Tax for the Owner-Manager

Editor: Thomas E. McDonnell, QC

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The Problem with Dividend Refunds

Subsection 129(1) provides that when a return of a corporation's income is made within three years after the end of the taxation year, the minister may refund the lesser of one-third of the taxable dividends paid by the corporation and its refundable dividend tax on hand (RDTOH). The minister will deny the dividend refund if the tax return is not filed within three years after the end of the taxation year, regardless of the circumstances.

In the typical fact situation, Opco pays Holdco a dividend on which part IV tax is exigible. Holdco pays a dividend to its shareholder, who pays the appropriate amount of part I tax; Holdco is then eligible for a dividend refund. If the tax return for Holdco is not filed within the three-year period, at some point after that period the minister assesses part IV tax, denies the offsetting dividend refund, and in some cases does not add the amount of the dividend refund to the RDTOH account.

In recent years, there have been a significant number of these assessments. Taxpayers and their advisers should ensure that the corporate return is filed within the three-year period. At the same time, in a broader policy context, it should be recognized that in many cases where the three-year period is missed, the result of the assessment is neither fair nor equitable. Assessments have been issued when a dividend refund would have been payable if the taxpayer's return had been made on time; when there was no retroactive tax planning involved; and when there was no undue deferral of tax.

The scheme of the Act is designed to ensure that a stream of income is taxed only once. The part IV tax and the dividend refund mechanisms are part of that scheme. If no dividend refund is granted, the result is double tax on the stream of income. This was not the intention of Parliament; in fact, part IV tax and the dividend refund mechanism were enacted to ensure that this did not happen.

The minister has taken the position that because subsection 129(1) is an administrative provision, there is no discretion to provide any relief unless it is expressly permitted by a provision in the Act. But there are other provisions with the same "within three years" limitation. For example, subsection 164(1)—which provides for the refund of overpaid tax, interest, and penalties to individuals (other than trusts) and testamentary trusts—is essentially an administrative provision whose function is to simplify the process of making refunds. Absent such a provision, no refund of an overpayment could be made without an order in council under the Financial Administration Act. (See, for example, *FJA Davidson v. The King*, [1945] CTC 189 (Ex. Ct.).)

The need for a relieving provision was illustrated by the decisions in *Hughes v. Canada* ([1991] 1 CTC 492 (FCTD)) and *Chalifoux v. MNR* ([1991] 2 CTC 2243 (TCC)), two cases in which refunds were denied because tax returns had not been filed within three years after the end of the taxation year. In response to those cases, subsection 164(1.5) was enacted as part of the fairness package. The subsection gives the minister the discretion to make a refund even though the tax return was not filed within the three-year period. The CRA has indicated that it will issue a refund if it is satisfied that such a refund would have been made had the taxpayer's return or request been filed or made on time, and provided that the necessary assessment is correct in law and has not been previously allowed (*Information Circular* 07-1, "Taxpayer Relief Provisions," May 31, 2007, at paragraph 71).

Upon enactment, subsection 164(1.5) applied retroactively to refunds for the 1985 and subsequent taxation years. In respect of the 1980 to 1984 taxation years, a special remission order was issued under the Financial Administration Act for overpayments that could have

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been refunded had the period for reassessment or refund not expired, provided that certain conditions were met. Applicable to tax returns filed after 2004, subsection 164(1.5) was amended so that no refund can be issued unless the tax return is filed within 10 calendar years after the end of the taxation year.

On the basis of judicially recognized principles of fairness and the intention of Parliament when it enacted the dividend refund provisions, a taxpayer should not be required to take its case to the Tax Court in an attempt to vacate an assessment that denies a dividend refund. A technical amendment similar to subsection 164(1.5), with retroactive application, would provide a simple solution to the administrative problem presented by subsection 129(1) and the lack of a relieving provision.

Brian J. Wilson
Wilson Vukelich LLP
Markham, ON

The Impact of the New Partnership Rules on Joint Ventures

The March 22, 2011 federal budget proposed rules that would eliminate the income deferral that has always been available to corporate partners other than professional corporations. The June 6, 2011 federal budget confirmed that these proposals would be passed into law.

In essence, if the fiscal year-end of a partnership does not coincide with that of a corporate partner that has a 10 percent or greater interest in the income of the partnership, the corporate partner must include a notional amount of additional partnership income. For example, if the year-end of the corporate partner is December 31, 2011 and its share of income at the partnership's January 31, 2011 year-end is $100,000, the corporate partner will be required to report additional income equal to $^{11}/_{12}$ of $100,000.

The introduction of these rules raises a familiar question: what about unincorporated joint ventures and other similar forms of business undertakings, such as syndicates? Are there meaningful ways of distinguishing between partnerships and these other business structures (all referred to below as "joint ventures")? The question is important because unincorporated joint ventures are common in the natural resource, real estate, and construction industries.

