) by four brothers through individual Holdcos. The remaining nominal interest belonged to a general partnership held by one of the brothers. Toward the end of the project, the members of the partnership were faced with taxable income of close to $13 million. They attempted to mitigate their tax liability by bringing into the partnership an unrelated public corporation with available tax losses and deductions (Nuinsco) just before the partnership's year-end. Virtually all of the partnership's income for tax purposes was allocated to Nuinsco. As a consequence of this transaction, there was no taxable partnership income to allocate to the individual Holdcos. The CRA's reassessment of one of these Holdcos (the respondent) on the basis of GAAR was the subject of this litigation.

The FCA ruling was based on whether the object, spirit, or purpose of section 96 was frustrated within the series of transactions. The court found that it was:

> The result of the series of transactions was that the . . . family had shifted the entire taxable income from the development to an unrelated party which had virtually no economic interest or risk, except for a 10 percent "deal fee." I agree with the Crown that this defeats the object, spirit or purpose of subsection 96(1) and therefore there is an avoidance transaction that is abusive. [Paragraph 71]

Further, there was no common business interest toward profit when Nuinsco entered the partnership. This defeated the spirit and object of section 96 since the allocation of the income was skewed to Nuinsco, which had no common business interest with the partners; the only intent was to avoid a tax liability. Such a requirement for common interest was highlighted in an earlier SCC judgment: *Mathew v. Canada* (2005 SCC 55). As a result, the FCA concluded that the application of GAAR to Partnerco resulted in Partnerco being allocated a portion of the partnership's taxable income, and therefore to have a tax liability for the purpose of section 160.

The series of transactions also caused a transfer of cash from Partnerco to Holdco without consideration (through a combination of a stock dividend and redemption). Thus, by the creation of a deemed year-end in Partnerco after a transfer of property but before the tax liability was incurred, the application of section 160 was circumvented. Together, these actions showed a tax benefit, an avoidance transaction, and an abuse of section 160—accordingly, GAAR applies to Holdco.

An interesting aspect of this particular FCA ruling is the lack of reliance on a specific provision within the Act regarding loss trading or profit trading. (This issue was part of the basis for the TCC ruling in favour of the taxpayer.) Rather, the FCA concluded that the object, spirit, or purpose of subsection 96(1) was frustrated, which led through a chain of analysis to the application of GAAR on the basis of an abuse of section 160.

Balaji Katlai
MNP LLP, Montreal
bal.katlai@mnp.ca

La CAF applique la RGAE à un transfert de pertes par attribution du revenu d'une société de personnes

Dans l'arrêt *Canada v. 594710 British Columbia Ltd.* (2018 FCA 166; demande d'autorisation d'appel à la CSC), la CAF a annulé la décision de la CCI (2016 CCI 288) et elle a appliqué la RGAE au motif que le contribuable avait commis un abus dans l'application de l'article 160. Cet article vise à empêcher une personne ayant une dette fiscale d'éviter le recouvrement de l'impôt en transférant des biens à une personne avec laquelle elle a un lien de dépendance pour une contrepartie insuffisante. Bien que la situation ait concerné une opération liée aux pertes d'une société de personnes, la Cour s'est prononcée sur l'appel sans faire de commentaires sur la question plus vaste de l'existence d'une économie générale de la Loi interdisant le transfert des pertes, comme l'avait suggéré la Couronne.

L'affaire impliquait une structure de société de personnes composée de quatre sociétés partenaires (constituées en vue de réaliser des projets de construction immobilière) qui étaient détenues indirectement (99,9 pour cent) par quatre frères, par l'entremise de sociétés de portefeuille individuelles. La participation nominale restante appartenait à une société en nom collectif détenue par un des frères. Vers la fin du projet, les associés de la société de personnes avaient un revenu imposable de près de 13 millions de dollars. Ils ont tenté de réduire leur dette fiscale en intégrant dans la société de personnes une société publique non liée ayant des pertes et des déductions fiscales (Nuinsco) juste avant la fin de l'exercice de la société de personnes. Pratiquement tous les revenus aux fins fiscales de la société de personnes ont été attribués à Nuinsco. En conséquence de cette opération, il n'y avait aucun revenu de société de personnes imposable à répartir aux sociétés de portefeuille individuelles. La nouvelle cotisation établie par l'ARC à l'encontre de l'une de ces sociétés de portefeuille (l'intimée) au titre de la RGAE était l'objet de ce litige.

