On July 18, 2017, the Federal Liberal government (working with the Federal Department of Finance) released a report and series of widespread proposals and draft legislation ("Proposals") that are intended to make the most radical reshaping of the Canadian income tax system in a generation. The Proposals target a single segment of Canadian society — private enterprise and, in particular, Canadian controlled private corporations ("CCPCs"), their owners, and the owners' families. The Government has defended these changes as being fair to the "middle class" and necessary to defend the Canadian tax base.

Canada's New Estate Tax Explained

For purposes of this discussion, we will focus on two sets of changes in the Proposal.

1. **Tax on Split Income Rules that Tax Capital Gains as Dividends**

The Income Tax Act (Canada) (the "Act") deems a person to dispose of his or her capital property, such as shares of a Canadian private or public corporation, as a result of death or emigration from Canada (collectively, "Deemed Dispositions"). These Deemed Dispositions create taxable events where the value of the shares at the time of the Deemed Dispositions is in a gain or loss position even though the shareholder will still own the shares and will not have received any proceeds from the sale that he or she can use to pay the Deemed Disposition taxes.

Under the Proposals, Deemed Dispositions of corporate securities (this discussion will focus on shares only) of CCPCs will be taxed as top tax rate dividends rather than as capital gains taxed at the shareholders' marginal tax rates, regardless of the age of the shareholder unless the owner can establish that his or her personal contribution of human and/or financial capital met certain uncertain and difficult-to-meet hurdles in the discretion of the Canada Revenue Agency ("CRA").

The effect of this aspect of the Proposals will be to eliminate marginal tax rate taxation for adults who are subject to this element of the Proposals and to increase the tax rates on Deemed Dispositions for many shareholders of CCPCs from the top marginal tax rate of 26.76% to the top marginal tax rate applicable to dividends of 45.30%. This tax increase will apply if the affected shareholders acquired their interest in the CCPC with...
no (or nominal) consideration and, in many cases, the tax increase will also apply even where the acquisition has been made with their own assets and/or borrowed funds. In their current form, the Proposals will apply to all existing or accumulated value in CCPCs — not just on value that appreciates after July 18, 2017.

The Proposals do not impact the capital gains rate realized by investors in public corporation shares in any way or form.6 As a result, Deemed Dispositions of such shares will continue to attract tax at ordinary marginal capital gains rates subject to a maximum tax rate of 26.76%. This will be true whether the person acquiring the shares received the shares as a gift,7 with his own wealth, or whether he acquires the shares with borrowed funds, including borrowed funds from non-arm’s length persons at favourable interest rates.8

Ostensibly the additional level of taxation applicable to the CCPC shareholder is intended to overcome the unfairness that non-active family holders of such shares are able to enjoy capital gains treatment in situations where they have taken little or no financial risk to generate such gains. Excellent articles have been written9 that make it clear that many, if not most, family members holding such shares have indirectly borne the risks of building the business. Regardless of such arguments, no explanation has been provided as to why public market share transactions should be treated differently from Canadian private corporate share transactions in respect of the taxation of capital gains.

Many articles have also noted that, combined with other changes in the Proposals (including those discussed below), this particular change will favour business owners selling the family business to arm’s length parties instead of passing the business on to family members. In addition, those articles have made it clear that the combined impact of the Proposals will provide significant advantages to public, foreign, and other large entities to acquire CCPCs and, in many situations, will effectively eliminate the ability for owners of CCPCs to utilize their lifetime capital gains exemptions.

**Surplus Stripping Rules that will Cause Canadian Private Corporation Shareholders to Pay Dividends a Second Time**

By their nature, publicly traded shares tend to be liquid. As a result, owners of such shares are generally able to sell them to fund their capital gains taxes arising on Deemed Dispositions in a straightforward manner.

Shareholders of CCPCs do not have the luxury of ready liquidity. There is often no market to sell the shares in a satisfactory manner that ensures the value of the shares is not compromised and within the time limits in the Act to pay taxes on the Deemed Dispositions.

Over time, the CRA came to accept a practice that put CCPC shareholders on a more even footing with public shareholders by allowing CCPC shareholders to draw funds out of CCPCs to the extent that their shares had been paid for with after-tax dollars or had been the subject of Deemed Dispositions.10 However, the Government has targeted this practice in the Proposals and, as of July 18, 2017, it is no longer possible take advantage of this concession.11 Instead, the government has taken the position that the only way for CCPC shareholders to access CCPC funds is through the receipt of dividends or as a result of the deemed receipt of dividends on the repurchase of shares. Requiring dividend (deemed dividend) tax treatment to access corporate funds will typically result in additional tax payable on the same shares at tax rates of 45.30%.12 This additional level of taxation will apply to all CCPC shareholders — even the founders of such entities who have directly risked their financial and human capital to create equity in their CCPC shares.

