CANADIAN TAX focus

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# "Tax Benefit" for GAAR: The Defences

While GAAR jurisprudence and commentary typically focus on whether an avoidance transaction exists and is abusive, the threshold condition for the application of GAAR—that a tax benefit exist—has received less attention. Some may assume that there is no possibility of a successful defence on this basis, but the record shows otherwise. Jurisprudence has established two defences to the Crown's assertion of a tax benefit:

1) the transaction creates, increases, or preserves valuable tax attributes that could result in future tax savings but have not yet done so; and
2) the alternative or benchmark transaction that the Crown has advanced to confirm the existence of a tax benefit fails in one or more established ways.

Similar defences apply where, instead of a single transaction, a series of transactions is involved.

## Tax Attribute Defence

The taxpayer's successful argument here is that creating, increasing, or preserving valuable tax attributes has merely "created the potential" for tax savings, and there is no tax benefit where "that potential has, to date, not been realized": *Wild*, sub nom. *1245989 Alberta Ltd. v. Canada (Attorney General)*, 2018 FCA 114 (PUC increase, but no tax reduction). See also *Rogers Enterprises (2015) Inc. v. The Queen*, 2020 TCC 92 (CDA increase and income reduction, but no tax reduction) and *Gladwin Realty Corporation v. Canada*, 2020 FCA 142 (CDA increase, but no tax reduction).

Taxpayers should consider that using this defence may only delay a GAAR challenge until after the tax benefit is realized (if that occurs): *Deans Knight Income Corporation v. The Queen*, 2019 TCC 76 (taxpayer used various tax attributes). The avoidance transaction may conceivably have occurred many years earlier in the series of transactions. Recognizing this, the taxpayer in *Gladwin* undertook to pay a tax-free capital dividend so that the courts could find a tax benefit and focus on the abuse stage of the analysis.

## Alternative Transaction Defence

In *The Queen v. Canada Trustco Mortgage Company* (2005 SCC 54), the SCC stated that, in some circumstances, the existence of a tax benefit can only be established by comparison with an alternative transaction. The alternative transaction can be challenged in various ways:

- *The alternative transaction produces the same tax result as the taxpayer's actual transaction.* In *Canada v. Bank of Montreal* (2020 FCA 82), the FCA held that even without the creation of a separate class of preferred shares, subsection 112(3.1) would not have reduced the capital loss realized on the disposition of the common shares.
- *It is not reasonable to conclude that the taxpayer would have undertaken the alternative transaction.* In *Univar Canada Ltd. v. The Queen* (2005 TCC 723), the TCC found no tax benefit since the taxpayer's officers' evidence showed that the taxpayer had no intention of undertaking the Crown's proposed alternative transaction. In *Copthorne Holdings Ltd. v. Canada* (2011 SCC 63), the SCC found in favour of

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the Crown: the SCC accepted the principle that the alternative transaction must be one that "might reasonably have been carried out but for the existence of the tax benefit" (paragraph 35) but concluded that the requirement was met.
- *The alternative transaction is not an appropriate comparison* (perhaps for some non-tax reason, such as regulatory or commercial considerations). It appears that this defence has not yet been successfully argued.

### An "Alternative" Alternative Transaction?

Another possible defence is for the taxpayer to propose its own alternative transaction. Similar to the three points above, the proposed transaction would have to (1) produce the same tax result as the actual transaction, (2) be an alternative that the taxpayer would have reasonably considered undertaking, and/or (3) be an appropriate comparison.

A defence of this type was attempted in *594710 British Columbia Ltd. v. The Queen* (2016 TCC 288; aff'd on this point 2018 FCA 166), but it failed because of item 2 above: the TCC concluded that the taxpayer's proposed alternative was not reasonable based on the facts, and that the only alternative transaction that should be considered was the possibility that the actual transaction had not occurred.

In *Fiducie financière Satoma v. The Queen* (2017 TCC 84; aff'd 2018 FCA 74), another attempted defence of this type, the taxpayer failed to prove item 3 above. The TCC did not consider the taxpayer's proposed alternatives of investing directly or through a corporation as appropriate comparisons, because a trust was an essential part of the plan at issue, and the tax treatment of the taxpayer's proposed alternatives differed substantially from the transactions it actually undertook.

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## Avoiding the Double Year-End Where a Sale Causes Loss of CCPC Status

During a sales transaction in which a CCPC becomes a non-CCPC, the loss of CCPC status may occur in advance of closing when a letter of intent (LOI), a securities purchase agreement (SPA), or another similar document is signed. The loss of CCPC status results in a deemed year-end under subsection 249(3.1). This occurs separately from the deemed year-end on acquisition of control under subsection 249(4), creating two deemed year-ends for a single transaction. While the deemed year-end on acquisition of control is unavoidable, the deemed year-end on the loss of CCPC status can be eliminated by electing under subsection 89(11). Although this election produces its own workload, it is much less burdensome than the subsection 249(3.1) deemed year-end.

For the purposes of the CCPC definition, paragraph 251(5)(b) gives deemed control to shares or voting rights owned by a person (in this case, a non-resident or non-private person) that has a right under contract to acquire them. In technical interpretation 2014-0552711E5 (July 7, 2015), the CRA noted the following conditions for a contract to trigger the application of this paragraph:

- the contract must contemplate the right to acquire the shares or voting rights;
- the right can be absolute or contingent, and can be exercised immediately or in the future; and
- the contract must include two or more persons.

Given this broad interpretation, an LOI or SPA often satisfies the conditions of paragraph 251(5)(b). In that case, the loss of CCPC status occurs immediately upon the signing of the contract, even if the closing is in the future and contingent.

In addition to the normal impact of an additional deemed year-end—most notably the acceleration of loss carryforwards, foreign tax credits, and ITCs—a loss of CCPC status results in loss of ABIL and the SBD, lower ITC rates for SR & ED claims, and the potential creation of a low-rate income pool (LRIP). (Fortunately, one does not immediately lose access to the lifetime capital gains exemption in this specific circumstance—see paragraph 110.6(14)(b).) While these consequences would occur anyway once the deal closed, the timing of these impacts may surprise practitioners and cause unintended or unexpected results.

A subsection 89(11) election deems the entity not to be a CCPC at any time during or after the taxation year in which the election is made, which means that the entity is considered a non-CCPC starting on the first day of the taxation year in which the election is made. With an election in place, an entity cannot lose its CCPC status under subsection 249(3.1) through an LOI, SPA, or similar document since it is already a non-CCPC prior to anything being signed. The subsection 249(3.1) year-end does not occur. The CRA confirmed this point in technical interpretation 2014-0523171E5 (March 27, 2014).

While the subsection 89(11) election does not completely avoid the consequences of losing CCPC status, it accomplishes two things. First, it prevents the deemed year-end under subsection 249(3.1) that can cause a large administrative burden. Second, it usually ensures that accurate accounting information is available for the computations required when transitioning from a CCPC to a non-CCPC. Because the subsection 249(3.1) year-end occurs at an unusual time, and often involves little notice, it would be rare for a year-end of that type to allow proper cutoff work to be completed in order to produce a fully accurate measurement of income.

To illustrate the different dates in the process, suppose a calendar-year corporation signs a contract of sale on February 1, 2021 and the deal closes on April 1, 2021. There is a deemed year-end under subsection 249(4) on March 30, 2021.

The subsection 89(11) election is made for the short taxation year of January 1, 2021 to March 30, 2021, and it deems the corporation to have ceased to be a CCPC at the beginning of that year. The signing of the contract of sale on February 1, 2021 does not trigger a year-end under subsection 249(3.1), since the corporation is already a non-CCPC at that time. The acquisition-of-control return and the subsection 89(11) election are both due six months after the end of the short taxation year, which is September 30, 2021.

An anomaly produced by the rules is that a loss-of-CCPC-status return is technically required until the subsection 89(11) election is filed. Thus, in the example, that return is due on July 30, 2021 and would be considered late during the interim period.

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## Dividend Payment Trap: ERDTOH Converted to NERDTOH

Changes to the taxation of investment income in 2018 replaced the single refundable dividend tax on hand (RDTOH) account with two accounts: eligible refundable dividend tax on hand (ERDTOH) and non-eligible refundable dividend tax on hand (NERDTOH). Where, in the same taxation year, a corporation pays eligible dividends to one corporation and non-eligible dividends to a second corporation, a portion of the opening ERDTOH account balance in the payer corporation may be converted to a NERDTOH account balance in a payee corporation. This results in overtaxation when the dividend is ultimately received by a personal taxpayer.