Dans cette affaire, la CAF devait décider si la série d'opérations contrecarrait l'objet ou l'esprit de l'article 96. La Cour a statué que c'était le cas :

> [traduction] Cette série d'opérations avait eu pour résultat que la famille [...] avait transféré la totalité du revenu imposable provenant du projet à une partie non liée qui n'avait pratiquement aucun intérêt économique ni risque économique, à l'exception d'« honoraires » de 10 pour cent. Je conviens avec la Couronne que cela contrecarre l'objet ou l'esprit du paragraphe 96(1) et qu'il y a donc une opération d'évitement qui est abusive. [Paragraphe 71]

Il n'existait en outre aucun intérêt commercial commun à la réalisation de profits lorsque Nuinsco s'est jointe à la société de personnes. Cela contrecarrait l'esprit et l'objet de l'article 96 puisque la répartition du revenu était dirigée vers Nuinsco, qui n'avait aucun intérêt commercial commun avec les associés; la seule intention était d'éviter une dette fiscale. Un arrêt antérieur de la CSC a attiré l'attention sur cette exigence d'un intérêt commun : *Mathew c. Canada* (2005 CSC 55). Par conséquent, la CAF a conclu que l'application de la RGAE à la société partenaire avait pour effet que la société partenaire était tenue d'inclure une partie du revenu imposable de la société de personnes dans le calcul de son propre revenu et, par conséquent, d'avoir une dette fiscale en application de l'article 160.

De plus, la série d'opérations a donné lieu à un transfert des liquidités de la société partenaire à la société de portefeuille sans contrepartie (par la combinaison d'un dividende en actions et d'un rachat). Ainsi, la création d'une fin d'exercice réputée pour la société partenaire après un transfert de biens, mais avant que la dette fiscale ne soit contractée, avait pour effet de contrecarrer l'application de l'article 160. Ensemble, ces actions montraient un avantage fiscal, une opération d'évitement, et un abus dans l'application de l'article 160 — en conséquence, la RGAE s'applique à la société de portefeuille.

Un des aspects intéressants de cet arrêt de la CAF est qu'on n'y invoque pas une disposition particulière de la Loi sur l'échange de pertes ou l'échange de profits. (Cet aspect faisait partie du fondement de l'arrêt de la CCI en faveur du contribuable.) La CAF a plutôt conclu que l'objet ou l'esprit du paragraphe 96(1) avait été contrecarré, ce qui a mené, par une chaîne d'analyse, à l'application de la RGAE au motif qu'il y avait eu abus dans l'application de l'article 160.

Balaji Katlai
MNP S.E.N.C.R.L., s.r.l., Montréal
bal.katlai@mnp.ca

Creditors Cheer SCC Decision on GST Debts

Where a supplier has failed to remit GST to the Crown, ETA subsection 222(3) extends a deemed trust over the unremitted GST in favour of the Crown to cover the supplier's property equal in value to the unremitted GST. Moreover, a creditor that receives sale proceeds of property subject to this deemed trust may be liable to pay such proceeds to the Crown. This deemed trust is extinguished on the supplier's bankruptcy (ETA subsection 222(1.1); *Century Services Inc. v. Canada (Attorney General)*, 2010 SCC 60), so the Crown ceases at that time to have priority over other creditors. However, uncertainty remained concerning the continuing liability of a creditor, following the supplier's bankruptcy, to pay to the Crown proceeds that it received from the supplier prior to bankruptcy. This has now been resolved: in *Callidus Capital Corp. v. Canada* (2018 SCC 47), the SCC ruled that the creditor's obligation to pay such proceeds to the Crown also ceases on the supplier's bankruptcy.

In contrast, a majority of the FCA panel (2017 FCA 162) had concluded that the creditor's personal liability under subsection 222(3) survived the supplier's bankruptcy. In dissent at the FCA, Pelletier JA rejected the majority's conclusion that the creditor's liability "crystallized" as a personal liability independent of the deemed trust over the unremitted GST. He found instead that this liability was entirely dependent on the amount of unremitted GST subject to the deemed trust, noting that any remittances of GST by the supplier prior to its bankruptcy would have reduced the creditor's liability under subsection 222(3). Since subsection 222(1.1) reduced to nil the amount subject to the deemed trust over unremitted GST, Pelletier JA concluded that the creditor's liability to remit the proceeds was also reduced to nil and extinguished.

The creditor appealed to the SCC with the support of several associations of insolvency professionals. The intervenors characterized the FCA majority's decision as effectively preserving the subsection 222(3) deemed trust after bankruptcy. In addition, the Canadian Bankers' Association submitted that the FCA had created "a general regime of personal liability of the secured lender for the unpaid sales taxes of its borrower on the sole basis that said lender received a voluntary repayment of the debt of its borrower." This submission suggested that the creditor would not have been liable under subsection 222(3) to pay the proceeds to the Crown, regardless of any bankruptcy of the supplier.