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6 This may also generally be true for shareholdings of other large widely-held conglomerates whether domestic or foreign. This article only discusses publicly traded shares.

7 If the gift recipient is a spouse or minor, certain attribution rules will apply that may negate the benefit of marginal rates while that person remains a spouse or minor.

8 Provided the interest rates charged meet certain minimum standards (currently 1% interest rates would need to be charged by the lender).

9 Please feel free to contact the author to obtain a selection of these articles.

10 This is often referred to as pipeline planning. The CRA’s administration of this concession was often criticized for being arbitrary, but at least it ensured that owners of CCPC shares could, in many cases, be treated similarly to those holding publicly traded securities.

11 This element of the Proposals targets so-called “surplus stripping”, and catches a host of other transactions that the government does not approve of. In our view, there are much better ways to deal with issues associated with surplus stripping, but that is a discussion for a different article.

12 In some cases, where strict criteria can be met, the provisions of the Act may permit the total tax to be reduced to 45.30% (this is sometimes referred to as subsection 164(6) planning) — still nearly double the tax cost applicable to the public company shareholder. Unfortunately, due to changes introduced by the Proposals, it will generally be much more difficult to use the Act to reduce the tax rate to even this level.
The combination of the two changes discussed in this article will potentially tax the same gains twice at 45.30% each time. As a result, the combined effect of the full force of these elements of the Proposals will nearly completely expropriate the equity of many CCPC shareholders.13

It is unclear why either of the two changes described in this article need to be made to the Act. This is particularly true since these changes will result in exacerbating the pre-existing unfair tax treatment of CCPC shareholders when compared to the tax treatment of gains available to shareholders of public corporations.

**Concluding Comments**

The purpose of this article is to point out a particularly egregious effect of certain elements of the Proposals on CCPCs, their owners, and the owners’ families. However, the focus of this article on these particular problems is not intended to take away from the many other technical, policy, and other flaws the Proposals create in their interaction with one another and the preexisting provisions of the Act, as well as the broader risks to the Canadian economy that may result if the Proposals are implemented. For these reasons and the reasons that have been expressed elsewhere, including by this author,14 the implementation of the Proposals should be suspended if not completely abandoned.

**CURRENT ITEMS OF INTEREST**

**British Columbia Budget**

British Columbia Finance Minister Carole James presented the post-election budget, Budget 2017 — September Update, on September 11, 2017. A number of tax measures were announced, including a new personal tax bracket for incomes over $150,000, increased carbon tax, an increase in the general corporate income tax rate, and a reduction in the small business corporate income tax rate. See [http://bcbudget.gov.bc.ca/2017_Sept_Update/default.htm](http://bcbudget.gov.bc.ca/2017_Sept_Update/default.htm) for budget details.

**Nova Scotia Budget**

Nova Scotia tabled a post-election budget on September 26, 2017.

**Employment Insurance Rate for 2018**

The government announced that the employment insurance ("EI") premium rate for 2018 will be 1.66% of insurable earnings. This is up from 1.63% in 2017, but remains considerably lower compared to 1.88% from 2013 to 2016. Also note that Budget 2017 expanded EI benefits in various respects, and originally estimated that EI premiums would increase to 1.68% as a result. The maximum insurable earnings for 2017 is $51,300, but the limit for 2018 has yet to be announced.

**Budget 2017 Draft Tax Proposals Released**

The Department of Finance has released draft legislation with respect to the outstanding Budget 2017 measures. Both GST/HST and income tax measures are included, with explanatory notes.

Notably, the billed-basis accounting proposals have been revised with a five-year phase-in period, which is considerably longer than what was originally proposed.

Also included are further technical revisions to "stub period foreign accrual property income" and the previously-announced change with respect to the Canadian Forces personnel and police deduction.

The consultation period with respect to all of these proposals ends after October 10, 2017.