A number of articles by tax commentators have addressed this issue. From my perspective as an accountant, such articles, though well researched, have not shed much light on the subject in a practical sense. For example, the commentators generally say that joint venturers, unlike partners, share gross proceeds, not net profits. In my experience, this is never the case. Joint venturers, like partners, share net profits. Does this mean that the so-called joint ventures are really partnerships and will be affected by the new rules? To add to the confusion, in *Woodlin Developments* (86 DTC 1116 (TCC)), the court stated that "[p]artnership and joint venture have often been treated as synonymous, a joint venture being regarded as simply a partnership established to fulfil a particular business undertaking within a limited time."

Most commentators have taken the passage from *Woodlin Developments* to heart: they generally agree that a joint venture's life is co-extensive with the life of a particular project. For example, a joint venture might exist if a number of corporations pool their resources to acquire building lots at a particular site for the purpose of constructing thereon homes for sale. However, if in the course of the enterprise additional lots are acquired at a different location, the business entity might really be a partnership.

GST/HST *Policy Statement* P-171R (February 24, 1999) provides insight into the CRA's thinking regarding the distinctions between partnerships and joint ventures. The jurisprudence in this area is somewhat helpful but not conclusive. Some of the cases are discussed briefly below.

Woodlin Developments provides a good review of the subject. In that case, a partnership agreement had been executed. The evidence presented by the taxpayer to support the contention that the entity was a joint venture, including prospectuses that referred to the entity as a joint venture, could not, in the eyes of the court, overcome that agreement.

In *Marion Estates* (90 DTC 1369 (TCC)), an entity that purported to be a joint venture was held to be a partnership. Evidence showed that the parties had initially agreed to form a partnership; in fact, the financial statements of one of the parties referred to the entity as a partnership. One of the points noted by the court was that profits had been computed at the partnership level and distributions of net profits had been made. The court stated that "[i]n the absence of a written agreement the evidence establishing the existence of a joint venture must be reasonably clear and unequivocal." There was no evidence of the right of mutual control or management, as might be found in a joint venture. Rather, management was vested in a number of the parties, as would normally be the case in a partnership.

In *D & B Oilfield Contracting* (89 DTC 425 (TCC)), an entity was held to be a partnership and not a joint venture as alleged by the minister. The written agreement governing the enterprise stated that it was a partnership. The court noted that "the venture was not limited in time nor was it limited to a project."

Although it will always be difficult to distinguish between a partnership and a joint venture, as a practical matter it appears to be unusual for the CRA to contend that an entity held out to be a joint venture is actually a partnership. However, to have the best chance of successfully contending that an entity can properly be characterized as a joint venture, it is advisable to (1) have a written agreement that states that the entity is a joint venture and not a partnership; (2) limit the duration of the entity to a particular project; (3) vest management of the project in all of the members; and (4) allocate gross revenues and expenses to the individual members rather than share and distribute net profits.

Perry Truster
Truster Zweig LLP
Richmond Hill, ON

New RRSP Anti-Avoidance Rules May Create Surprise Tax Liability for Entrepreneurs

The 2011 federal budget strengthens the anti-avoidance rules that apply to RRSPs by adding rules similar to those now in place for tax-free savings accounts (TFSAs). Under these new rules, some investments that previously qualified for RRSPs become prohibited, and only limited transitional relief is available. Entrepreneurs who used their RRSPs under the current law to hold, for example, private company shares may be caught by the new rules and may be liable for a significant tax penalty if they do not remove these investments from their RRSPs before 2013.

Assume that Mr. X has an RRSP that holds shares of a private company (Opco). Mr. X is one of five unrelated shareholders in Opco. Opco's shares are currently considered a qualified investment for RRSP purposes under regulation 4900. (Private company shares are qualified investments for RRSP purposes if, at the time the shares are acquired, the annuitant and related persons hold less than 10 percent of the company's shares. Alternatively, even if an arm's-length annuitant holds more than 10 percent of the company's shares, the shares can still be considered a qualified investment, provided that the cost amount of the shares is less than $25,000. The RRSP originally acquired Opco's shares for $20,000.) The shares are now worth $1 million. Opco is a rapidly growing business, and all its (and its shareholders') monies are used to fund its expansion. Under the proposed 2011 federal budget measures, the Opco shares will become a prohibited investment because Mr. X has a significant interest in Opco.

The budget's prohibited-investment rule for RRSPs is based closely on the TFSA prohibited-investment rules. A prohibited investment will include debt of the RRSP holder and investment in entities in which the RRSP holder or a non-arm's-length person has a significant interest (generally 10 percent or more) or with which the RRSP holder does not deal at arm's length. A special tax equal to 50 percent of the fair market value of the investment will apply to the RRSP holder on the acquisition of a prohibited investment by his or her RRSP.

Generally, the prohibited-investment tax will be refunded if the RRSP holder disposes of the investment by the end of the year following the year in which the tax applied, unless the RRSP holder knew or ought to have known that the investment was a prohibited investment when the holder acquired it. The new provisions will apply to transactions occurring and investments held after March 22, 2011.