In an exceptional outcome, the SCC delivered an oral judgment allowing the creditor's appeal and adopting the reasons of Pelletier JA. However, the SCC specifically noted that it was unnecessary to decide "the scope of the deemed trust or any liability under s. 222 of the ETA prior to bankruptcy." The SCC therefore declined to deal with what types of transfers by the supplier to its creditor would have engaged subsection 222(3).

The SCC's decision is welcome news to lenders and insolvency professionals. At both the FCA and the SCC, the parties and intervenors were quite concerned with the practical consequences of the decisions. Both the majority and the dissent at the FCA took great pains to deal with the consequences of allowing the creditor to soak up remaining assets before having the supplier assigned into bankruptcy. At the SCC, the central focus was the effect of the FCA majority's decision on bankruptcy trustees and lenders. Bankruptcy will now provide more comfort to secured lenders in that they will not be liable for any unremitted GST of their insolvent debtors. The decision reached by the SCC has been tailored to be limited in its scope. It may, however, still result in a legislative amendment.

Eric Brown
Bennett Jones LLP, Vancouver
BrownE@bennettjones.com

Philip B. Ward
Bennett Jones LLP, Toronto
WardP@bennettjones.com

Due Diligence Report Obtained by CRA

In *Canada (National Revenue) v. Atlas Tube Canada ULC* (2018 FC 1086; under appeal), the FC found that the CRA, in the course of a tax audit, was entitled to obtain from Atlas Tube Canada ULC (Atlas) a due diligence report prepared by Ernst & Young (EY) in connection with a previous transaction involving Atlas. This decision is a reminder to taxpayers engaged in a due diligence process (and their advisers) that documents prepared for such purposes, when they are not subject to solicitor–client privilege, are difficult to shield from the CRA's broad audit powers.

In 2012, Atlas's parent company, JMC Steel Group Inc. (JMC), acquired the shares of an Ontario public corporation, Lakeside Steel Inc. (LSI), which at the time owned all of the shares of a subsidiary, Lakeside Steel Corporation (LSC). JMC hired EY to conduct due diligence as part of this acquisition. The audit report included sensitive information, such as LSI's and LSC's tax profiles and LSC's material tax exposures, gleaned from previous tax returns.

Atlas challenged the requirement to provide the report to the CRA on three grounds: (1) the document's relevance to the ongoing tax audit had not been established, (2) the document was protected under solicitor–client privilege, and (3) the disclosure of the report would impose on Atlas an obligation to self-audit. The FC dismissed all of Atlas's claims.

First, the FC found that the threshold of relevance under subsection 231.1(1) was low; the minister did not have to establish that the requested documentation was relevant to the audit, only that it might be. In this case, because the report had been prepared for JMC's acquisition of LSI's shares, and because the CRA's audit of Atlas was related to this transaction, the information in the report could be relevant in determining amounts payable by the company under the Act.

Second, although the due diligence report (prepared by an accounting firm) was not a direct communication between a lawyer and a client, the FC reiterated that solicitor–client privilege might still apply to a document generated by a third party. However, after a careful analysis of the events leading up to the preparation of the report, the court determined that JMC's main purpose in commissioning the report was to inform its business decision on the merits of the transaction and the purchase price of the shares, not to obtain legal advice on the structure of the potential transaction. Hence, the report was not covered by solicitor–client privilege.

Finally, the FC held that providing the document did not offend the principle developed in *BP Canada Energy Company v. Canada (National Revenue)* (2017 FCA 61), which precludes the imposition on taxpayers of an obligation to self-audit. In that decision, the FCA prohibited general and unrestricted access to tax accrual working papers that had been requested by the CRA to guide and facilitate any *possible* audit. In contrast, in *Atlas* the FC determined that the request for access to the report commissioned by JMC was made during an *active* tax audit and that, as such, the report could validly be requested.

The CRA indicated at CTF's 2018 annual tax conference that it will amend its official policy on access requests for documents containing sensitive tax information to reflect this FC decision.

François Desjardins
Raymond Chabot Grant Thornton LLP, Montreal
Desjardins.Francois@rcgt.com

L'ARC obtient l'accès à un rapport de vérification diligente

Dans *Canada (National Revenue) v. Atlas Tube Canada ULC* (2018 CF 1086; portée en appel), la CF a conclu que l'ARC pouvait valablement obtenir de la société canadienne Atlas Tube Canada ULC (Atlas), au cours d'une vérification fiscale de celle-ci, la transmission d'un rapport de vérification diligente préparé par la firme Ernst & Young (EY) dans le cadre d'une transaction antérieure impliquant Atlas. Cette décision rappelle aux contribuables (et leurs conseillers) engagés dans un processus de vérification diligente que les documents préparés dans ce contexte, lorsqu'ils ne bénéficient pas du secret professionnel de l'avocat, sont difficilement à l'abri du pouvoir général de vérification de l'ARC.