The income tax proposals include:

- The Ecological Gifts Program;
- Clean energy generation equipment — geothermal energy;
- The Canadian exploration expense — oil and gas discovery wells;
- The reclassification of expenses renounced to flow-through share investors;


14 Ibid.
The meaning of factual control;
Extending the base erosion rules to foreign branches of life insurers;
Investment fund mergers;
The timing of recognition of gains and losses on derivatives; and
Billed-basis accounting.

The GST/HST proposals are primarily revised versions of technical amendments that were originally announced on July 22, 2016. GST/HST amendments that have not been previously announced propose to:

- Revise the timing requirements for GST/HST rebate applications by public service bodies to provide them with improved flexibility and administrative simplicity;
- Extend the application of the GST/HST rules applicable to selected listed financial institutions to include investment limited partnerships, and provide GST/HST relief to investment limited partnerships with non-resident investors where certain conditions are met; and
- Revise the federal excise framework to ensure that beer made from concentrate is taxed in a manner that is consistent with other beer products.

CRA Update on Compliance Enforcement Activities

As promised in its initial response to the recommendations by the House of Commons Standing Committee on Finance, the CRA published its first report on tax evasion enforcement efforts. This report contains data on results such as fiscal impact, offshore audits completed, total penalties on promoters and tax preparers, number of convictions, etc. This information will continue to be reported to the public on a recurring basis going forward.

The CRA also provided a progress update on another committee recommendation that the government review all of its treaties and information exchange agreements to ensure that they do not facilitate non-compliance. The government has found that two of its treaties do not meet international standards. The first is the tax treaty with Trinidad and Tobago, who the Department of Finance will be contacting to discuss renegotiations before the end of 2017. The second is the treaty with Malaysia, which is currently under renegotiation — the government will insist on an exchange of information provision that meets the international standard.

FOCUS ON CURRENT CASES

This is a regular monthly feature examining recent cases of special interest, coordinated by John C. Yuan and Christopher L.T. Falk of McCarthy Tétrault LLP. The contributors to this feature are from McCarthy Tétrault LLP, Montreal, Toronto, Calgary, and Vancouver.

The “At-Risk” Rule Does Not Result in the Stranding of Limited Partnership Losses Where There Is More Than One Layer of Partnership

The Queen v. Green, 2017 DTC 5068 (Federal Court of Appeal)

The Green decision of the Federal Court of Appeal was a Crown appeal involving an interesting interpretive issue regarding the allocation of business losses to a limited partner of a partnership where there is more than one layer of partnership. The main disputed legal question in Green was somewhat convoluted but can be paraphrased as follows:

[... ] in a situation involving a particular partnership which is a limited partner of another partnership, where (1) the particular partnership has no at-risk amount in respect of the other partnership at the end of a particular fiscal period, and (2) where the other partnership has incurred a business loss in the particular fiscal period, does the business loss incurred by the other partnership retain its character as a business loss of the particular partnership which can be allocated to a partner of the particular partnership as a business loss?

Put simply, if the answer to this question is yes, then a business loss incurred by a bottom-tier partnership can flow up multiple levels of partnerships and retain its character as a business loss in the hands of a limited partner at the top level of the structure, which business loss can be carried forward by that limited partner to future taxation years and
deducted if and when that limited partner’s at-risk amount in the top-level partnership becomes sufficient to do so. The Federal Court of Appeal answered the question in the affirmative, preventing business losses from potentially becoming “stranded” in a multi-tier partnership scenario.

The background of the Green decision is relatively straightforward. Certain individual taxpayers (the respondents) were limited partners in a partnership referred to as MLP. MLP was a limited partner in a number of other partnerships, referred to as the PSLPs. From 1996 to 2008, each of the PSLPs incurred business losses. However, from 1996 to 2008, the respondents’ at-risk amount in respect of MLP and MLP’s at-risk amounts in respect of the PSLPs were nil. Generally speaking, under subsection 96(2.1) of the Income Tax Act (the “Act”), a limited partner of a partnership cannot deduct a business loss allocated to it by the partnership to the extent that such loss exceeds the limited partner’s at-risk amount in respect of the partnership. Paragraphs 96(2.1)(c) to (e) provide that the amount by which a business loss exceeds the relevant at-risk amount shall:

(c) not be deducted in computing the taxpayer’s income for the year,

(d) not be deducted in computing the taxpayer’s non-capital loss for the year, and

(e) be deemed to be the taxpayer’s limited partnership loss in respect of the partnership for the year.