Consider the following example:

- Opco is a private corporation. Holdco owns all of Opco's common shares and Investco owns all of Opco's preferred shares. Holdco and Investco are related to Opco.
- Before the payment of dividends, Opco had a general-rate income pool (GRIP) of $100,000, an ERDTOH account balance of $38,333, and a NERDTOH account balance of $100,000.
- During its taxation year, Opco paid an eligible dividend of $100,000 to Holdco. It also redeemed preferred shares held by Investco, resulting in a non-eligible deemed dividend of $500,000.

Under subsection 129(1), the eligible dividend paid by Opco entitles Opco to a refund of the entire ERDTOH account balance. In turn, the deemed dividend triggers a refund of the entire NERDTOH account balance.

The part IV income tax that Holdco and Investco have to pay is determined on the basis of the aggregate dividends that Opco paid and the total dividend refund that it received during its taxation year. Specifically, the part IV tax payable by Holdco and Investco amounts to 1/6 and 5/6, respectively, of Opco's total dividend refund, since those are the proportions of Opco's total dividends that the two corporations received ($100,000/$600,000 and $500,000/$600,000). The total dividend refund is $138,333 ($100,000 + $38,333). Calculating the 1/6 and 5/6 fractions of $138,333 results in part IV tax amounts of $23,055 for Holdco and $115,278 for Investco.

The next step involves determining the type of RDTOH account to which the part IV income tax paid should be added. Under subsection 129(4), all the part IV tax that Holdco paid should be added to its ERDTOH account, because the tax is payable as a result of a dividend received from a payer corporation that obtained an ERDTOH dividend refund. However, no amount may be added to Investco's ERDTOH account, because the dividend Investco received did not entitle Opco to receive an ERDTOH dividend refund. Thus, the entire amount of part IV income tax that Investco paid is added to its NERDTOH account.

As a result, the only non-zero RDTOH balances in the corporate group after the dividends are an ERDTOH balance of $23,055 for Holdco and a NERDTOH balance of $115,278 for Investco. Thus, at the corporate group level, the effect of the dividend payments is to move $15,278 from ERDTOH to NERDTOH, which increases the amount of tax to be paid by the ultimate shareholder.

This result could have been avoided if the redemption of preferred shares had been made in the following taxation year or if the total dividends paid had not exceeded 38.33 percent of Opco's total NERDTOH and ERDTOH account balances.

In policy terms, the problem results from the fact that paragraph 186(1)(b) does not establish any link between the type of RDTOH account that generated Opco's dividend refund and the type of dividend that Holdco and Investco received.

This type of problem currently comes up more frequently because of the transitional measures accompanying the 2018 changes. However, the problem will continue to occur in the future for companies that have both ERDTOH and NERDTOH account balances.

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## Piège potentiel lors du versement de dividendes inter-sociétés : Conversion de l'IMRDD en IMRDND

Dans la foulée des changements au régime fiscal apportés à l'égard des revenus de placement en 2018, le compte d'impôt en main remboursable au titre de dividendes (IMRTD) a été remplacé par deux nouveaux comptes :

le compte d'impôt en main remboursable au titre de dividendes déterminés (IMRDD) et le compte d'impôt en main remboursable au titre de dividendes non déterminés (IMRDND). Si, au cours de la même année d'imposition, une société verse un dividende déterminé à une société et un dividende non déterminé à une autre société, une partie du solde d'ouverture du compte d'IMRDD de la société payante peut être convertie en IMRDND pour la société bénéficiaire. Il en résulte alors une surimposition lorsque le dividende est reçu ultimement par l'actionnaire qui est un particulier.

L'exemple suivant est utilisé pour illustrer cette possibilité :

- La société opérante (Opco) est une société privée. Une société de portefeuille (Holdco) détient toutes les actions ordinaires d'Opco tandis qu'une société de placement (Investco) détient toutes les actions privilégiées d'Opco. Holdco et Investco sont rattachées à Opco.
- Avant le versement des dividendes, Opco avait un compte de revenu à taux général (CRTG) de 100 000 $, un solde d'IMRDD de 38 333 $ ainsi qu'un solde d'IMRDND de 100 000 $.
- Au cours de son année d'imposition, Opco a versé à Holdco un dividende déterminé de 100 000 $. Elle a également racheté les actions privilégiées détenues par Investco, occasionnant un dividende non déterminé réputé payé de 500 000 $.

En vertu du paragraphe 129(1), en versant un dividende déterminé, Opco a droit, dans un premier temps, au remboursement du solde intégral du compte d'IMRDD. Par la suite, le dividende non déterminé réputé payé, permet à Opco d'obtenir le remboursement de la totalité du compte d'IMRDND.

L'impôt de la partie IV payable par Holdoco et Investco est déterminé en fonction de l'ensemble des dividendes versés par Opco et du remboursement au titre de dividendes (RTD) total que celle-ci a reçu au cours de son année d'imposition. Plus particulièrement, cet impôt payable représente, pour Holdco et Investco respectivement, ⅙ et ⅚ du RTD total reçu par Opco, soit les proportions dans lesquelles les dividendes totaux d'Opco ont été versés aux deux autres sociétés (100 000 $/600 000 $ et 500 000 $/600 000 $). Le RTD d'Opco est de 138 333 $ (100 000 $ + 38 333 $). En appliquant à cette somme les fractions de ⅙ et de ⅚, on obtient un impôt de la partie IV de 23 055 $ pour Holdco et de 115 278 $ pour Investco.

Il faut ensuite déterminer dans quel compte d'IMRTD l'impôt de la partie IV payé par les sociétés bénéficiaires doit être ajouté. Conformément au paragraphe 129(4), l'impôt de la partie IV payé par Holdco est ajouté à son compte d'IMRDD, puisque cet impôt résulte d'un dividende reçu d'une société payante qui a obtenu un RTD provenant de son compte d'IMRDD. Cependant, aucune somme ne peut être ajoutée au compte d'IMRDD d'Investco, car le dividende reçu par cette dernière n'a pas conféré à Opco le droit à un RTD provenant de son compte d'IMRDD. Par conséquent, le montant total de l'impôt de la partie IV payé par Investco est ajouté à son compte d'IMRDND.

En résumé, après le versement des dividendes, les seuls comptes d'IMRTD du groupe de sociétés sont les suivants : le compte d'IMRDD de Holdco, dont le solde est de 23 055 $, et le compte d'IMRDND d'Investco, dont le solde est de 115 278 $. Ainsi, au niveau du groupe, les versements de dividendes entraînent une conversion d'IMRDD en IMRDND de 15 278 $, ce qui augmentera l'obligation fiscale de l'actionnaire ultime.

Ce résultat aurait pu être évité si le rachat des actions privilégiées avait eu lieu au cours de l'année d'imposition suivant le versement du dividende déterminé, ou si la totalité des dividendes versés n'avait pas dépassé 38,33 % du solde total des comptes d'IMRDND et d'IMRDD d'Opco.

Sur le plan législatif, le problème est attribuable au fait que l'alinéa 186(1)b) n'établit aucun lien entre le type de compte d'IMRTD à l'origine du RTD d'Opco et le type de dividende reçu par Holdo et Investco.

À l'heure actuelle, ce problème semble être plus fréquent en raison des mesures transitoires introduites par le budget fédéral de 2018. Il continuera néanmoins de se produire dans l'avenir pour les sociétés ayant des soldes d'IMRDD et d'IMRDND.

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## Judicial Review with Teeth

*Mokrycke* (2020 FC 1027) is the first reported case where a taxpayer has been successful in requesting a judicial review of the CRA's refusal to grant a remission order. This forms part of a series of cases, following *Vavilov* (2019 SCC 65), in which the CRA's decisions have been faulted (for example, *Sangha*, 2020 FC 712). Paragraphs 39 and 65 of the *Mokrycke* decision make it clear, using quotations from *Vavilov*, that henceforth the CRA will have to provide clear, logical, and convincing reasons for its discretionary decisions if they are to pass judicial review. The *Mokrycke* decision further suggests, albeit in obiter, that the CRA should be more transparent about its decision-making guidelines, lest it be open to attack on the grounds of natural justice and procedural fairness.

The taxpayer, who represented himself at the TCC, was an architect. An auditor concluded that he had underreported his income and deducted unsupported expenses. During the audit, he was immersed in health issues, family-law disputes, and financial strain, including the potential for two foreclosures and the failure of a major project. His accountant filed a notice of objection, but the accountant abandoned the matter for personal reasons. A second accountant provided a superficial submission to the CRA Appeals Division. The CRA issued a notice of confirmation, after which the second accountant took no further action. The taxpayer allowed the deadline to appeal to the TCC to lapse. A taxpayer relief application was then filed by the taxpayer, but it was unsuccessful. The taxpayer then applied for remission pursuant to the Financial Administration Act.