En 2012, JMC Steel Group Inc. (JMC), la société mère d'Atlas, a acquis les actions d'une société ontarienne publique, Lakeside Steel Inc. (LSI), qui détenait alors la totalité des actions d'une filiale, soit Lakeside Steel Corporation (LSC). Dans le cadre de cette acquisition, un processus de vérification diligente a été mené par EY pour le compte de JMC. Le rapport émanant de la vérification comprenait plusieurs informations sensibles, telles que le profil fiscal de LSI et de LSC ainsi que les principaux risques fiscaux de LSC résultant de ses déclarations de revenus antérieures.

Atlas a contesté l'obligation de fournir ce rapport à l'ARC en soutenant 1) l'absence de pertinence du document dans le cadre de la vérification fiscale en cours, 2) la protection conférée à celui-ci par le secret professionnel de l'avocat et 3) l'obligation d'autovérification découlant de la production imposée du rapport. La CF a rejeté l'ensemble des prétentions d'Atlas.

D'une part, la CF précisa que le seuil de pertinence prévu par le paragraphe 231.1(1) était peu élevé, de sorte que le ministre n'avait pas à établir que la documentation demandée était pertinente aux fins de la vérification, mais seulement qu'elle pouvait l'être. En l'espèce, puisque le rapport avait été préparé aux fins de l'acquisition des actions de LSI par JMC et que la vérification d'Atlas effectuée par l'ARC était liée à cette transaction, les informations contenues au rapport pouvaient être pertinentes afin de déterminer tout montant payable par la société en vertu de la LIR.

D'autre part, bien que le rapport de vérification diligente ne constituait pas une communication directe entre un avocat et un client, puisque préparé par une firme comptable, la CF rappela que le secret professionnel pouvait tout de même s'appliquer à un document généré par un tiers. Toutefois, à la suite d'une analyse minutieuse du fil des événements ayant mené à la préparation du rapport, elle détermina que l'objectif principal à l'origine de celui-ci était pour JMC d'obtenir des conseils commerciaux sur le bienfondé de la transaction et sur le prix d'acquisition des actions, et non de bénéficier d'un avis juridique sur la structure de la transaction envisagée. De ce fait, le rapport n'était pas protégé par le secret professionnel.

Finalement, la CF estima que la production du document ne portait pas atteinte au principe développé par *BP Canada Energy Company c. Canada (Revenu national)* (2017 CAF 61), selon lequel un contribuable n'est pas tenu de procéder à une autovérification. Dans cette décision, la CAF avait notamment interdit l'accès général et sans restriction, en vue d'orienter et de faciliter toute vérification éventuelle, aux documents de travail sur l'impôt couru demandés par l'ARC. Contrairement à la situation prévalant dans cette affaire, la CF détermina que la demande d'accès au rapport commandé par JMC était effectuée au cours d'une vérification fiscale *active* et que, à ce titre, celui-ci pouvait valablement être transmis.

L'ARC a précisé, lors de la Conférence annuelle 2018 de la Fondation canadienne de fiscalité, qu'elle modifiera en ce sens sa politique officielle relativement aux demandes d'accès visant les documents contenant des informations fiscales sensibles.

François Desjardins
Raymond Chabot Grant Thornton S.E.N.C.R.L, Montréal
Desjardins.Francois@rcgt.com

Attending TCC Hearings

The TCC regularly sits in 59 locations across Canada and, on application, may sit in other locations. Hearings are generally open to the public and listed on the TCC website, unless the hearing has been designated by the court as confidential. Thus, a tax practitioner could plan to attend a hearing out of general curiosity or an interest in a specific case; however, there is a significant risk that the hearing may be cancelled at the last minute. There can be a great variety of cases to choose from, depending on the city; for example, as of early January 2019, 43 different hearings were scheduled for Toronto during the week of February 4, 2019.

The TCC is a superior court that has exclusive original jurisdiction to hear appeals and references pursuant to 14 acts of Parliament, ranging from the Income Tax Act to the War Veterans Allowance Act. Most appeals relate to income tax, goods and services tax, and employment insurance.

The TCC provides information about upcoming hearings. On the TCC's hearings schedule page, select the hearing location (city) and the week of interest, then click to generate a "set down list report." The exact location is noted under "facility"; however, the locations may vary within any given city from hearing to hearing, although they will generally all be in the same building in the largest cities. The report also lists the date, time, hearing type (for example, appeal or status hearing), style of cause (which shows the taxpayer's name), the representatives in court of the taxpayer (who could be self-represented) and the Crown, the nature of the appeal, the tax year(s) in dispute, and the language of the hearing. The style of cause also indicates both the type of tax at issue—income tax (IT) and GST being the most common—and the hearing procedure. A hearing to be held under the general procedure is listed with a "G" at the end; "I" indicates a hearing under the informal procedure. A single judge of the TCC presides over each hearing. The name of that judge is not normally listed in the report, but it can usually be obtained by calling the registrar (whose phone number is listed in the report) within two weeks of the hearing date.