As a result, the respondents did not deduct the business losses allocated to them by MLP from 1996 to 2008 for their 1996 to 2008 taxation years. Instead, the respondents added such business losses to their limited partnership losses under paragraph 96(2.1)(e). A limited partner’s limited partnership loss for the year under paragraph 96(2.1)(e) can potentially be deducted in a future year under paragraph 111(1)(e) provided that the limited partner’s at-risk amount is sufficient in that future year. In 2009, MLP allocated a capital gain to its limited partners, thus increasing the respondents’ at-risk amounts in respect of MLP. Each of the respondents then claimed, in their 2009 taxation years, a portion of the accumulated limited partnership losses under paragraph 111(1)(e).

The Crown denied the respondents’ deductions on the basis that, when the PSLPs allocated business losses to MLP in years in which MLP’s at-risk amount in respect of the PSLPs was nil, such losses were deemed by paragraph 96(2.1)(e) to be limited partnership losses in the hands of MLP. In other words, in the Crown’s view, the business losses allocated to MLP by the PSLPs lost their character as business losses in MLP’s hands and could not be allocated as business losses to the respondents. Indeed, as section 96 does not contemplate the allocation by a partnership of a “limited partnership loss” to its own partners, MLP could not, under the Crown’s argument, allocate to the respondents any of the losses that flowed to it from the PSLPs. Further, in the Crown’s view, MLP could not carry forward the limited partnership losses to future years under paragraph 111(1)(e) because that provision only permits the deduction of limited partnership losses by a “taxpayer”—a partnership is not a “taxpayer” for the purposes of paragraph 111(1)(e). The practical effect of the Crown’s argument would be that a business loss incurred by a lower-tier partnership could be stranded in a higher-tier partnership if that higher-tier partnership had no at-risk amount in a lower-tier partnership of which it was a partner.

The Federal Court of Appeal sought to construe the effect of subsection 96(2.1) in the context of the overall scheme of the Act as it relates to the computation of income and the allocation of income and losses to taxpayers by partnerships. As a starting point for this analysis, the Court noted that, as a partnership does not pay tax, the purpose of section 96 is to allocate the income or losses of a partnership to its partners such that the members of the partnership can properly compute their income. The Court noted that section 3 of the Act provides for the computation of a taxpayer’s income as an aggregate of the taxpayer’s income from different sources. Likewise, subsection 111(8) provides for the computation of a taxpayer’s non-capital loss for a taxation year for the purpose of applying such losses to past or future taxation years. Since a partnership is not a “taxpayer” for the purposes of sections 3 or 111, the Court considered that paragraphs 96(2.1)(c) and (d), which contain rules concerning the computation of a taxpayer’s income and non-capital loss, do not apply to partnerships.

Similarly, paragraph 96(2.1)(e) deems certain losses to be limited partnership losses which can be carried forward by taxpayers (but not partnerships) under paragraph 111(1)(e). The Court considered it implausible that Parliament would have intended 96(2.1)(e) to apply to transform a business loss into a limited partnership loss in the hands of a partnership, if that partnership could not then avail itself of the same limited partnership loss in a subsequent year when its at-risk amount had increased. In one hypothetical scenario considered by the Court, one of the PSLPs could allocate a $1,000 business loss to MLP in year 1, which would, under the Crown’s interpretation, be deemed to be a limited partnership loss that could not be allocated to the respondents or carried forward to a future year. In year 2, if the same PSLP were to allocate $1,000 of income to MLP, that income could not be offset by the loss that was
incurred in year 1. The Court considered this result to be inappropriate from a policy perspective, thus supporting the conclusion that paragraph 96(2.1)(e) was not intended to apply to partnerships that are members of other partnerships, but only to the taxpayers to whom partnership income and losses are ultimately allocated.

The Crown argued that permitting business losses to retain their character even when allocated up a chain of partnerships could lead to the circumvention of the at-risk rules in certain circumstances. For example, if the respondents were general partners of MLP, then their deduction of the losses incurred by the PSLPs would not be subject to the at-risk rules. However, the Court considered that the concern arising from the Crown’s hypothetical scenario was outweighed by the problematic results that could flow from the Crown’s proposed interpretation. The Canada Revenue Agency could counter any inappropriate circumvention of the at-risk rules using the general anti-avoidance rule and Parliament could amend the Act to fix any perceived problem.

Accordingly, the Court decided that a business loss incurred by a bottom-tier partnership (in this case, a PSLP) retains its character as a business loss when allocated to an upper-tier partnership (in this case, MLP) and can be allocated to partners of the upper-tier partnership (in this case, the respondents) as business losses.