Remission of tax and penalties may be granted where "collection . . . is unreasonable or unjust or . . . it is otherwise in the public interest." Internal CRA guidelines indicate that remission should be recommended where there is (1) extreme hardship, (2) financial setback coupled with extenuating factors, (3) incorrect action or advice on the part of CRA officials, or (4) an unintended result of the legislation. These guidelines are said to be illustrative but not exhaustive.

The grounds of the application included extenuating circumstances, significant financial hardship, and incorrect action on the part of CRA officials. The CRA refused to recommend remission, citing the absence of any substantive representations in response to the audit proposal, the absence of evidence that the taxpayer's health difficulties affected his ability to engage in the audit and objection processes, and the contention that the failures of a representative are a matter to be addressed between the taxpayer and the representative alone. The taxpayer sought judicial review.

The FC found that, while remission was an extraordinary measure, *Vavilov* affirmed the need for CRA decisions to be both justifiable and properly justified in reasons provided to a party subject to the decision. The CRA did not meaningfully address the argument that it failed to consider the taxpayer's extenuating circumstances. This was not an attempt to craft a parallel objection or appeal procedure: the CRA's obligation was to consider whether the party seeking remission could not use those procedures owing to extenuating circumstances. Furthermore, it was no answer to the taxpayer's contention that he was reasonable in his reliance on tax professionals to merely state that errors of a tax professional are a matter to be settled between adviser and client. The decision was not properly justified and was therefore unreasonable.

Neither party made submissions with respect to whether the CRA had also breached the requirements of natural justice and procedural fairness, but the FC remarked in obiter that the taxpayer had never been provided with the guidelines and that the CRA's allusion to the option of remission in its correspondence was trite and cursory. The guidelines themselves were marked "For CRA use only."

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## Self-Help To Remedy Inventory Errors Creates Disaster

The recent decision of *Yorkwest Plumbing Supply Inc. v. The Queen* (2020 TCC 122) demonstrates the court's reluctance to embrace self-help remedies as an alternative to amending previously filed returns in the manner prescribed by law. Tax preparers need to exercise extreme caution when taking accounting shortcuts, especially when the amounts concerned are material, lest the tax preparer become the author of the client's misfortune.

The taxpayer converted its periodic inventory system to a perpetual inventory system in 2009, which caused a significant disruption and required considerable attention from management. The taxpayer acquired $1.3 million of inventory before the end of its 2009 taxation year. Since the taxpayer had not fully transitioned the inventory system, a special purpose account was created to enable payment to its suppliers. Unfortunately, the taxpayer forgot about this account until 2012. In the taxpayer's 2010 and 2011 taxation years, revenue from this inventory was recorded in real time as it was sold, but the cost of sales was not deducted. As a result, the taxpayer's net income was overstated by $1.3 million—a substantial amount for a taxpayer with annual revenue of $60 million.

It was open to the taxpayer to amend its tax returns for its 2010 and 2011 taxation years to correct the error. However, the taxpayer determined that this exercise "would have diverted time and energy from more important matters." Instead, in 2012, the taxpayer decided to write down its inventory to effectively create a deduction for the cost of these sales. As a result, the taxpayer's 2012 taxable income was underreported by $1.3 million, and the CRA reassessed accordingly. The deadline for filing an adjustment to the taxpayer's 2010 tax return had passed by that time, so the taxpayer's only option was to contest the reassessment.

On appeal, Spiro J confirmed that "inventory" means goods available for sale in the current taxation year, and therefore it cannot include goods that were sold in an earlier taxation year. Since the goods acquired in 2009 had been sold in the taxpayer's 2010 and 2011 taxation years, the goods were not inventory and could not be written down in 2012. Spiro J held further that the cost of inventory is recognized only in the taxation year in which the inventory is sold. This precluded the taxpayer from deducting the $1.3 million at issue in its 2012 taxation year, or in any year other than the year in which the inventory was sold.

The taxpayer argued that its only possible choice was to take the deduction in 2012, and that this resulted in an accurate picture of the taxpayer's overall profit in accordance with the SCC's decision in *Canderel* ([1998] 1 SCR 147). Spiro J was not persuaded. The taxpayer's argument relied on an incorrect calculation of its cost of sales, so it could not possibly produce an accurate picture of income and did not meet the *Canderel* standard. While this result of the reassessment may be unfair, it was the only legally permissible outcome.

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## SR & ED Performed Under Contract: Whose SR & ED Is It?

Where one party performs SR & ED under contract with another party, the tax authorities have an interest in ensuring that both parties do not make SR & ED claims for the same work. Where the amount paid fits the definition of a contract payment (which is similar under both Quebec tax legislation and the Income Tax Act), only the payer can make the claim. In *MDA Systems Ltd.* (2020 QCCQ 4190; under appeal), the Court of Quebec ruled that the funding party's payment to the taxpayer fit this definition, significantly reducing the amount of the SR & ED tax credit for salaries and wages the taxpayer could claim. This is a landmark decision on a rarely litigated but crucial question that is highly relevant to the pricing of SR & ED projects to be done under contract.

The case concerned a project involving different phases of satellite design, manufacture, and delivery funded by the Canadian Space Agency and contracted out to the taxpayer. The issue was whether all or part of the amount paid was a contract payment. In both Quebec and Canadian tax legislation, a "contract payment" is defined as an amount paid to a taxpayer for SR & ED to be performed for or on behalf of a taxable supplier. Generally, the application of this concept reduces the amount used as the basis for calculating SR & ED tax incentives.

To determine the nature of the payments received by the taxpayer, the court analyzed the four criteria set out in section 5.5 of the CRA's "Assistance and Contract Payments Policy." Despite the fact that these criteria are not in the law itself, the court relied strictly on them and on tax practitioner Lucie Bélanger's comments about them. The court also affirmed that this issue was a question of mixed fact and law and noted that none of these criteria are, in themselves, conclusive. The court's analysis of the four criteria was as follows:

- *Contractor performance requirements*. The project contracts did not contain any explicit requirement that the taxpayer perform SR & ED. However, the court considered that, given the sophisticated and novel nature of the deliverables, the parties knew that this would be necessary. The court used this interpretation to conclude that SR & ED was an implied requirement of the contracts, rather than conducting an analysis of the parties' common intent—a crucial point of analysis in Quebec civil litigation. This interpretation was a key element favouring the Crown, so it is expected to be central to the taxpayer's planned appeal.
- *Pricing versus risks assumed*. The court conducted an overall analysis of the contractual agreements to determine that the funding party was assuming the majority of the financial risks should the project fail. Again, this supported the Crown. However, the court did not analyze each of the project phases separately, even though the phases had different terms.
- *Intellectual property*. The court found that this criterion supported the Crown because the intellectual property ultimately belonged to the funding party—even though the taxpayer had obtained perpetual, irrevocable, and royalty-free licences to use the intellectual property resulting from the SR & ED.
- *Contract for services*. The project contracts were held to be service contracts (not contracts for the sale of goods) within the meaning of article 2103 of the Civil Code of Québec, because SR & ED was crucial (not incidental) to the project and there was an implied obligation to perform SR & ED. This again supported the Crown, so all four criteria were held to support the Crown's case.

Another notable aspect of the judgment is the brief and enigmatic comment in paragraphs 87 and 88 on the current model of burden of proof in tax appeals. These paragraphs are not completely consistent with recent FCA decisions (notably *Sarmadi v. Canada*, 2017 FCA 131 and, more recently, *Eisbrenner v. Canada*, 2020 FCA 93).

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## RS&DE dans le cadre d'un contrat : Qui a droit au crédit d'impôt?

Lorsqu'une partie réalise des activités de RS&DE pour le compte d'une autre partie en vertu d'un contrat, les autorités fiscales ont intérêt à veiller à ce que le crédit d'impôt auquel ces travaux donnent droit ne soit pas demandé par les deux parties. Si la somme payée correspond à la définition d'un paiement contractuel (similaire dans la législation fiscale québécoise et la Loi de l'impôt sur le revenu), seul le payeur a droit au crédit. Dans l'affaire *MDA Systems Ltd.* (2020 QCCQ 4190; en appel), la Cour du Québec a jugé que le paiement versé au contribuable par le partenaire financier satisfaisait à cette définition. Par conséquent, les montants que le contribuable pouvait demander au titre du crédit d'impôt relatif aux salaires pour la RS&DE ont été considérablement réduits. Ce jugement traite d'une question qui est rarement tranchée par les tribunaux, mais qui sera déterminante pour fixer la contrepartie des projets de RS&DE réalisés en vertu de contrats.