In the example, the RRSP's previously qualifying investment in the Opco shares effectively becomes a prohibited investment after March 22, 2011. However, the 50 percent tax will not apply to prohibited investments that were held on March 22, 2011 if the RRSP holder disposes of them before 2013. As a result, unless Mr. X removes his investment in Opco from his RRSP before 2013, he will be subject to a tax of $500,000 on his Opco shares (50 percent of the $1 million fair market value).

The new RRSP anti-avoidance rules also mirror current TFSA rules that are designed to disallow certain "advantages," which the government says are generally benefits obtained from transactions that are intended to exploit the tax attributes of a TFSA. RRSP advantages will include, for example, benefits derived from transactions that would not have occurred in a regular open market between arm's-length parties if it is reasonable to conclude that the taxpayer undertook the transactions to benefit from the tax attributes of RRSPs. These advantages are subject to a tax equal to their fair market value.

The new RRSP advantage rules apply to transactions occurring and investments acquired after March 22, 2011. In addition, income generated on an investment acquired before the budget, and the portion of capital gains accruing after March 22, 2011 that is earned from a prohibited investment, will be subject to the advantage rules.

However, the RRSP advantage rules will not apply to swap transactions completed before July 2011. A swap transaction is a transfer of property, other than a contribution or a withdrawal, between an RRSP and its annuitant or a non-arm's-length person. Swap transactions undertaken to ensure that an RRSP complies with the proposed rules by removing an investment that would otherwise be considered a prohibited investment (or an investment that gives rise to an advantage) under the proposed rules will be allowed until December 31, 2012.

In the example, Mr. X must remove the Opco shares from his RRSP before July 2011 to avoid the prohibited investment and advantage rules, or, in the case of a swap transaction, after July 2011 but before 2013 to avoid only the prohibited-investment rules.

Practically speaking, it may be very difficult for Mr. X to undertake a swap transaction with his RRSP if, for example, all of his available cash and credit have been used to fund Opco's expansion. It is hoped that the draft legislation to enact these rules will provide more transitional relief in these types of situations.

David Denley
KPMG LLP, Victoria

SR & ED: Are the CRA and Parliament Pulling in Opposite Directions?

Anecdotal evidence suggests that the CRA has been adopting an increasingly restrictive view of SR & ED eligibility. When it comes to determining what types of activities qualify for SR & ED benefits, the wording of the legislation itself is rather vague. However, useful guidance can be gleaned from the history of the legislation and from the court decisions that have considered the definition of SR & ED.

In October 2010, the federal government established a panel of experts to examine the economic efficacy of various R & D incentives, including the SR & ED program. A review of the approximately 200 submissions received by the panel leaves little doubt that some Canadian businesses are experiencing diminished access to SR & ED benefits. This excerpt from the submission made by the Canadian Federation of Independent Business is indicative of many:

> There is concern with inconsistency in the decisions being made on SRED applications. Some members have had their applications denied after having had it accepted for the exact same type of work a year earlier while others have told us about firms doing similar types of R&D but having one application accepted in one part of the country but denied in another.

The Act deals with SR & ED eligibility in two places. Subsection 37(1) contains several pages of rules pertaining to fiscal issues, and subsection 248(1) contains a dozen or so paragraphs that attempt to define what kinds of R & D work qualify. In our experience, most SR & ED disputes between taxpayers and the CRA involve the interpretation of the definition of "scientific research and experimental development" in subsection 248(1). Most of these disputes arise from misinterpretation (either by the CRA or by the taxpayer) of the meaning of the term "experimental development" in paragraph (c) of the definition, which in our experience is the basis for the large majority of SR & ED claims.

Given the disagreement that seems to have developed between the CRA and taxpayers about what qualifies as "experimental development" and what does not, it is helpful to look at what Parliament's intention was when it chose to use that phrase in the Act. While most of the subsection 248(1) definition has remained essentially the same since 1966 (when it was contained in regulation 2900), the one part that has changed significantly over time is the wording of paragraph (c). A review of the six revisions to date shows that Parliament was intent on broadening, not narrowing, the range of activities that qualify as "experimental development."

The last material change in the definition of "experimental development" was made in 1994, when the wording changed from "use of the results of basic or applied research" for the purpose of creating something new to "achieving technological advancement" for the purpose of creating something new. To solidify Parliament's intention, legislators added a few more key phrases to the end of paragraph (c) that allow even "incremental improvements" to something new to qualify as SR & ED. In short, the 1994 revisions changed the definition of "experimental development" from the utilization of "scientific research" to the seeking of "technological advancement" in aid of creating something new. This is a significant change in the eligibility requirement: "scientific" implies a result of knowledge, but "technological" implies a result of practical functionality.