Unfortunately, the "nature of appeal" column provides only very general information about the types of issues that will be raised. Typical entries include capital expenditures, unreported income, penalties, business expenses, employment or self-employment, employment expenses, time extensions, appeals, and directors' liability. If a case is of special interest, one can contact the TCC in advance at any of its 18 registry offices for a copy of the written pleadings.

No statistics are available about the typical length of a hearing. In 2017-18, TCC judges spent 2,247 days in court (which likely includes procedural hearings, such as status hearings or motions, which can take place prior to the final hearing of an appeal), and 774 files were prepared for hearing and heard in court. This suggests that an average hearing lasts just under three days, but this average might be skewed by some very long hearings. It is likely that a typical hearing might be a half day or one full day.

It would be prudent to check the latest set down list report before attending a hearing because the party that instituted the appeal may discontinue it at any time by written notice (perhaps because of a settlement between the parties); this can happen just minutes before the hearing is scheduled to begin. In 2017-18, only a minority of cases that were scheduled for a hearing were prepared and heard in court (774 of 1,818), although there are no data available on the length of time between the cancellation and the hearing's scheduled time.

Sameer Nurmohamed
Osler, Hoskin & Harcourt LLP, Toronto
snurmohamed@osler.com

FCA: Value-Shifting Transaction Abuses Stop-Loss Rules

2763478 Canada Inc. (2018 FCA 209) concerned the use of a "paper loss"—as opposed to an economic loss—to shelter capital gains. The FCA upheld the TCC decision (2017 CCI 98) that GAAR applied to disallow the taxpayer's use of the capital loss. The FCA decision highlights the fact that parents and their children are not affiliated for the purpose of the stop-loss rules, despite the strong familial relationship. Although this suggests an opportunity—to craft a transaction exploiting this lack of affiliation, hopefully in such a way that the risk of GAAR applying is minimal—it appears that amendments to subsection 55(2) subsequent to the events of this case make it difficult or impossible to create such a paper loss.

The creation of the paper loss at issue resulted from a series of transactions in regard to the sale of an operating corporation, Groupe AST, to an arm's-length party. An individual, Mr. Jobin, owned Groupe AST and the corporate appellant (276). A new holding corporation (Holdco) was created. 276 transferred its shares of Groupe AST to Holdco at their fair market value of approximately $13 million in exchange for the issuance to 276 of class A shares of Holdco. As a result of this transfer and other transactions in the series, 276 realized capital gains. Holdco subsequently sold its shares of Groupe AST to the arm's-length party without realizing a capital gain. Several months later, Holdco declared a stock dividend on its shares held by 276, and issued preferred shares with a fixed redemption value equal to the approximately $13 million value of the class A shares. As a result, the value of the Holdco shares lay with the newly issued class B shares; the class A shares had a large unrealized capital loss, and the class B shares had a large unrealized capital gain. 276 subsequently sold its Holdco class A shares to a holding corporation owned by Jobin's son (Sonco)—for estate-freeze reasons, according to the taxpayer—and realized a capital loss on the sale.

Generally speaking, a loss realized on a disposition by a corporation to an affiliated person will be denied under subsection 40(3.4). However, since 276 and Sonco were not affiliated within the meaning of section 251.1, the stop-loss rule did not apply, allowing 276 to apply the capital loss against the capital gains realized in the reorganization. The minister disallowed the capital loss on the basis of GAAR, which was upheld by the TCC.

The FCA distinguished a "paper loss" from an "economic loss" or "true loss." Under paragraph 3(b), the increase in the value of property becomes a taxable source of income only when the property is disposed of and the gain is recognized. The FCA held that the recognition of a capital loss should follow the same logic. Allowing a paper loss to offset a true gain would frustrate the object, spirit, and purpose of the capital gains regime. In this case, 276 retained all the economic value but tried to reduce that value with a paper loss and was unsuccessful for the good reasons provided by both the TCC and the FCA.

Jin Wen
Grant Thornton LLP, Toronto
jin.wen@ca.gt.com

Costing of Election Promises: PBO Guidelines

The 2017 amendments to the Parliament of Canada Act introduced a new mandate for the parliamentary budget officer (PBO) to estimate the financial cost of election campaign proposals on request. This new mandate was criticized by the then PBO primarily on the basis that it would cause the non-partisan PBO to become involved in parties' pre-election development processes and strain limited PBO resources. However, no backing down on this commitment has taken place. Thus, with a federal election coming up in October 2019, the PBO published on November 23, 2018 some information on how this will work.