— Theodore Stathakos

Unsophisticated Taxpayer’s Errors in His Tax Return Due to “An Abject Lack of Understanding” Did Not Constitute Gross Negligence

*Liu v. The Queen, 2017 DTC 1068 (Tax Court of Canada)*

This case is notable for an unusual procedural concession allowing the taxpayer to submit evidence after the hearing, and for a finding by the Tax Court that while the taxpayer’s unsophistication and disorganization gave rise to a reassessment, the substantial mistakes in the taxpayer’s returns were due to “an abject lack of understanding” and not gross negligence.

The taxpayer, Mr. Liu, was the sole proprietor of Sun Star Enterprises, a heating and air conditioning business. Mr. Liu did not maintain organized records of the revenues and expenses of the business. Given that the Minister considered Mr. Liu’s books and records to be a shambles, the Minister conducted a net worth assessment under subsections 152(7) and (8) of the *Income Tax Act* in reassessing Mr. Liu for the 2010 and 2011 taxation years. The Minister analyzed Mr. Liu’s bank deposits and calculated the amount of undeclared income for 2010 and 2011 by subtracting from the total unexplained deposits his reported business income and applicable GST and HST. The Minister applied gross negligence penalties under subsection 163(2) given the magnitude of the undeclared income and disallowed expenses. Mr. Liu appealed from the reassessment to the Tax Court.

At trial, Mr. Liu conceded that his poor record keeping gave rise to the reassessment. Mr. Liu insisted, however, that he had records for additional specific expenses, understood the importance of producing them (although he was not in a position to do so at the hearing), and could produce them soon after the hearing. Counsel for the Minister was not opposed to this (presumably based at least in part on the fact that the taxpayer was self-represented), so Mr. Liu was permitted to submit records for specified expense categories to the Court and to counsel for the Minister, and he did so after the hearing and before the Court rendered its decision.

The three main issues were: the unreported income calculation; whether additional specific expenses could be deducted; and whether gross negligence penalties were appropriate.

Mr. Liu did not adduce records to support the amount of his income for the years in issue. The Court referenced the two taxpayer strategies that were identified in *Golden* (2009 DTC 1273) for combatting a net worth assessment: the taxpayer could argue that a net worth assessment was not the best method to assess the taxpayer’s income, or the taxpayer could challenge the calculation methodology used by the Minister. In the Court’s view, Mr. Liu did not provide countervailing evidence to challenge the reassessment with either strategy. The Court accepted the Minister’s determination of Mr. Liu’s unreported income for 2011 but adjusted Mr. Liu’s reassessed income for 2010 in Mr. Liu’s favour given a concession by the Minister and an amount withdrawn from a Home Buyers’ Plan which did not constitute income to Mr. Liu. The amount of Mr. Liu’s unreported income was determined by the Court to be $65,865.63 for 2010 and $43,011.00 for 2011.

In respect of additional expenses to those allowed in the reassessment, the Court allowed such expenses if it were more likely than not, based upon Mr. Liu’s supplementary documentation, that the expenses were incurred to generate
income for Sun Star Enterprises. The Court determined an inclusion rate per category of expense, for example including 70% of vehicle expenses on the basis that Mr. Liu testified that 70% of his vehicle use was business-related. The Court reduced the disallowed expenses for both the 2010 and 2011 taxation years based upon its calculation. The Minister also made a sizeable concession for the 2011 taxation year, resulting in disallowed expenses after appeal of $10,175.18 for 2010 and $44,156.21 for 2011.

Subsection 163(2) provides gross negligence penalties for taxpayers that knowingly or through gross negligence make false statements or omissions in a return. Mr. Liu admitted to errors in his 2010 and 2011 tax returns. Counsel for the Minister did not assert that Mr. Liu knowingly committed the errors. Therefore, the Court considered whether the Minister could discharge its burden to prove on a balance of probabilities that Mr. Liu’s conduct constituted gross negligence.

In Venne (84 DTC 6247), Strayer J. defined gross negligence as "a high degree of negligence tantamount to intentional acting, an indifference as to whether the law is complied with or not." In Panini (2006 DTC 6450), Nadon J. held that "gross negligence" in subsection 163(2) includes "wilful blindness" and that

[...] the law will impute knowledge to a taxpayer who, in circumstances that dictate or strongly suggest that an inquiry should be made with respect to his or her tax situation, refuses or fails to commence such an inquiry without proper justification.