Another signal of Parliament's intention was seen in 1995 when the definition of "scientific research and experimental development" was moved from regulation 2900 to subsection 248(1). Regulations can be amended by the governor in council (that is, Cabinet), but amendment of the Act requires the assent of Parliament. It can be argued that the definition was moved into the Act to protect it from administrative predation, such as might occur during periods of fiscal belt tightening. It is exactly this legislative permanence of the definition that makes the Canadian SR & ED program superior to its US counterpart, which, owing to budgetary constraints, has been allowed to lapse 13 times since 1981.

While the legislation is the baseline starting point to determine eligibility for SR & ED, it is not the whole story. Court decisions provide guidance on the meaning of "experimental development" in paragraph (c) of the definition. Although space does not permit a summary of those decisions in this note, in our view the courts have consistently upheld the requirement that experimental development must entail systematic investigation to address a technological uncertainty whose resolution is outside the bounds of the standard body of knowledge possessed by a qualified specialist. The decisions make it clear that "experimental development" does not require the production of scientific knowledge that is new to the world, and it does not require the presence of a technological obstacle characterized by shortcomings or limitations of the current state of technology, as is suggested in some of the CRA's latest administrative publications.

The legislative history of the definition of "scientific research and experimental development" and the courts' interpretation of this definition point to a Canadian government intent on ensuring that Canadian business can count on tax credits as a reliable incentive for incremental product development and technical problem solving, not just for scientific research.

David R. Hearn
Scitax Advisory Partners LP, Toronto

A. Christina Tari
Richler & Tari, Tax Lawyers, Toronto

Business Limit Allocation Do-Overs

By virtue of the combined operation of subsections 125(2) and (3) of the Act, a group of associated corporations is required to share one business limit. The allocation of the business limit between members of the group is determined either by an allocation made by the associated corporations in the prescribed form, or by the minister in the event of a failure by the associated corporations to make an allocation following a demand that they do so.

As held by Brulé J in *Deneschuk Building Supplies Limited v. The Queen* (96 DTC 1467 (TCC)), no time limit is prescribed for the filing of an allocation in form T2, schedule 23. In *Deneschuk*, the court permitted the filing of an allocation on form T2013 (the predecessor to form T2, schedule 23) five years after the end of the taxation year in question. The associated group had previously filed allocations, but those were found to be invalid because each allocation was not made by all of the associated corporations as required by subsection 125(3); the late-filed allocation was the first valid allocation filed, and it was therefore binding on the minister.

The court in *Deneschuk* did not consider whether the minister was required to accept an amended allocation when a valid allocation was previously made, and that question remains open. However, in a recently issued technical interpretation (2009-0351721E5, March 29, 2011), the CRA indicated that it will accept amended business limit allocations, provided that the amount allocated for the taxation year to any corporation for which an assessment would be statute-barred remains unchanged.

The taxpayer described in the TI was a member of an associated group of corporations. The taxpayer reported taxable income for the year and was allocated a portion of the group's business limit. In a subsequent year, the taxpayer realized a non-capital loss. It proposed to carry the non-capital loss back to the earlier year and, in conjunction with the loss carryback, to reallocate its portion of the business limit to the other members of the associated group. The combined carryback and reallocation would eliminate the taxpayer's taxable income and reduce the tax payable for the earlier year by the other members of the associated group.

The CRA confirmed that the proposed reallocation would be effective retroactive to the date of the original allocation, resulting in an increase in the tax payable for the earlier year by the taxpayer and in a reduction in the tax payable for the earlier year by the other corporations. The reallocation would result in an overpayment of tax by the other corporations, which would be entitled to a refund of the overpayment plus refund interest for the period between the date on which the overpayment arose and the date of the refund pursuant to subsection 164(3).

For the purpose of calculating the taxpayer's arrears interest, paragraph 161(7)(a) applied to the combined reallocation and carryback to deem the tax payable for the earlier year to be the amount that would have been payable if the taxpayer's initial taxable income had been taxed at the general rate. The date of the reduction of the taxable income as a result of the loss carryback was deemed by subparagraph 161(7)(b)(iv) to be the date 30 days after the loss carryback request was made. The taxpayer would be liable for arrears interest on this deemed balance for the period beginning on the balance-due day for the earlier year and concluding 30 days after the date of the loss carryback request. This interpretation is consistent with another recent technical interpretation (2009-0331501I7, March 3, 2010).

The CRA further opined that the reallocation would also affect the amount of any late-filing penalties that had initially been assessed. The reallocation would not in and of itself give rise to a penalty when the original returns were filed on time, because the reallocation was an adjustment of a previously filed return and not the late filing of a separate return. However, if the taxpayer was assessed a penalty under subsection 162(1), the increase in its tax payable as a result of the reallocation would increase the penalty, while the decrease in the tax payable for the other corporations would reduce the penalties payable by those corporations.