The guidelines, prepared following consultations with stakeholders, outline how the PBO will deliver its new mandate and ensure transparency in its process. The basic structure of the mandate is provided in the enacting legislation; however, the guidelines provide a framework for the costing request process and address some of the practical details that are not contained in the legislation. For example, the report sets out the request process, timelines, guidelines for the types of costs it may estimate, the PBO's resource and financial allocation, and how it will prioritize requests. It also clarifies that the PBO will not provide implementation advice or address the practical details of proposed policies. Three stated principles guide the report framework: the framework should (1) ensure that the PBO's analysis remains non-partisan, (2) ensure that the PBO's analysis remains credible, and (3) be manageable within the legislated time frame of 120 days (or the period following dissolution of Parliament).

The report also clarifies the interactions of the PBO with departments. Under the Parliament of Canada Act, ministers, departments, and agencies are required to assist the PBO in delivering the campaign costing mandate. This has been criticized as potentially creating a situation where parties may have to discuss elements of their platforms with government departments headed by a minister of an opposing party. In the report, the PBO clarified that the departments' role will be to prepare estimates if the PBO is unable to (due to confidentiality of data or lack of modelling capacity), as well as provide technical advice and peer review. The PBO emphasized its focus on maintaining its independence.

Although there will undoubtedly continue to be criticisms of the PBO costing process, and likely further refinements of the process as the new mandate gets under way, this report provides a helpful guideline for addressing the initial concerns with the mandate and provides practical details for its implementation. For further details on the PBO's new mandate, see "Role of the Parliamentary Budget Officer in Tax Policy," *Canadian Tax Focus*, August 2017.

Amanda Laren
Robins Appleby LLP, Toronto
alaren@robapp.com

Cryptocurrency Mining as a Service

The CRA treats cryptocurrency mining as an activity that generates or produces inventory—namely, the cryptocurrency (CRA document no. 2014-0525191E5, "Virtual Currencies (Bitcoins)," March 28, 2014). Accordingly, the mining of a cryptocurrency generates business income only when the cryptocurrency is sold. An alternative view—that cryptocurrency mining is a service provided by the miner to the blockchain network—produces very different tax results.

The function of cryptocurrency mining in the blockchain ecosystem is to provide computing power to the network in order to verify and record transactions on the blockchain. This function is in the nature of a service that the miner provides to the blockchain network in exchange for the cryptocurrency compensation. Further, the blockchain network could be recognized as a service recipient—either as an unincorporated association of participants (who are identifiable) or as a standalone organization. Most tax authorities currently reject this view (see, for example, the German Federal Ministry of Finance and the Australian Taxation Office).

The tax implications of this view depend, in part, on whether one considers cryptocurrency a commodity or a currency. Although the CRA has viewed it as a commodity, this issue is in flux: at the March 2018 Canadian Bar Association round table, the CRA said (at question 7) that it is considering whether payments in cryptocurrencies could be an exempt supply of a financial service (that is, of money or similar instruments) for the purposes of the GST/HST.

There are several implications for the cryptocurrency miner if its activities are viewed as the rendering of a service:

- At the time the service is rendered by the miner, there will be immediate revenue recognition. This differs from the CRA's current view, which delays revenue recognition until the cryptocurrency is sold. The amount of revenue depends on one's view of cryptocurrency: if it is a currency, the revenue is the value of the cryptocurrency; if it is a commodity, the revenue is the FMV of the service being provided. The latter value will be difficult to measure, but it should be at least equal to the electricity costs incurred; since these are variable costs in economic terms, a miner not getting at least that much revenue in return would shut down.
- Miners can argue for capital gains treatment of any increase in the value of the currency between the time that it was generated and the time of its disposition (using the criteria in *Interpretation Bulletin* IT-479R, "Transactions in Securities," February 29, 1984). This situation-specific result will apply regardless of whether the cryptocurrency is a commodity or a currency. In the CRA's current view, a sale of cryptocurrency attracts income treatment (as a sale of inventory).
- The mining service will not be a taxable supply for GST/HST purposes—at least, if the cryptocurrency is viewed as a currency, because it will be an exempt supply of a financial service. (For a discussion of the outcome when the cryptocurrency is viewed as a commodity, see "Making or Accepting Payment in Crypto: A GST/HST Risk?" *Canadian Tax Focus*, February 2018.)

For the blockchain itself, the question posed by the view of mining as a service is whether the blockchain is a person capable of being GST/HST-registered, or even a person subject to income tax. This question will become more relevant as we see further attempts at creating organizations in which decentralized control over operations is run entirely by smart contracts—the DAO (decentralized autonomous organization) being one well-known and unsuccessful example.