Courts distinguish "gross" negligence from "ordinary" negligence by weighing four factors:

(1) the magnitude of the omission in relation to the income declared;
(2) the opportunity the taxpayer had to detect the error;
(3) the taxpayer’s education and apparent intelligence; and
(4) whether the taxpayer made a genuine effort to comply.

In respect of Mr. Liu’s education and apparent intelligence, the Court concluded that Mr. Liu was unsophisticated in tax and accounting matters. For the second and fourth factors, Mr. Liu testified that he genuinely attempted to comply. He hired an accountant, filed returns, and paid taxes according to those returns. Mr. Liu’s disorganized records necessitated the reassessment but the Court recognized that in light of Mr. Liu’s unsophistication, the "not necessarily simplistic nature of the tax returns", and discrepancies between the unreported income and disallowed expenses in the reassessment and those calculated by the Court, it would not have been easy for Mr. Liu to detect errors.

Counsel for the Minister submitted that the magnitude of the omission in relation to the income declared and expenses claimed was the most important factor and was determinative. The Court calculated the percentage of unreported to reported amounts and percentage decrease in initial assessment after appeal and noted that most of the unreported income and disallowed expenses were adjusted in Mr. Liu’s favour.

In the Court’s opinion, the “calculations [...] reveal the vain efforts of a hardworking small entrepreneur, hopelessly lost in the accounting and records side of a business he owned and operated alone”. The Court concluded that Mr. Liu’s failure to properly complete his returns was due to “his ignorance, lack of knowledge and inexperience” but were not “a high enough degree of negligence to achieve the elevated level of intentional action or wrongful intent.” The penalties were therefore cancelled.

The Court did not award costs in the appeal due to the mixed result and the allowances of the Minister’s counsel in response to Mr. Liu’s disorganized documents.

In this case, both the Court and the Minister demonstrated sympathy toward an unsophisticated taxpayer. While false statements and omissions in Mr. Liu’s tax returns necessitated a reassessment, in the Court’s view Mr. Liu should not be subject to gross negligence penalties given that he admitted his errors and made efforts to comply with his tax obligations, both before and after the reassessment.

— Alyssa Novoselac, Articling Student
Claims for Negligent Tax Advice Were not “Discoverable” Until After the CRA’s Confirmation of the Relevant Reassessment

Presidential MSH Corporation v. Marr Foster & Co. LLP, 2017 DTC 5049 (Ontario Court of Appeal)

When a client wants to commence a legal action against a professional advisor for negligent advice, a threshold issue is whether the action has been initiated before the end of the applicable limitation period for that type of claim. The applicable limitation period only begins to run from the date on which the claim was "discoverable", rather than the date on which the professional advisor carried out the alleged negligent act (if that is a different date). In this case, the client corporation commenced an action against an accountant for professional negligence in respect of its corporate tax filings. The Ontario Court of Appeal held that, for limitation period purposes, the claim was not yet discoverable when a notice of assessment highlighting the error was issued to the corporation. Instead, the limitations clock only began to run after the CRA responded to the corporation’s Notice of Objection and indicated it would be confirming the reassessments.

Larry Himelfarb was the accountant for Presidential MSH Corporation (“Presidential”). For tax years 2004, 2005, and 2006, Mr. Himelfarb was late in filing Presidential's corporate tax returns. On April 12, 2010, Presidential received Notices of Assessment from the CRA disallowing certain tax credits that would have been available to it had the returns been filed in time. Mr. Himelfarb advised Presidential to retain a tax lawyer to respond to the CRA. Three days later, on April 15, 2010, Presidential retained a lawyer who filed a Notice of Objection to the CRA and an application for discretionary relief to the Minister. Mr. Himelfarb assisted Presidential and its lawyer in putting together these documents. On May 16, 2011, the CRA responded to the Notice of Objection and advised Presidential that it intended to confirm the assessments, which it did on July 7, 2011. Presidential did not pursue an appeal of the reassessments to the Tax Court of Canada, as there was presumably no factual basis for disputing that the relevant returns were late-filed or any arguable interpretation of the relevant provisions of the Income Tax Act that would support the granting of the tax credits in the circumstances. The Notice of Objection appears to have been an attempt to mitigate the effect of the error by seeking discretionary relief.