It is interesting that the CRA would allow a reallocation in these circumstances, even when the decision to reallocate appears to be based on a desire to obtain a more favourable tax outcome having regard to subsequent events, and may be a form of retroactive tax planning. The CRA appears to be permitting the taxpayer to reallocate on the basis of changed circumstances (that is, a subsequent loss in a previously profitable corporation), which would not be permissible if the original allocation was a "genuine election": see *The Queen v. Nassau Walnut Investments Inc.* (97 DTC 5051 (FCA)) and *Miller v. The Queen* (93 DTC 5035 (FCA)).

Sarah S. Chiu
Felesky Flynn LLP, Calgary

H. Michael Dolson
Felesky Flynn LLP, Edmonton

The ULC PUC Increase Strategy: US Partnerships Versus LLCs

Since the adoption of the fifth protocol to the Canada-US tax treaty, there has been considerable confusion about the application of articles IV(6) and IV(7)(b). Article IV(6) was intended to allow qualifying members of fiscally transparent entities to enjoy reduced treaty withholding rates, while article IV(7)(b) was intended to address certain abusive cross-border structures.

In response to the overly broad application of article IV(7)(b), a number of creative techniques have been developed to allow after-tax income of a Canadian ULC to be paid to its US shareholders without triggering the application of the article (see technical interpretation 2009-0318491I7, November 13, 2009, for examples). One such method that has generally been approved by the CRA is to have the ULC increase the stated capital and PUC of its shares, resulting in a deemed dividend pursuant to subsection 84(1) that may qualify for the reduced treaty withholding rates under article X(2). A subsequent tax-free return of capital to the ULC's shareholders results in a corresponding decrease to the stated capital and PUC of the ULC's shares. Although the CRA has issued numerous rulings approving the use of the PUC increase strategy, that approval has not been extended to LLCs that are shareholders of ULCs.

Article IV(6) was intended to benefit fiscally transparent LLCs by allowing their members to claim reduced treaty rates where a member is considered under US law to have derived an amount through the LLC and the US tax treatment of the amount would be the same if it had been derived directly by the member. However, an amount paid by a ULC to an LLC is disregarded for US tax purposes, and is not recognized as an item of income in the hands of the members of the LLC. Instead, the United States taxes the LLC members on the basis of their respective share of the ULC's earnings. Unfortunately, the CRA has determined that because the deemed dividend arising on the adoption of the PUC increase strategy is disregarded for US tax purposes, it cannot be considered to be derived by the LLC members through the LLC, and therefore they cannot claim treaty benefits on amounts received pursuant to the PUC increase strategy. The CRA confirmed this position in technical interpretation 2009-0345351C6 (February 11, 2010), which states that "the CRA will not accept a claim for treaty benefits made by a LLC to the extent that the claim relates to a 'disregarded' amount that is paid or credited after 2009."

Readers might think that if the CRA will not accept a claim for treaty benefits made by one fiscally transparent entity (an LLC), then it will not accept the same claim for treaty benefits made by another fiscally transparent entity (such as a partnership). However, in rulings 2009-0341681R3 (2009) and 2010-0364531R3 (2010), the CRA approves of fiscally transparent US partnerships claiming a reduced treaty withholding tax rate on dividends deemed to have been paid by a Canadian ULC pursuant to the PUC increase strategy. What accounts for this difference in treatment between two seemingly similar fiscally transparent entities?

Senior CRA Rulings officials have orally confirmed that members of a fiscally transparent partnership—but not members of an LLC—were allowed to claim treaty benefits before the fifth protocol on the Canadian common-law principles that the partnership itself is not a legal person and that the property of a partnership is held by its partners. However, an LLC itself is not liable to tax in the United States and therefore is generally not a US resident for the purposes of article IV, which determines eligibility for treaty benefits even when all the members of the LLC are US residents for treaty purposes (see, for example, CRA document no. 9713120, May 20, 1999).

The introduction of article IV(6) creates a problem for members of fiscally transparent US entities that are not considered under US law to have derived a particular amount through a transparent entity because the amount is disregarded for US tax purposes (for example, a deemed dividend paid pursuant to the PUC increase strategy). Although the CRA has interpreted article IV(6)(a) to deny treaty benefits to members of LLCs, a more purposive interpretation has been adopted for partnerships. Senior CRA Rulings officials have confirmed that because partnerships were already entitled to treaty benefits before the fifth protocol, and because article IV(6) was meant to be relieving in nature, it would be inappropriate to interpret the article to deny treaty benefits to members of a partnership.

The use of LLCs in the structures that article IV(7)(b) was intended to discourage may partly explain why the CRA has not adopted a more favourable interpretation of article IV(6) for LLCs. When considering the use of a Canadian ULC to distribute earnings to US investors, tax practitioners should be mindful of the more favourable treatment that the CRA has afforded US partnerships.