Laura Gheorghiu
Gowling WLG LLP, Montreal
laura.gheorghiu@gowlingwlg.com

Le minage des cryptomonnaies considéré comme un service

Pour l'ARC, les activités de minage de cryptomonnaies génèrent ou produisent un bien figurant à l'inventaire : la cryptomonnaie (l'ARC document nº 2014-0525191E5, « Virtual Currencies (Bitcoins) », 28 mars 2014). Par conséquent, le minage d'une cryptomonnaie génère un revenu d'entreprise seulement lorsque la cryptomonnaie est vendue. Si on considère plutôt le minage des cryptomonnaies comme un service fourni par le mineur au réseau des chaînes de blocs, on obtient des résultats fiscaux très différents.

Dans l'écosystème de la chaîne de blocs, le minage des cryptomonnaies sert à fournir au réseau la puissance informatique nécessaire pour vérifier et enregistrer les transactions dans la chaîne de blocs. Cette fonction a la nature d'un service fourni par le mineur au réseau des chaînes de blocs en contrepartie de la cryptomonnaie. De plus, le réseau des chaînes de blocs pourrait être reconnu comme le bénéficiaire du service — soit en tant qu'association de participants sans personnalité morale (lesquels sont identifiables) ou en tant qu'organisation autonome. La majorité des administrations fiscales rejette actuellement cette position; voir les documents du ministère fédéral des Finances de l'Allemagne et de l'Australie.

Cette position a des implications fiscales selon qu'on considère la cryptomonnaie comme une marchandise ou comme une monnaie. Bien que l'ARC ait considéré la cryptomonnaie comme une marchandise, cette question évolue : l'ARC a annoncé à la table ronde de l'ABC (question nº 7) en mars 2018 qu'elle examine la possibilité de considérer les paiements faits à l'aide de cryptomonnaies comme des services financiers exonérés (c'est-à-dire, argent ou instruments similaires) dans le régime de la TPS/TVH.

Pour le mineur, considérer ses efforts comme la fourniture d'un « service » a plusieurs implications :

- Un revenu serait constaté au moment où le mineur a fourni le service. Ce résultat diffère de la position actuelle de l'ARC, qui reporte la constatation du revenu au moment de la vente de la cryptomonnaie. Le montant du revenu dépend de la façon dont on considère la cryptomonnaie; s'il s'agit d'une monnaie, le revenu équivaut à la valeur de la cryptomonnaie; si elle est plutôt une marchandise, le revenu est égal à la JVM du service fourni. Cette dernière valeur serait difficile à mesurer, mais elle devrait être au moins égale aux coûts d'électricité engagés; puisque en termes économiques ce sont des coûts variables, un mineur cessera ses activités s'il ne reçoit pas en retour un montant de revenu au moins équivalent.
- Les mineurs pourraient préconiser que soit traitée en tant que gains en capital toute augmentation de la valeur de la monnaie entre le moment où elle a été générée et le moment de sa disposition (au moyen des critères cités dans le *Bulletin d'interprétation* IT-479R, « Transactions de valeurs mobilières », 29 février 1984). Ce résultat particulier à la situation s'appliquerait, que la cryptomonnaie soit considérée comme une marchandise ou comme une monnaie. La position actuelle de l'ARC est que la vente de la cryptomonnaie génère un revenu (provenant de la vente d'un bien figurant à l'inventaire).
- Le service de minage ne serait pas considéré comme une fourniture taxable pour le régime de la TPS/TVH; du moins si la cryptomonnaie est une monnaie, car elle serait la fourniture exonérée d'un service financier. (Sur la cryptomonnaie considérée comme une marchandise, voir « Making or Accepting Payment in Crypto: A GST/HST Risk? », *Canadian Tax Focus*, février 2018.)

Pour la chaîne de blocs elle-même, la question qui se pose lorsque le minage est considéré comme un service est de savoir si la chaîne de blocs est considérée comme une personne capable d'être inscrite au régime de la TPS/TVH, ou même une personne assujettie à l'impôt sur le revenu. Cette question deviendra encore plus pertinente lorsque nous considérons d'autres tentatives de créer une organisation où le contrôle sur les opérations, qui est décentralisé, est exercé uniquement par des contrats intelligents — comme *the DAO* (*decentralized autonomous organization*) qui a connu un échec retentissant.

Laura Gheorghiu
Gowling WLG S.E.N.C.R.L., s.r.l., Montréal
laura.gheorghiu@gowlingwlg.com

Amalgamations: Avoiding PUC Shifts

Subsection 87(3) provides computation rules for PUC in respect of a class of shares of a corporation that is formed on an amalgamation. This provision can create a shift of PUC relative to the PUC of the shares of the predecessor corporation, but this can often be avoided by using the subsection 87(3.1) election. This results from the interplay between the Act and the relevant corporate law.