On August 1, 2012, Presidential commenced litigation in Ontario’s Superior Court of Justice against Mr. Himelfarb and his firm for professional negligence in the preparation of the returns. Mr. Himelfarb brought a motion for summary judgment to dismiss the action on the basis that it was time-barred under the Ontario Limitations Act. Mr. Himelfarb argued that Presidential knew or ought to have known that it had a claim against him by April 2010, when it received the Notices of Assessment disallowing the deductions, which was more than two years before it commenced the action. Presidential argued in response that its claim was not discoverable until the CRA responded to the Notice of Objection because it was only at that point that, as required under subparagraph 5(1)(a)(iv) of the Limitations Act, "having regard to the nature of the injury, loss or damage", Presidential knew that "a proceeding would be an appropriate means to seek to remedy it."

At first instance, the motion judge found in favour of Mr. Himelfarb and dismissed Presidential’s action. The Court reasoned that, although the applications for relief from the CRA and the Minister may have had the result of reducing or eliminating Presidential’s tax liability, they “would not have eliminated the claim entirely” because the cost of pursuing those proceedings formed part of the claim against Mr. Himelfarb (Presidential MSH Corp. v. Marr, Foster & Co LLP, 2017 DTC 5049). Presidential appealed the dismissal to the Ontario Court of Appeal.

On appeal, Presidential renewed the argument that it would not have been appropriate to commence litigation while Mr. Himelfarb was actively assisting it before the CRA and the CRA had not yet confirmed its disallowance of the credits. The Ontario Court of Appeal first turned to the purpose of subparagraph 5(1)(a)(iv) of the Limitations Act (the so-called "appropriate means" element), which is not a part of the common law discoverability doctrine. The Court held that the “appropriate means” element was intended to deter "needless litigation" and can thus effectively "postpon[e] the start date of the two-year limitation period beyond the date when the plaintiff knows it has incurred a loss because of the defendant’s actions", citing 407 ETR Concession Company Ltd. v. Day (2016 ONCA 796).

In light of this statutory purpose, the Court considered two key principles in the law of discoverability. First, it reviewed the impact of Mr. Himelfarb’s participation in attempting to resolve the damages his alleged wrongdoing caused. In this connection, the Ontario Court of Appeal previously held that the limitation period applicable to a plaintiff claiming medical malpractice does not begin to run while the same medical professional is attempting to remedy the alleged problem (Brown v. Baum, 2016 ONCA 325, and Chelli-Greco v. Rizk, 2016 ONCA 489).

Second, the Court looked to the pursuit of other processes with the potential to resolve the parties’ dispute and eliminate the loss. It observed that allowing parties to pursue other means of dispute resolution without triggering the limitations clock is consistent with the administrative law principle that a court proceeding is premature if the alternative remedial process has not yet been exhausted (Volochay v. College of Massage Therapists of Ontario, 2012 ONCA 541). The Ontario Court of Appeal has applied this principle under subparagraph 5(1)(a)(iv) in the context of a
claim against a law firm for allegedly negligent tax advice relating to a charity contributions scheme (Lipson v. Cassels Brock & Blackwell LLP, 2013 ONCA 165). In Lipson, the Court held that a claim was not discoverable until the CRA settled test cases concerning the allegedly invalid tax arrangement because it was only at the point of settlement that the individuals who allegedly relied on the law firm’s advice knew that the tax credits would be disallowed and the opinion invalid. The fact that the CRA “resisted” granting the credits was not enough to make litigation appropriate for purposes of the Limitations Act.

Applying those two lines of authority, the Ontario Court of Appeal reversed the motion judge’s decision. It reasoned that a proceeding for professional negligence against Mr. Himelfarb was not appropriate — and the claim was therefore not discoverable — until May 2011 when the CRA responded to the Notice of Objection and advised that it would confirm the reassessments. Until that time, Mr. Himelfarb was still actively participating in the efforts to ameliorate Presidential’s loss. If those efforts had been successful, the claims against him would have been “substantially eliminated”. In addition, the administrative process with the CRA was still ongoing until its decision to confirm the assessments.

The Ontario Court of Appeal’s decision has the potential to inject further uncertainty into the law of discoverability, especially in matters where there is an alternative procedure to recover the potential loss. Applying the Court’s reasoning, there seems to be no principled reason why the CRA’s communication in May 2011 that it would confirm its Notices of Assessment should trigger the limitation period. At that point, Presidential could have filed a Notice of Appeal in the Tax Court of Canada to challenge the CRA’s assessment. Had it done so, it may yet have been successful in avoiding the losses resulting from Mr. Himelfarb’s error.