L'affaire portait sur un projet comportant différentes phases de conception, de fabrication et de livraison de satellites financé par l'Agence spatiale canadienne et sous-traité au contribuable. En l'espèce, le nœud du litige était de déterminer si les sommes versées constituaient, en tout ou en partie, un paiement contractuel. Les législations québécoise et fédérale définissent toutes deux un « paiement contractuel » comme un montant payé à un contribuable pour la réalisation de travaux de RS&DE pour le payeur ou pour le compte du payeur. L'application de cette notion a généralement pour effet de réduire le montant servant de base pour le calcul des crédits d'impôt pour la RS&DE.

Pour établir la nature des paiements reçus par le contribuable, le tribunal a analysé les quatre critères énoncés à la section 5.5 de la « Politique sur l'aide et les paiements contractuels » de l'ARC. Le jugement s'appuie strictement sur ces critères, qui ne sont pas énoncés dans la loi, ainsi que sur les commentaires formulés à ce sujet par la fiscaliste Lucie Bélanger. La Cour souligne, par ailleurs, qu'il s'agit d'une question à la fois de fait et de droit, et qu'aucun de ces critères n'est en soi déterminant. Voici, en résumé, l'analyse de la Cour en ce qui concerne les quatre critères :

- *Exigences du contrat quant aux travaux à effectuer.* Les contrats liés au projet ne stipulaient pas explicitement que le contribuable avait une obligation de réaliser des travaux de RS&DE. Néanmoins, compte tenu de la nature complexe et novatrice des produits livrables, la Cour a estimé que les parties savaient que de tels travaux seraient nécessaires. En se fondant sur cette interprétation, le tribunal a conclu à l'existence d'une obligation contractuelle implicite concernant la RS&DE. Il ne s'est donc pas attardé à la recherche de la commune intention des parties, un élément d'analyse essentiel en matière de litige civil au Québec. Cette interprétation étant l'un des éléments qui ont milité le plus fortement en faveur de l'ARQ, nous anticipons qu'elle occupera une place centrale dans les arguments que le contribuable présentera éventuellement en appel.
- *Prix par rapport aux risques assumés.* Au terme d'une analyse de l'économie générale des contrats, le tribunal a déterminé que le partenaire financier assumait la majeure partie des risques financiers en cas d'échec du projet, une autre conclusion en faveur de l'ARQ. En revanche, le tribunal n'a pas analysé chacune des phases du projet séparément, malgré que celles-ci étaient assorties de modalités différentes.
- *Propriété intellectuelle.* La Cour a déterminé que ce critère étayait la thèse de l'ARQ, car la propriété intellectuelle appartenait en définitive au partenaire financier et ce, même si le contribuable avait obtenu des licences perpétuelles, irrévocables et libres de redevances pour l'utilisation de la propriété intellectuelle issue des travaux de RS&DE.
- *Contrat de services.* Les contrats dans le cadre du projet ont été considérés comme des contrats de services (plutôt que des contrats pour la vente de biens) au sens de l'article 2103 du Code civil du Québec, car les travaux de RS&DE étaient essentiels (et non accessoires) au projet et il existait une obligation implicite de réaliser ces travaux. Le tribunal a conclu que ce critère, à l'instar des trois précédents, appuyait les arguments de l'ARQ.

Un autre élément intéressant du jugement est le commentaire à la fois bref et énigmatique fourni aux paragraphes 87 et 88, qui porte sur la question du fardeau de la preuve dans le cadre d'appels en matière fiscale. Ces paragraphes divergent quelque peu de la jurisprudence récente de la CAF (notamment dans *Sarmadi c. Canada*, 2017 CAF 131, et, plus récemment, *Eisbrenner c. Canada*, 2020 CAF 93).

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## TCC on Retrospective Modification of Tax Positions for Loss Years

There is a view that, unless a notice of determination of losses has been issued for a year in which no tax was payable, a taxpayer can retrospectively modify its tax positions for that year—even after the expiry of the normal reassessment period—where doing so is relevant to its tax liability in a future, taxable year (see Michael Lubetsky's article in the *Canadian Tax Journal* [2019] 67:3). However, in *St. Benedict* (2020 TCC 109), the TCC appears to at least qualify this proposition, interpreting differently a decision that may have been thought to support it (*Clibetre Exploration Ltd. v. Canada*, 2003 FCA 16). *St. Benedict* is consistent with the CRA's negative view of adjusting CCA claims for past years to revive expired losses (CRA document no. 2013-0474111I7, March 25, 2013). The correctness of this decision remains uncertain, since the taxpayer has appealed to the FCA.

In *St. Benedict*, the taxpayer claimed CCA on class 13 depreciable property in its 1997-2003 taxation years. The minister issued nil assessments in respect of those years. In filing its tax returns for the 2014-2016 taxation years, the taxpayer carried forward non-capital losses from its 1996-2007 taxation years. The minister reassessed the taxpayer for 2014-2016, denying the non-capital loss claims on the basis that the losses had expired. In its notice of objection, the taxpayer accepted the expiry. However, it reduced its class 13 CCA claims for the 1997-2003 and 2010 taxation years to increase its future UCC balance; its tax payable for those years continued to be nil. This adjustment created a terminal loss in the 2017 taxation year, which the taxpayer sought to carry back to reduce the amount of the reassessments. The sole issue before the TCC was whether the taxpayer could retrospectively adjust its CCA claims in this way.

The taxpayer argued that the facts in *Clibetre* were similar to those before the court. In *Clibetre*, the taxpayer had, in past years, claimed as ordinary business expenses amounts that should have been classified as Canadian exploration expenses (CEE). The taxpayer would have had non-capital losses in those years, even without CEE deductions. In a later year, the taxpayer filed its return on the basis that it had an available cumulative CEE balance, which it deducted in that year. The FCA accepted this recharacterization.

The court in *St. Benedict* observed that *Clibetre* "stands for the proposition that neither the taxpayer nor the Minister is bound by a mistake made regarding the tax treatment of expenses" (paragraph 30), stating further that "the outcome would have been different had the taxpayer properly included the expenses in the CEE pool at the outset and then claimed a deduction from the pool" (paragraph 31). Because the facts in *St. Benedict* did not involve the correction of a mistake, *Clibetre* was held not to be relevant.

In dismissing the taxpayer's appeal, the court concluded that once a taxpayer claims a deduction for CCA on its income tax return, variable E of the definition of UCC operates on a "purely mechanical basis": the "total depreciation allowed to the taxpayer . . . before that time" automatically reduces the UCC balance and cannot subsequently be changed unilaterally.

The court indicated that the taxpayer's interpretation of the law would, if correct, have broad implications under the Act that Parliament may not have intended. The Act has many regimes similar to the CCA rules, which allow for the accumulation and subsequent deduction of expenses on a discretionary basis. Accordingly, the court noted that effective management of our self-assessment system might be compromised if taxpayers could unilaterally choose which discretionary deductions to adjust in later years, adding that the taxpayer's proposal seemed to be "unilateral retroactive tax planning."

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## Is the Omissions Penalty Based on Gross Income or Net Income?

The subsection 163(1) omissions penalty applies where there has been a failure to report an amount included in computing a person's income in the current taxation year and one of the preceding three taxation years. One of the elements of the calculation of this penalty is 10 percent of the unreported amount (which generally becomes 20 percent when the provincial penalty is added). But, for business and property income, is the unreported amount the gross income or the net income? Previous commentators and CRA published commentary opt for gross income, but the argument for net income on the basis of established jurisprudence is more persuasive.

Subsection 163(1) applies to an amount that a person "failed to report" and that was "required to be included in computing the person's income." On that basis, commentators have taken the view that subsection 163(1) seems to apply to gross income without any allowance for deductions (for example, Richard Yasny's 2012 *Canadian Tax Highlights* article). Similarly, a letter from the Department of Finance to the CRA dated October 23, 1989 stated: "The Act contemplates that the computation of the income from a source is done by including some amounts . . . and by deducting other amounts. . . . One should not confuse amounts *included* in the computation with the amount of the net income *resulting* from the computation" (emphasis in original). The CRA's published views (such as CRA document no. 3M05251, January 12, 1993) agree with the gross-income interpretation.