Greg Lindsey and Lauchlin MacEachern
Gowling Lafleur Henderson LLP, Calgary

Deductibility of Marketing Expenses: Business Owner Personally Involved

In *Bilous v. The Queen* (2011 TCC 154), the main issue was whether Yorkton Distributors could deduct business expenses and capital cost allowance for a building and for the snowmobiles housed therein (collectively, "the snowmobile museum") in its 2003 and 2004 taxation years. The CRA denied the expenses on the basis that they were not made for the purpose of gaining or producing income as required under paragraph 18(1)(a). Alternatively, the CRA claimed that the amounts deducted were not reasonable and were not deductible by virtue of section 67. The CRA also claimed that those expenses were incurred for the personal benefit of Mr. B, the principal shareholder of Yorkton, who was reassessed under subsection 15(1) for a small amount for 2004.

Yorkton's principal business was the sale of transgenic canola seed and crop-protection products to farmers. Both Mr. B and Yorkton were involved in the development and support of snowmobiling organizations, and both were active in the snowmobiling community in the Yorkton area and beyond. Mr. B's presence in snowmobiling circles was useful in connecting him with Yorkton's customers, a good number of whom had snowmobiles. Yorkton started collecting vintage snowmobiles in 1998, and in 2001 commenced construction of the snowmobile museum on Mr. B's farm.

In 2003, Yorkton decided to use the snowmobile museum to develop its relationships with its customers. In 2003 and 2004, the museum became a featured stop on the snowmobile trail ride sponsored by one of Yorkton's suppliers; museum tours were available on request, and some tours were conducted. In the years subsequent to 2003 and 2004, Yorkton continued to use the snowmobile museum as part of its marketing strategy.

Sheridan J concluded that the expenses were incurred by Yorkton to advertise and promote its business and were deductible. With respect to the application of paragraph 18(1)(a) and regulation 1102(1)(c), she relied on the test in *Symes v. Canada* ([1993] 4 SCR 695), in which Iacobucci J stated in paragraph 73 that in order to determine the deductibility of expenses, the courts are required to "look for objective manifestations of purpose, and purpose is ultimately a question of fact to be decided with due regard for all of the circumstances."

Sheridan J also relied on *Matt Harris & Son Ltd. v. The Queen* (2000 CanLII 475 (TCC) (informal procedure)) and *Ross v. The Queen* (2005 TCC 286), in which the Tax Court applied the test in *Symes* and concluded that advertising expenses were properly deductible. In *Harris*, the taxpayer was involved in a wood-cutting business. Its principal was a stock car and snowmobile enthusiast who personally raced the machines, and the bulk of the company's advertising was focused on the principal's participation in such events. In *Ross*, the taxpayer was employed as a securities salesman and broker. He deducted expenses related to the breeding and buying of thoroughbred racing horses, with which he was personally involved. Both Tax Court justices rejected the idea that a business owner's personal interest in the promotional activity made the expenses non-deductible.

In *Bilous*, Sheridan J concluded that there was no difference between the promotional activities in the *Harris* and *Ross* cases and Yorkton's use of the snowmobile museum as part of its promotional strategy. Relying on the *Symes* case, she stated that for an expense to be deductible it was not necessary to show the effectiveness of the strategy, or to establish a causative relationship between a particular expense and a particular receipt or even to show that the expense had ever borne fruit.

In concluding that the expenses were not unreasonable, the Tax Court relied on the comments of Noël J in *Hammill v. Canada* (2005 FCA 252), in which he stated that in order to deny an expense as unreasonable, one must conduct a quantitative review of the expenditure.

The Crown argued that the expenses "were unreasonable because they outstripped significantly the promotional use to which [the snowmobile museum] was put in 2003 and 2004." The Crown questioned why Yorkton did not continue to use its existing marketing strategy, and submitted that it would have been more reasonable for Mr. B to have underwritten the cost of the museum and for Yorkton to have rented the facilities from him as and when required. Sheridan J rejected those arguments because (1) they were not supported by the pleadings; (2) Yorkton had proved that the quantum of the expenditures was reasonable; and (3) on the principles expressed in *Keeping v. Canada* (2001 FCA 182), it was not the place of the courts to second-guess the business acumen of a taxpayer whose commercial venture turned out to be less profitable than anticipated. Sheridan J also stated that "it [was] difficult to see how the expenses claimed by a consistently profitable business like [Yorkton] for expenses which are significantly less than total revenues can be seen as unreasonable."

Philip Friedlan
Friedlan Law
Toronto and Richmond Hill, ON

Beware of Warrantless Seizures

Employees of the CRA have broad powers to "inspect, audit or examine" the books and records of taxpayers (see, in particular, sections 231.1 and 231.2 of the Income Tax Act, and sections 288 and 289 of the Excise Tax Act). CRA auditors are permitted to examine any document or property of the taxpayer or any other person that may assist in the audit; they are also authorized to enter into any place where business is carried on, property is kept, or anything is done in connection with the business. (If the place is a taxpayer's dwelling, the consent of the occupant or a judicial warrant is specifically required.)

In this article, we review *R v. He* (2011 BCSC 368), a recent British Columbia case that considered, for the first time, the limits on auditor searches and at what point the CRA's actions may constitute a "breach of the [taxpayer's] rights under s. 8 of the *Charter* to be free from an unreasonable search or seizure."