Suppose Mr. A owns all of the issued and outstanding shares of ACo, which have an FMV of $1,000 and PUC of $100. Mr. B is in a similar position with respect to BCo, except that his PUC is $10. The two corporations are amalgamated and continued as ABCo under the CBCA, and Mr. A and Mr. B are issued class A and B common shares of ABCo ("the substituted classes") in exchange for their shares of ACo and BCo ("the exchanged classes"), respectively. Pursuant to subsection 87(3), the PUC of each substituted class is $55 ($1,000 − [$2,000 − $110] * [$1,000/$2,000]).

This may be problematic if the two parties want their PUC amounts to continue at the pre-amalgamation level. Thus, the goal would be to create two distinct classes of shares in ABCo: Mr. A wants to receive class A shares with PUC of $100, and Mr. B wants to receive class B shares with PUC of $10.

One way to do this would be to take advantage of the subsection 87(3.1) election. This election requires, among other things, that the PUC of each substituted class be identical to the PUC of the corresponding exchanged class. Both of these amounts are to be determined without reference to the provisions of the Act—which, in this example, means using the stated capital amounts for the two classes of shares as determined under the CBCA. Thus, for ABCo, class A shares need to have a stated capital of $100, and class B shares need to have a stated capital of $10.

Although the CBCA does not specifically define "stated capital," one can infer from section 26(3) of the CBCA that it is essentially the amount of capital contributions made directly to the corporation by its shareholders; therefore, for corporate-law purposes, stated capital is the equivalent of PUC since it generally serves the same function (that is, to track share capital contributions). Normally, a corporation is required to add to its appropriate stated capital account the FMV of the share capital contributions. However, CBCA section 26(3)(b), together with CBCA section 26(4), permits an amalgamated corporation to designate the stated capital account of any class of its shares as an amount between nil and the FMV of the contributions made. This permits ABCo to designate the stated capital account for classes A and B as the desired amounts of $100 and $10, respectively, and hence the subsection 87(3.1) election achieves the two parties' goal.

This example illustrates the legal principle that the Canadian income tax system is an accessory system: the legal substance of a given transaction or event has to be determined first by applicable common or statutory law, and then the tax consequences can be determined pursuant to tax law based on that legal substance. This concept was first articulated in *The Queen v Lagueux & Frères Inc.* (74 DTC 6569 (FCTD)) and has been discussed in the CTF 2006 annual tax conference report paper, "The Tax Treatment of Transformation Transactions."

Yahui Zhu
Ernst & Young LLP, Vancouver
yahui.zhu@ca.ey.com

Potential authors are encouraged to send ideas or original submissions to the editor of *Canadian Tax Focus*, Alan Macnaughton (amacnaughton@uwaterloo.ca), or to one of the contributing editors listed below. Content must not have been published or submitted elsewhere. Before submitting material to *Canadian Tax Focus*, authors should ensure that their firms' applicable review policies and requirements for articles bearing the firm's name have been met.

For each issue, contributing editors from Young Practitioners chapters across Canada suggest topics and assist authors in developing ideas for publication. For the February 2019 issue, we thank Timothy Fitzsimmons, editorial adviser, and the contributing editors shown in the list below. In Montreal, an editorial board works together in preparing articles. We thank the board chair, Olivier Fournier (olfournier@deloittetaxlaw.ca), and Raphael Barchichat (rbarchichat@psbboisjoli.ca); Justine Morin (justinemorin@kpmg.ca); Angelo Discepola (adiscepola@mccarthy.ca); Kareen Tea (ktea@bdo.ca); Alexandre Papale (apapale@morencyavocats.com); François Desjardins (desjardins.francois@rcgt.com); Nathalie Perron (n.perron@barsalou.ca); and Jonathan Lafrance (jonathan.lafrance@nortonrosefulbright.com).

Halifax:
- Bryan Whalen (bpwhalen@collinsbarrow.com)

Ottawa:
- Mark Dumalski (mdumalski@deloitte.ca)
- Nick Korhonen (nick.korhonen@mnp.ca)

Toronto:
- Amanda Laren (alaren@robapp.com)
- Melanie Kneis (melanie.kneis@rbc.com)

Winnipeg:
- Nora Fien (nfien@FillmoreRiley.com)
- Ari Hanson (ahanson@FillmoreRiley.com)

Saskatoon:
- Byron Bitz (bbitz@bbllp.ca)

Edmonton:
- Tim Kirby (tkirby@felesky.com)

Calgary:
- Marshall Haughey (HaugheyM@bennettjones.com)
- Steve Marshall (smarshall@mccarthy.ca)

Vancouver:
- Sam Liang (sam@taxlegal.ca)

ISSN 1925-6817 (Online). Published quarterly.