Notwithstanding the above, we are not aware of any jurisprudence on this point. To interpret the meaning of an amount that is "required to be included in computing the person's income," the logical place to turn to is section 3. That section provides that the income of a taxpayer is computed by adding amounts from different sources, and one of those sources is income from business or property. This is a net concept, as affirmed by the SCC in *Symes* ([1993] 4 SCR 695) and *Canderel* ([1998] 1 SCR 147). It is true that in *Ludco* (2001 SCC 62, at paragraphs 59 and 60) the SCC stated that "income" is not the equivalent of "profit" or "net income," but that case was decided in the context of whether borrowed money had been used for the "purpose" of earning income, not whether income is otherwise gross or net under the Act.

Admittedly, income from business or property is computed using gross income as one of the elements. However, it is net income from business or property that is included as income under section 3, as required by subsection 9(1). Subsection 9(1) identifies a taxpayer's income from a business or property as being that person's "profit" (a net concept) from that business or property in the year.

Also, when it is based on gross income, the omissions penalty can be many times the amount of the unpaid federal tax. Thus, one could argue that, in such circumstances, its application may breach section 11 of the Charter, raising the standard of proof required of the Crown. In *Guindon* (2015 SCC 41), the SCC found that an administrative penalty can be considered penal where it is "out of proportion" to the amount required to achieve its regulatory purpose.

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## TCC Finds Misrepresentation Through Lack of Due Diligence

In *Gestions Cholette Inc.* (2020 CCI 75), the TCC confirmed that a taxpayer's failure to verify its tax return and question its tax preparer to ensure the accuracy of the data it contains is evidence of the taxpayer's lack of due diligence. It thereby counts as a misrepresentation that triggers an extension of the normal reassessment period. The court added that a taxpayer is liable for any error made by the taxpayer itself, its legal representatives, and any person authorized to file its tax return. The court further emphasized that a taxpayer must verify its tax return before signing it.

The taxpayer, a corporation, mistakenly did not include taxable dividends received during the fiscal year in its taxable income, but still claimed the associated subsection 112(1) deduction. Consequently, its taxable income was understated by the amount of the dividends. There was no concealment, since the dividends had been entered on schedule 3 (among other places); thus, the error was apparently inadvertent. The finance director confirmed that in order to meet deadlines, tax returns were often filed electronically before they were reviewed and signed. The company had been using the services of the same chartered accountant for 20 years, and the accountant had over 40 years of experience.

Subparagraph 152(4)(a)(i) allows for an assessment after the normal reassessment period where a taxpayer or the person filing the return made a misrepresentation attributable to neglect, carelessness, wilful default, or fraud. On one hand, the taxpayer claimed to have exercised due diligence by entrusting the filing of the tax return to an expert and providing all the necessary information. On the other hand, the minister pointed out that subsection 152(4) is a remedial provision that applies when a taxpayer's carelessness or negligence has resulted in a reported tax result that is inappropriately in its favour. In such circumstances, a new assessment may be issued after the normal assessment period to remedy the situation.

The minister had the burden of proving the misrepresentation attributable to neglect or carelessness. The court was satisfied with the evidence and concluded that the taxpayer subject to the provision includes a tax preparer. The chartered accountant was careless—even negligent—which was enough to trigger the application of subsection 152(4). The finance director was financially sophisticated enough to able to detect this simple error, and the fact that he allowed the tax return to be filed before verifying and signing it was evidence of negligence on his part.

Thus, it appears that liability related to an income tax return is not limited to its preparation. To meet their duty of responsibility, taxpayers cannot simply have good-faith reliance on the tax preparer; they must exercise due diligence by taking cognizance of their return before signing it. This is consistent with *Aridi* (2013 TCC 74), which established the following four-part test for avoiding a misrepresentation through reliance on the tax preparer (quoting *Robertson*, 2015 TCC 246):

> (1) the taxpayer submits all materials to the professional advisor; (2) a discussion is had between the advisor and the taxpayer touching upon the inclusion or exclusion from income of the item; (3) that discussion gives rise to a review of the facts related to the inclusion or exclusion; and (4) a clear, factual confirmation made by the professional advisor leads to the misrepresentation.

Simply relying on the tax preparer to do the right thing falls far short of that standard.

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## Fausse déclaration en raison d'un manque de diligence raisonnable reconnue par la CCI

Dans l'affaire *Gestions Cholette inc.* (2020 CCI 75), la CCI confirme qu'un manque de diligence raisonnable de la part du contribuable est constaté par l'absence de vérification de la déclaration de revenus et par l'omission de questionner le préparateur afin de garantir l'exactitude des données. Cela compte donc comme une fausse déclaration qui déclenche une prolongation de la période normale de réévaluation. La Cour a ajouté qu'un contribuable est responsable de toute erreur commise par le contribuable lui-même, ses représentants légaux et toute personne autorisée à produire sa déclaration de revenus. La Cour a en outre souligné qu'un contribuable est tenu de vérifier sa déclaration de revenus avant de la signer.

Selon les faits, le contribuable, une société, a omis, par erreur, d'ajouter à son revenu imposable tous les dividendes imposables reçus au cours de l'exercice et a demandé la déduction selon le paragraphe 112(1). De ce fait, son revenu imposable était sous-estimé du montant des dividendes. Il n'y a pas eu de dissimulation puisque les dividendes avaient été inscrits à l'annexe 3 (entre autres), de sorte que l'erreur était apparemment involontaire. Le directeur des finances a confirmé qu'afin de respecter les délais, les déclarations de revenus étaient souvent produites par voie électronique avant d'être examinées et signées. La société avait recours aux services du même comptable agréé depuis 20 ans, et le comptable avait plus de 40 ans d'expérience.

Le sous-alinéa 152(4)a)(i) permet une cotisation après la période normale de prescription lorsqu'un contribuable ou la personne produisant la déclaration a fait une fausse déclaration par négligence, inattention, omission volontaire ou fraude. D'une part, le contribuable affirme avoir fait preuve de diligence raisonnable en confiant la production de la déclaration de revenus à un expert en la matière et en fournissant tous les renseignements nécessaires. D'autre part, le ministre rappelle que le paragraphe 152(4) se veut une disposition réparatrice applicable lorsqu'un contribuable a fait preuve d'un manque d'attention ou de négligence qui a eu pour effet de générer une cotisation plus avantageuse en sa faveur. Dans de telles circonstances, une nouvelle cotisation peut être émise après la période d'évaluation normale afin de rétablir la situation.

Le ministre avait le fardeau de prouver la présentation erronée des faits par négligence ou inattention. La Cour, convaincue par la preuve, conclut que le contribuable visé par la disposition inclut le préparateur de la déclaration de revenus. L'expert-comptable a fait preuve d'inattention — même de négligence — ce qui était suffisant pour appliquer le paragraphe 152(4). Le directeur financier était suffisamment sophistiqué financièrement pour détecter cette simple erreur, et le fait qu'il ait autorisé la production de la déclaration de revenus avant de la vérifier et de la signer était une preuve de négligence de sa part.

Ainsi, il appert que la responsabilité liée à une déclaration de revenus ne repose pas uniquement sur sa préparation. Pour répondre à son devoir de responsabilité, un contribuable ne peut pas simplement se fier au préparateur et être de « bonne foi »; il doit faire preuve de diligence raisonnable en prenant connaissance de sa déclaration avant de la signer. Cela est conforme à *Aridi* (2013 CCI 74), qui a établi le test en quatre éléments factuels ci-dessous pour éviter une fausse déclaration en se fiant au préparateur de déclarations (citant *Robertson*, 2015 CCI 246) :

> (1) le contribuable remet tous les documents au conseiller professionnel; (2) une discussion a lieu entre le conseiller et le contribuable concernant l'inclusion ou l'exclusion du revenu en question; (3) cette discussion donne lieu à un examen des faits liés à l'inclusion ou à l'exclusion; et (4) une confirmation claire de la part du conseiller professionnel a mené à la présentation erronée.

Le simple fait de se fier au préparateur de déclarations pour se conformer à la Loi est très en deçà de la norme.

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## Single-Family Offices: A Tax-Deferral Opportunity

Growth in the fortunes of Canada's "top 1 percent" over time has increased the number of families with wealth of $100 million or more. Such families may create a corporation for the sole purpose of managing their investments: a single-family office, or SFO. Where the family does not want to pay out all of the profits as a dividend, there is an opportunity for significant tax deferral if the SFO can avoid the status of specified investment business (SIB).