The case involved the CRA's electronic records evaluation (ERE) pilot project. The ERE project, which began in 2005, is run by a subgroup of the CRA's Audit Division known as "electronic commerce audit specialists." The trial judge found that the CRA's objectives in this project included raising awareness of CRA requirements among taxpayers, system vendors, and software developers, and ensuring that the requirements kept pace with technological changes to minimize the burden on taxpayers.

Mr. H, along with two other taxpayers, operated a corporation that carried on business as a restaurant. In August 2006, the CRA notified the corporation that it had been selected for review; the CRA said that the purpose of the review was to determine the adequacy of the restaurant's electronic records and that although the review was not an audit, any deficiencies could result in a referral to the Audit Division.

In November 2006, three CRA employees attended at the restaurant and met with Mr. H and two managers. At the conclusion of the meeting, the CRA copied the data from the point-of-sale system onto a USB key and seized 14 diskettes of older backup data for copying. Mr. H was given a receipt for the diskettes. As a result of the review of the electronic records, criminal charges were laid against the taxpayers under the ITA and the ETA.

The Crown elected to proceed by summary conviction, but at trial a preliminary issue was raised with respect to the admissibility of the seized documents. The provincial court judge held a voir dire and ruled that the evidence obtained from the taxpayers' restaurant was not admissible at trial on the basis that it had been unlawfully seized, and that the taxpayers' Charter rights had been violated, requiring that the evidence be excluded. The CRA consented to the acquittal of the taxpayers and then appealed the voir dire ruling.

On appeal, the primary question was whether the CRA had lawful authority to seize and copy the taxpayers' electronic records; if it did not, was the trial judge correct in excluding the evidence pursuant to section 24(2) of the Charter? The Crown argued that the CRA had validly used its inspection powers under section 231.1 to review the taxpayers' books and records, and that the trial judge had applied an incorrect test to the exercise of those powers. (The trial judge had essentially adopted the test in *James Richardson & Sons, Limited v. MNR* (84 DTC 6325 (SCC)), a case dealing with the CRA's demand powers under the predecessor to section 231.2.) The taxpayers argued that the principles and test from *Richardson* were equally applicable to the CRA's use of its inspection powers under section 231.2 because the two sections were very similar (although it was noted that section 231.1 was actually more intrusive because it did not require that the CRA provide any notice prior to the search and seizure).

After reviewing the factual background, the positions of the parties, and section 231.1, the court reviewed *Richardson*, which it noted was the leading case on the application of section 231.2. The court also noted that section 231.1 had not been considered in the context of books and records reviews. In *Richardson*, the CRA had requested client data, including names, addresses, and monthly statements, pursuant to section 231.2. The CRA acknowledged that neither the taxpayer nor its clients were under investigation in respect of their tax liability—it simply wanted to verify the accuracy of income tax returns made by some clients. The SCC ruled that section 231.2 was available to the minister only "to obtain information relevant to the tax liability of some specific person or persons if the tax liability of such person or persons is the subject of a genuine and serious inquiry." In other words, the CRA could not use the section to go on a random fishing expedition.

The court in *R v. He* accepted the taxpayer's argument that the CRA's inspection powers under section 231.1 were clearly more intrusive than the demand powers under section 231.2. The court held that the *Richardson* test was equally applicable to both sections: that is, the CRA could lawfully use its inspection powers under section 231.1 only if it was attempting to obtain relevant information in the course of a genuine and serious inquiry into the tax liability of a specific person or persons.

On that point, the court found that the CRA's ERE pilot program was designed to randomly target businesses to evaluate their electronic records. The program's purpose was to generate awareness among taxpayers, to begin a dialogue with software developers, and to better understand what systems were being used by randomly selected businesses—not a genuine and serious inquiry into anyone's tax liability. This was exactly the "type of action by the CRA that the Supreme Court of Canada found to be an unacceptable use of their powers." While not completely adopting the reasons of the trial judge, Bowden J held that the CRA had not lawfully exercised its powers; it had therefore committed what amounted to a warrantless seizure and a violation of the Charter right of the taxpayers to be free from unreasonable search and seizure.

Because evidence obtained in violation of section 8 of the Charter is not automatically excluded at trial, the court reviewed the trial judge's decision on section 24(2) of the Charter. Holding that the trial judge had correctly stated the relevant test for exclusion of evidence, the court upheld the decision to exclude the improperly seized evidence.

The CRA's broad powers under sections 231.1 and 231.2, which cover any purpose related to "administration or enforcement," appear to be more or less limited to audits and similar serious and genuine reviews. It is settled law that the CRA cannot lawfully use its powers under sections 231.1 and 231.2 when its predominant purpose is to further a criminal investigation rather than an audit (see *R v. Jarvis*, 2002 SCC 73). Similarly, *Richardson* and *He* stand for the proposition that the CRA cannot lawfully use its powers under sections 231.2 and 231.1, respectively, when its predominant purpose is less than an audit.