One way of escaping SIB status is to avoid being a CCPC by, for example, incorporating in a foreign jurisdiction (for details, see Andrew Plant's paper from the CTF 2019 Atlantic Provinces Tax Conference, "A Review of Specified Investment Business Rules and the Taxation of Canadian Corporate Investment Income"). However, since there may be concerns about potential CRA pushback and amendments to the tax rules to eliminate this strategy, other alternatives may be more attractive.

The other approach to escaping SIB status, and having income taxed as ABI, is to have a business that employs more than five full-time employees. Changes in the investment landscape have made this alternative more attractive. Namely, such families are beginning to bring investing in-house rather than fully outsourcing, or using a combination of both strategies. Wealthy families often have access to their own direct investment opportunities or want to have control of their own investments rather than go through intermediaries.

In particular, there is a general trend toward an increased allocation to alternative investments—loosely, an asset class that does not include stocks, bonds, or cash, and may include private equity or private lending. This is consistent with how the investment allocation of endowment portfolios of leading universities has changed over time. The motivation is that such investments may provide either higher returns or returns that have a low correlation with stock market returns. Such investments are not widely publicized and require significant human resources to identify, select, and manage.

The analysis above suggests that creating an in-house wealth management group would have two advantages for the SFO: (1) improving returns and (2) gaining the tax advantage of earning ABI. However, to illustrate the advantage of avoiding SIB status on its own, consider two situations that are assumed to have the same pre-tax investment return. A family in Ontario with a $200 million investment portfolio earns

$16 million gross interest return annually, with $1 million (50 basis points) investment management costs. The family can pay a multi-family office $1 million annually, or hire its own six-person (five full-time and one part-time) staff for the same amount. In either case, the net pre-tax investment return, and the amount of taxable income, is $15 million.

If the SFO outsources the family office role, it would be a SIB. The annual income tax would be $7.5 million ($15 million times the 50.2 percent rate for SIB income in Ontario in 2021). On the other hand, if the SFO hires its own staff, it would pay income tax of $4 million ($15 million times the 26.5 percent rate for ABI that does not qualify for the SBD). The tax-deferral savings of hiring its own staff are $3.5 million ($7.5 million − $4 million). Hence, the after-tax return has increased from 3.75 percent ([$15 million − $7.5 million]/$200 million) to 5.5 percent ([$15 million − $4 million]/$200 million). Assuming consistent annual after-tax returns, this would double the family's money in about 13 years rather than about 19 years (since $1.055^{13} \approx 2$ and $1.0375^{19} \approx 2$).

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## Canada's Multiple, Uncoordinated Netflix Taxes

The 2020 fall economic statement proposed significant changes to the Excise Tax Act to address deficiencies in taxing international e-commerce, effective July 1, 2021. With these proposals, the federal government is entering a space already occupied by a patchwork of provincial sales taxes and adding its own, different rules. The cumulative obligations for non-residents are far more onerous than the simple system envisioned by the OECD when it advocated mandatory registration for non-residents, although the proposed federal rules appear to have been designed with compliance burdens in mind.

The current federal GST/HST rules generally do not require non-residents to register and collect tax on Canadian sales unless they carry on business in Canada. Such supplies are deemed to be made outside Canada, and the consumer is required to self-assess the tax—a system widely acknowledged as ineffective—which results in revenue loss and competitive inequity. This was noted in the OECD's BEPS action 1. The federal government signalled its concern in the 2014 budget but, until now, did not take any action.

Under the proposals, a "specified non-resident supplier" (defined to mean a non-resident that does not carry on business in Canada and is not registered under the existing rules) and certain "distribution platform operators" (subject to exclusions, defined as a person that controls or sets the essential elements of the transaction; or that collects, receives, or charges and transmits the consideration to the supplier) will be required to register under a simplified system if they exceed $30,000 in sales of specified supplies to specified Canadian recipients (that is, business-to-consumer [B2C] sales) in any 12-month period after June 2021. "Specified supply" essentially means a taxable supply of intangible personal property or a service that is considered to be used or consumed in Canada. "Specified Canadian recipient" essentially means a person who is not GST/HST registered and whose usual place of residence (as defined) is in Canada. Notably, digital platform operators would have full liability for the tax on supplies made through their platform by specified non-resident suppliers. Consistent with OECD recommendations for simplified registration, persons registered under these rules will not be entitled to input tax credits (ITCs).

The proposals also include rules essentially requiring non-resident suppliers and digital platform operators to register under the normal registration rules in respect of sales of tangible goods, other than those sent by mail or courier from outside Canada. The rules are aimed at situations where goods are sold by unregistered non-residents but are fulfilled from within Canada. Although such goods may have been already taxed at import (under division III), there are concerns that this is inadequate. Related proposals have also been made to ensure that these rules give appropriate ITCs for the tax paid on import and work properly with the drop shipment rules.

The federal government, through the GST/HST, now joins Quebec, British Columbia, and Saskatchewan in significantly broadening registration rules for non-residents who do not carry on business in Canada. This will add another level of complexity for non-residents, since each regime has similarities and differences. Quebec's registration rules are the most similar in scope to the federal rules, applying to sales of services and intangibles by non-resident suppliers and sales through digital platforms by non-residents (although not to sales of tangible personal property [TPP]). The registration threshold is $30,000 in sales to Quebec consumers over 12 calendar months. British Columbia's rules for non-resident suppliers apply to sales of taxable services and telecommunication services (defined to include digital content). The registration threshold is $10,000 in BC sales over 12 months. Finally, Saskatchewan requires both non-resident suppliers and "marketplace facilitators" to register and collect tax on sales of TPP and services (defined to include digital content). There appears to be no explicit registration threshold.

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## Section 160: 2020 Highlights

Taxpayers that have income tax liabilities cannot avoid payment by transferring property to non-arm's-length parties: the CRA may assess both the taxpayer and the transferee so that they are jointly and severally, or solidarily, liable for the tax. Such an assessment can be up to the amount by which the FMV of the property at the time of transfer exceeds the FMV at that time of the consideration given for the property. Of the ten TCC decisions on section 160 in 2020, three are of particular interest.

### Dividends = No Consideration

In *Valovic* (2020 TCC 101), a husband and wife received a combination of employment income, business income, and dividends from Ivan's Electric Limited at a time when it had income tax owing. The CRA assessed both spouses under section 160 on account of the dividend payments, and they appealed the assessment on the basis that they provided consideration for the dividends.

In rejecting their argument, the TCC referred to a number of prior TCC and FCA decisions where taxpayers unsuccessfully made the same argument. Such decisions highlight the principle that a dividend is related to shareholding and not to any consideration the shareholder might have provided. Notwithstanding one outlier decision accepting the consideration argument (see *Davis et al. v. Canada*, [1994] 2 CTC 2033 (TCC)), the TCC held that section 160 applied so that the taxpayers were jointly and severally liable with the company for its tax debts.

### Determining the FMV

In *Mamdani Family Trust* (2020 TCC 93), the TCC considered the applicable time for determining the FMV of transferred property under section 160. In that case, Global Equity Fund Ltd. paid dividends to its sole shareholder, the Mamdani Family Trust, at a time when it owed income tax. The CRA assessed the trust under section 160.

The trust argued that the determination of the FMV of a dividend should be based on the assumption that a corporation may sell a stream of taxable dividend income to an arm's-length shareholder. In this situation, the FMV of a dividend would need to reflect the tax on the dividend in the shareholder's hands. The TCC rejected this argument, and held that the FMV must be determined with reference to the amount that the CRA could have seized from the transferor had there been no transfer. The TCC also emphasized that section 160 does not result in double taxation, because it is not a taxing or charging provision but rather a tax collection provision.

This decision suggests that a degree of caution is appropriate when owner-managers think of paying themselves dividends (as opposed to salary) to take advantage of favourable tax treatment.

### The Underlying Assessment

In *1455257 Ontario Inc.* (2020 TCC 64), the TCC held that the party challenging the section 160 assessment has the burden of proving that the underlying assessment is incorrect. In this case, the TCC rejected the appellant's argument that the CRA should have applied the transferor corporation's unused non-capital losses to the relevant taxation year, even though there was no request to do so. Applying the unused losses in this way would have reduced the transferor's tax liability and therefore reduced the amount subject to the section 160 assessment.

### Other Decisions

Other cases considered the non-arm's-length requirement (*Dreger v. The Queen*, 2020 TCC 25 and *Gentile Holdings Ltd. v. The Queen*, 2020 TCC 29), the meaning of a transfer of property (*White v. The Queen*, 2020 TCC 22), and how interest charges that were forgiven should affect the assessment (*Scott v. The Queen*, 2020 TCC 4).