In general, taxpayers are not advised to resist the CRA's requests for information (indeed, doing so may constitute an offence under subsection 238(1)). However, it is important for taxpayers to understand (and, if necessary, seek clarification of) the basis on which the CRA is making its request and the possible consequences flowing from that request. For example, if a taxpayer is contacted by a member of the CRA's Special Investigations Division, the taxpayer should be aware that the CRA is considering potential criminal charges and that the taxpayer generally has the right to remain silent and rely on a presumption of innocence. Generally speaking, when one is dealing with Special Investigations, it is advisable to seek legal assistance from a tax lawyer.

Robert G. Kreklewetz and John Bassindale
Millar Kreklewetz LLP, Toronto

Golden Pheasant: Oppression in Action

Editor's note: Corporate law may provide a remedy for a shareholder in a private company when there is a falling out with the other shareholders. This article describes how the oppression remedy was applied in British Columbia in a recent civil case. It does

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Canadian Tax Foundation
595 Bay Street, Suite 1200
Toronto, Ontario M5G 2N5
Telephone: 416-599-0283
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not deal with the tax consequences of exercising such a remedy, although they are often significant.

The recent case of *Golden Pheasant Holding Corp. v. Synergy Corporate Management Ltd.* (2011 BCSC 173) demonstrates the application of the oppression remedy to the breakdown and windup of a professional services firm. Three lawyers carried on a law partnership. In connection with the partnership, they formed a management company (SCM) that provided various management services to the partnership and owned some of the property used by it. In May 2010, the majority interest partner, Mr. W, withdrew from the partnership in hostile circumstances. Following his departure, the remaining lawyers voted to remove Mr. W as a director of SCM and to terminate the management agreement with the partnership, which was to be wound up for liability reasons. Mr. W's holding company, Golden Pheasant, remained a 40 percent shareholder of SCM.

Golden Pheasant sought an order under sections 227 and 324 of the British Columbia Business Corporations Act (BCA) that SCM be liquidated and dissolved and that the other SCM shareholders purchase its shares for their value on the date that Mr. W left the partnership. The respondents replied that valuing the shares on the basis that SCM was a going concern was an unrealistic approach to valuation, and that SCM's assets should be valued on a breakup basis and SCM should be liquidated and dissolved.

Section 227(2) of the BCA, which provides an oppression remedy, states that a shareholder may apply to court for an order where (1) the affairs of the company have been conducted, or the directors have exercised their powers, in a manner that is oppressive to one or more shareholders, including the applicant; or (2) some act of the company has been done or is threatened, or some resolution of the shareholders has been passed or is proposed, that is unfairly prejudicial to one or more shareholders. If the conditions of section 227(2) are satisfied, a court may grant a wide range of orders.

The court cited *BCE Inc. v. 1976 Debentureholders* (2008 SCC 69), where the SCC said that "the concept of reasonable expectations [of shareholders] is objective and contextual. . . . [T]he question is whether the expectation is reasonable having regard to the facts of the specific case, the relationships at issue, and the entire context." General commercial practice, conflicting claims and expectations, the nature of the corporation, the relationship between the parties, past practice, steps that the claimant could have taken to protect itself, and representations and agreements are all relevant considerations.

If a breach of a reasonable expectation is established, a court must then consider whether the impugned conduct was oppressive or unfairly prejudicial. Citing *Urquhart v. Technovision Systems Inc.* (2002 BCSC 172; aff'd. 2003 BCCA 45), the court noted that "oppressive" means conduct that is burdensome, harsh and wrongful or that lacks probity and fair dealing. "Unfairly prejudicial" has a broader meaning and covers a wider range of rights: it can be distinguished from "oppressive" on the basis that it focuses on the effect of the impugned conduct rather than on its character.

The court then turned to section 324(1) of the BCA, which states that various corporate stakeholders may apply to have a company liquidated and dissolved in circumstances where, inter alia, it is just and equitable to do so. This is generally a lower standard than the standard of oppression or unfair prejudice. The court noted that if it concluded that it was just and equitable to wind up SCM under section 324, it had available any of the powers set out in section 227 of the BCA to try to resolve each case justly.

Applying the principles described above, the court held that it would be reasonable to expect that SCM would be liquidated and dissolved (on a breakup basis) in circumstances where the majority-interest partner left the partnership, and that no oppression had taken place. SCM was integrally related to the business structure of the partnership. After Mr. W's departure, the remaining partners simply took a reasonable and necessary step to terminate the management contract and wind up SCM's affairs. Furthermore, given that SCM was no longer a going concern, it would be neither practical nor just and equitable to compel the remaining SCM shareholders to purchase Golden Pheasant's shares. Because SCM's only value was in its realizable assets, it was ordered to be liquidated and dissolved under sections 324 and 227 of the BCA.

Daniel Bellefontaine
Thorsteinssons LLP, Vancouver