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## After De Facto Directors, We Now Have De Facto Shareholders

Under section 160 of the ITA, a transferee of property may be assessed for the tax liability of the transferor to the extent that the FMV of the transferred property exceeds the FMV of the consideration given for the property. Salary payments are generally not subject to section 160, because the recipient has given consideration for the payment by performing services. In deciding to apply section 14.4 of the Tax Administration Act (TAA) (Quebec's version of section 160), the Court of Appeal of Quebec considered a purported salary payment to be a dividend, which is deemed to be a transfer of property without consideration. This approach gave the transferee the novel status of "de facto shareholder" of the corporation (*Normand c. Agence du revenu du Québec*, 2020 QCCA 450; aff'g 2019 QCCQ 7533). But it is not clear that this deemed shareholder status was required in order to apply section 14.4: would the mere existence of a transfer of property in excess of consideration have been sufficient?

The case concerned the actions of Adams Holding Inc. ("the corporation"), whose sole director was Mr. Adams, a business partner of Mr. Normand. Mr. Adams was required to compensate Mr. Normand to settle a dispute between the partners in respect of a business project they carried out together. Subsequently, the corporation issued cheques to Mr. Normand at a time when a related corporation had an unpaid tax liability. Revenu Québec assessed Mr. Normand under section 14.4, applying the principles established in *Ouellet c. Agence du revenu du Québec* (2015 QCCQ 12916).

One prerequisite for this section to apply was that Mr. Normand and the corporation could not be dealing at arm's length. This is a question of fact, given that Mr. Normand and the corporation were not related persons: Mr. Adams was the corporation's sole director. The court concluded that Mr. Normand's claim that the sums that he received from the corporation constituted a salary, and that he was merely an employee, was implausible. Instead, the court held that Mr. Normand was a de facto shareholder of the corporation, and he controlled the business project with Mr. Adams. The court also concluded that the steps taken by Mr. Normand to have a debt owed to him recognized, as well as the resulting concessions, were evidence of a balance of power between the partners in which neither had greater control than the other (*Fournier v. MNR*, 91 DTC 743 (TCC)). Thus, the court established that Mr. Normand and the corporation were not dealing at arm's length.

Regarding the issue of consideration, Mr. Normand contended that the sums that he received from the corporation were for his work on the business project. The court instead established that the sums received represented dividends paid to Mr. Normand as a de facto shareholder and director of the corporation. The jurisprudence is clear: the receipt of a dividend is linked to a person's status as a shareholder. A dividend is a return on capital invested, and is in no way dependent on a shareholder's conduct (*Larouche v. The Queen*, 2008 TCC 448). The court concluded that the sums received had to be treated as dividends, even if Mr. Normand was not legally registered as a shareholder. In this case, the payment of dividends represented a transfer of property. The transfer is deemed to have been made without consideration (within the meaning of the TAA) where the transferor is a tax debtor (*Bruneau v. The Queen*, 2010 TCC 145).

With this win for Revenu Québec, we believe that the concept of "de facto shareholder" will not only be discussed at length in the near future, but will be increasingly relied on by the tax authorities.

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## Après l'administrateur de facto, voici l'actionnaire de facto

Conformément à l'article 160 de la LIR, lorsqu'un débiteur fiscal cède un bien en faveur d'une personne avec laquelle il a un lien de dépendance pour une contrepartie inférieure à sa JVM, le cessionnaire devient solidairement débiteur des montants que le cédant est tenu de payer en vertu de toute loi fiscale. Puisque les salaires sont versés en contrepartie de la prestation des services rendus par un employé, ceux-ci ne sont généralement pas sujets à l'application de l'article 160. En appliquant l'article 14.4 de la Loi sur l'administration fiscale (LAF) (la concordance québécoise de l'article 160), la Cour d'appel du Québec a caractérisé un paiement à titre de dividende, qui est considéré comme un transfert de biens sans contrepartie, en dépit des prétentions du cessionnaire à l'effet qu'il s'agissait du versement d'un salaire. Cette conclusion a développé un concept novateur en droit fiscal et confère au bénéficiaire du paiement la qualité d'« actionnaire *de facto* » (*Normand c. Agence du revenu du Québec*, 2020 QCCA 450; conf. 2019 QCCQ 7533). Cependant, il demeure incertain que le statut d'actionnaire de fait était nécessaire pour appliquer l'article 14.4. La simple existence d'un transfert de bien dont la valeur excède celle de la contrepartie n'aurait-elle pas été suffisante?

L'affaire concerne Adams Holding inc. (la société), dont l'unique administrateur est M. Adams, un partenaire d'affaires de M. Normand. M. Adams était tenu de verser une compensation à M. Normand en règlement d'un conflit survenu entre les partenaires dans le cadre d'un projet d'affaires réalisé conjointement par ceux-ci. Subséquemment, des chèques ont été émis par la société à M. Normand au moment où celle-ci se trouvait à être débitrice de la dette fiscale d'une autre personne liée. Revenu Québec a donc imposé M. Normand en vertu de l'article 14.4, appliquant les principes établis dans *Ouellet c. Agence du revenu du Québec* (2015 QCCQ 12916).

Pour que l'article 14.4 trouve application, il doit exister un lien de dépendance entre M. Normand et la société. Comme M. Normand et la société n'étaient pas liés, puisque selon la preuve l'unique administrateur de celle-ci était M. Adams, l'existence d'un lien de dépendance reste une question de fait. La Cour a jugé peu plausibles les prétentions de M. Normand à l'effet que les montants reçus représentaient un salaire et qu'il n'était qu'un simple employé de la société. M. Normand était plutôt un actionnaire de fait de la société et il contrôlait le projet d'affaires avec M. Adams. La Cour a aussi conclu que les démarches entreprises par M. Normand pour reconnaître l'existence d'une dette en sa faveur et les concessions qui en ont résulté illustrent un rapport de force entre deux associés dont aucun n'avait un contrôle supérieur à l'autre (*Fournier c. MRN*, 91 DTC 743 (CCI)). La Cour a ainsi établi qu'il y a bien un lien de dépendance entre M. Normand et la société.

Quant à l'existence d'une contrepartie, M. Normand soutient que les montants reçus de la part de la société ont été reçus en contrepartie de son travail réalisé dans le cadre du projet d'affaires. La Cour a plutôt établi que les montants reçus représentaient des dividendes versés au demandeur à titre d'actionnaire de facto et dirigeant de la société. La jurisprudence est claire à l'effet que l'encaissement de dividendes est lié à la qualité d'actionnaire et qu'il s'agit du rendement d'un capital et non d'une récompense liée à la conduite de l'actionnaire (*Larouche c. La Reine*, 2008 CCI 448). La Cour a ainsi conclu que les montants reçus ne pouvaient être traités autrement qu'à titre de dividende, et ce, même si M. Normand ne se qualifiait pas officiellement à titre d'actionnaire de la société. En l'espèce, le paiement de dividendes représente un transfert de bien et ce transfert est effectué sans contrepartie au sens de la LAF lorsqu'il provient d'un débiteur fiscal (*Bruneau c. La Reine*, 2010 CCI 145).

Suite à cette victoire de Revenu Québec, force est de constater que le concept d'actionnaire de facto fera couler beaucoup d'encre; et sera davantage mis de l'avant par les autorités fiscales.

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## Achieving Temporary Relief from Tax on CEBA Loans

To the great dismay of many cash-strapped business owners, the potentially forgivable portion of loans under the Canada Emergency Business Account (CEBA) program is not taxable in the year of forgiveness, but rather in the year of receipt of the loan (pursuant to paragraph 12(1)(x)). (See CRA document no. 2020-0861461E5, November 10, 2020.) Although some have questioned this conclusion on the basis of *GMAC Leaseco Corporation* (2015 TCC 146), few people are willing to risk CRA pushback for a short-term deferral on a maximum $20,000 income inclusion. There is one ray of hope for this early income inclusion: where an outlay or expense funded by the loan does not occur until a subsequent taxation year, the income inclusion can be deferred until that taxation year by making the subsection 12(2.2) election. Still, the requirement to trace the loan to those future expenditures may convince many taxpayers to avoid the election.

Consider example 1: A calendar-year taxpayer receives the maximum $60,000 loan in 2020 and spends all of it on employee wages: $45,000 in 2020 and $15,000 in 2021. Without the election, there would be an inclusion of $20,000 in 2020 for the potentially forgivable amount of the loan, and each of the wage amounts would be deductible in the year incurred in the normal way ($45,000 in 2020 and $15,000 in 2021). With an election in the amount of $15,000 (the amount of the loan received in 2020 but not spent until after the 2020 year-end), the inclusion in 2020 can be reduced from $20,000 to $5,000 (subparagraph 12(1)(x)(vii)). On the other hand, the deduction for wages in 2021 is also reduced by $15,000. Thus, the deferral mechanism has two parts: income in 2020 is reduced, but income in 2021 is increased by an equal amount (by reducing the wage deduction).

**Example 1**

*Year 2020*

| | Without election | With election |
|---|---|---|
| Paragraph 12(1)(x) inclusion ....... | $20,000 | $ 5,000 |
| Wage deduction.................. | $45,000 | $45,000 |

*Year 2021*

| | Without election | With election |
|---|---|---|
| Paragraph 12(1)(x) inclusion ....... | — | — |
| Wage deduction.................. | $15,000 | — |

The difficulty with the election is administrative—tracing. How does the taxpayer prove to the government that the amount subject to the election was indeed used for a CEBA-eligible outlay or expense after the end of the taxation year? A separate bank account for the CEBA loan provides the best proof, although this is admittedly unrealistic. Taxpayers who are concerned about the possibility of enhanced audit efforts in relation to pandemic-related government funding might wish to forgo the election. Is the short deferral worth the extra compliance effort?

One curiosity about the election is that there can be a permanent reduction of tax—rather than just tax deferral—where there are non-deductible expenses. Inexplicably, such expenses are also eligible for the election (CRA document no. 9721505, October 15, 1997).

Consider example 2: The taxpayer again receives the maximum $60,000 CEBA loan in 2020, but spends all of it in that year: $8,000 on non-deductible expenses and the rest on wages. By choosing an election amount of $8,000, and choosing that the expenses or outlays to be reduced by the election are the non-deductible expenses, the taxpayer is able to decrease the paragraph 12(1)(x) income inclusion by $8,000 without any loss of tax deductions. Although the outlays and expenses subject to the election are reduced by $8,000 for the purpose of determining deductions, none of this amount would be deductible anyway.

**Example 2**

*Year 2020 (all effects are in one year)*

| | Without election | With election |
|---|---|---|
| Paragraph 12(1)(x) inclusion . . . . . . . | $20,000 | $12,000 |
| Wage deduction . . . . . . . . . . . . . . . . . | $52,000 | $52,000 |
| Other deductions . . . . . . . . . . . . . . . . | — | — |

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## Non-Arm's-Length as a Matter of Fact: ABIL Denied

Since the notion of a factual non-arm's-length relationship can be difficult to apply in practice, the court's finding of such a relationship in *Keybrand Foods Inc. v. Canada* (2020 FCA 201) is refreshing for its commonsense clarity: "[W]here a person pays in excess of $14 million for shares that do not have any value, the magnitude of the discrepancy raises doubts that the parties were dealing with each other at arm's length" (paragraph 69).

Keybrand and its parent, BWS, were guarantors of loans from GE Capital to a startup corporation, Vidabode. BWS had a minority interest in Vidabode. Vidabode defaulted on its loan repayments, and as a result GE Capital called in its outstanding loans. Possibly in order to avoid having to make good on its guarantee directly, Keybrand acquired new shares in Vidabode, and Vidabode used the funds to repay its debt to GE Capital. Even though the undisputed value of the shares was nil, the shares were issued at one dollar per share. Vidabode later filed for bankruptcy. Keybrand claimed an ABIL on one-half of the investment in Vidabode's shares.

The FCA denied the ABIL through the application of paragraph 251(1)(c), which specifies that it is a question of fact whether unrelated persons are dealing with each other at arm's length at a particular time.

In considering whether to apply this paragraph, the FCA noted that Vidabode was financially dependent on either Keybrand or one or more of the other companies in the group to repay GE Capital, since no other shareholders were willing or able to advance any funds and Vidabode would otherwise have had to cease operations. Additionally, there was a lack of negotiation with respect to the terms and conditions of the share subscription, including the share price. Thus, Keybrand controlled both sides of the transaction related to the issue of shares by Vidabode to Keybrand; this was also the situation in *Robson Leather Company* (77 DTC 5106 (FCA)) and *Swiss Bank Corporation* (71 DTC 5235 (Ex. Ct.); aff'd [1974] SCR 1144). Considering these decisions, and noting the peculiar economics of the transaction cited in the quotation above, the FCA concluded that Keybrand and Vidabode were not dealing with each other at arm's length at the time of the share investment.

The next step in the FCA's reasoning was to apply paragraph 69(1)(a). This provision states that when a taxpayer acquires property from a person with whom the taxpayer was not dealing at arm's length for an amount in excess of FMV, the taxpayer shall be deemed to have acquired the property at FMV. Applying this paragraph, the FCA deemed the shares to have a cost basis of nil. Thus, the disposition of the shares (presumably under the subsection 50(1) election for an insolvent corporation) involved proceeds of zero and a cost basis of zero, so the ABIL was denied.

The TCC, in contrast, had come to the same conclusion about the ABIL but followed a different route. The TCC found a non-arm's-length relationship by applying subsection 256(5.1), which deems that one corporation controls another where a corporation has direct or indirect influence that, if exercised, would result in control in fact of another corporation. The FCA disagreed with this approach, explaining that subsection 256(5.1) should be used only to determine the relationship between corporations. Non-arm's-length versus arm's-length status should be assessed on the basis of the facts of a particular transaction under paragraph 251(1)(c), and not in relation to the entities as a whole under subsection 256(5.1).

For further discussion of this and other issues in the case, see *The Arnold Report*, posting no. 194, January 13, 2021.

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## Share Compensation Taxable as Business Income When Receivable

Under accrual accounting, which is required for business and property income, amounts become relevant to the computation of income and cost when they become receivable. The time at which amounts are receivable is a critical timing issue in computing the business or property income of accrual-basis taxpayers, especially amounts to be paid in foreign currency or with property other than money. The standard test is that "for an amount to become receivable in any taxation years, two conditions must coexist: (1) a right to receive compensation; (2) a binding agreement between the parties or a judgment fixing the amount" (*Maple Leaf Mills Ltd. v. MNR*, [1977] 1 SCR 558). Further, this right must be "clearly legal, though not necessarily immediate" (*MNR v. John Colford Contracting Co. Ltd.*, 60 DTC 1131 (Ex. Ct.)).

These principles were applied to somewhat unusual facts in *Lockwood Financial Ltd.* (2020 TCC 128). In 2010, Lockwood assisted in brokering a farm-in agreement between its client, LEO, and another corporation, AOI. Pursuant to the agreement, a portion of the fee payable to Lockwood (once LEO reached certain expenditure targets) was to be paid in LEO common shares with an agreed-on value of $250,000, issued to Lockwood. A subsequent corporate acquisition and legal action resulted in this obligation being settled in 2012 by AOI issuing its shares (instead of LEO shares) to Lockwood. Those shares were disposed of in the same taxation year.

The main issue before the TCC was when the shares became receivable: in 2010 or 2012. Following the two-part *Maple Leaf Mills* test, the TCC held that the shares would be "receivable" when Lockwood had a clear legal, albeit not immediate, right to receive them, and the number of shares to be received was fixed pursuant to an agreement or a judgment. The shares were not receivable in 2010 because there was no evidence that LEO had met its expenditure targets at that time, and thus the conditions precedent were not satisfied. The TCC also found that the agreement did not fix the amount purportedly receivable by Lockwood, since the agreement specified only a maximum, but not a minimum, number of shares to be issued.

The TCC further held that the issuance of shares to Lockwood was business income. The shares were payment for services rendered, with the amount of income realized equalling the value of the shares on the date the shares were receivable. The TCC found that the AOI shares received by Lockwood in 2012 were intended to replace the LEO shares under the agreement. As a result, the value of the AOI shares on the issue date was included in Lockwood's business income in 2012. Lockwood had cost in its AOI shares equal to the business income inclusion pursuant to subsection 52(1), and therefore the capital gain was reduced from the amount that Lockwood had reported.

Both of these findings were adverse to the taxpayer. Lockwood's position had been that the LEO shares were receivable in 2010 and, as a result, $250,000 would have been included in business income at that time pursuant to paragraph 12(1)(b). This $250,000 amount would also have been the cost of the AOI shares. Further, the amount by which the value of the AOI shares eventually received exceeded $250,000 would have been a capital gain realized at the time the AOI shares were sold. The timing difference was relevant to the computation of the taxpayer's income. If the court had found that the shares were receivable in 2010, it would have resulted in reduced business income in 2010 and a larger capital gain in 2012.

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