Although there is merit from a policy perspective in allowing alternative processes to play out before requiring parties to commence private litigation, the potential indeterminacy of those processes and the possibility that a number of their steps may trigger the limitation period makes reliance on those processes dubious. This is particularly so when the purposes of limitation periods are finality, certainty in legal affairs, and “the prevention of indefinite liability” (Wellwood v. Ontario Provincial Police, 2010 ONCA 386).

Similarly, the Ontario Court of Appeal’s reliance on Mr. Himelfarb’s participation in the efforts to remedy the loss seems distinguishable from efforts, for example, by a plastic surgeon to ameliorate the impact of an allegedly negligent surgery, which was the situation in Brown v. Baum. Unlike in that case, Mr. Himelfarb was not primarily responsible for dealing with the CRA. Rather, Presidential’s lawyer had primary responsibility for the alternative process, and presumably would also have been in a position to advise Presidential that it had a potential claim against Mr. Himelfarb as a result of his failure to file the returns on time.

More importantly, unlike a surgical error that could be fixed (as in Brown v. Baum), or a challenge to the CRA’s interpretation (Lipson v. Cassels Brock & Blackwell LLP), it seems to have been clear to the lawyers, Mr. Himelfarb, and Presidential that the tax filing was an error incompatible with a substantive challenge that could fix the problem, but was only subject to administrative discretionary relief that could mitigate its effects.

In this regard, it is worth noting that, even though Presidential did not file appeals in the Tax Court of Canada to dispute the reassessments that gave rise to the claim against the accountant, the corporation subsequently appealed to the Tax Court of Canada in respect of reassessments for later years on a related issue. The issue in the later years was whether Presidential’s entitlement to claim the tax credits in the 2004, 2005, and 2006 tax years, despite being disallowed for late-filing, reduced the pool of available tax credits that could be claimed in the subsequent tax years given the way in which the composition of the pool was defined by statute. The Tax Court held that the tax credit pool was not reduced in 2004, 2005, and 2006 and the disallowed tax credits were available for Presidential to claim in subsequent tax years provided that the other requirements for claiming the credits were met (Presidential MSH Corporation v. The Queen, 2015 DTC 1101 (TCC)). It is not clear that the parties made the Ontario Court of Appeal aware of this concurrent proceeding. One wonders whether the existence and outcome in this proceeding would have had an impact on the discoverability analysis, since it appears to confirm that, despite the 2004, 2005, and 2006 late-filing, Presidential would still be entitled to enjoy the disallowed tax credits in later years and, therefore, Presidential’s claim against the accountant for denial of the tax credits in the earlier years was not discoverable until this proceeding was also resolved.

Ultimately, the practical issue in Presidential was whether the corporation would be advancing a claim against its accountant for the delay in filing the tax returns, or against its lawyers for failing to advise it to commence a claim against him for the error. The Court’s decision visits the blame on the accountant. The reader may suspect that this result had an impact on the Court’s application of the doctrine of discoverability.

— Paul Davis
Accountants Protected From Negligence Claim by a Broadly Drawn Mutual Release

Steve Biancanello, Nick Romano, Prinova Technologies Inc., Prinova Software Inc. v. DMCT LLP, Collins Barrow and Collins Barrow Toronto LLP, 2017 DTC 5061 (Ontario Court of Appeal)

This case is a decision in which the Ontario Court of Appeal (“OCA”) addresses whether a client is precluded from suing an accounting firm for an unanticipated claim arising from apparently negligent advice that was discovered after a release from all claims was signed.

The motion judge and Divisional Court found that the release did not bar the unanticipated claim. The OCA set aside the decision of the Divisional Court and allowed the appeal. The OCA concluded that even though the current claim was unknown at the time that the release was signed, the broad language of the release, which included all claims for services that the accounting firm provided during a specific period of time, captured both unknown and known claims within that period of time.

DMCT LLP (“DMCT”) provided accounting services to Prinova Technologies Inc. (“Prinova”). DMCT billed a total of $66,632.45 on three separate matters between 2006 and 2007, including applying for SR&ED tax credits, negotiating the departure of an employee, and structuring a butterfly transaction. Prinova objected to paying the fees and sued DMCT for overcharging for what was accomplished, being in a conflict of interest, performing unnecessary work, and performing deficient work. The parties settled the litigation in March 2008 with a total payment by Prinova of $35,000 in respect of the three matters. The release (“Release”) forever discharged both parties from:

...any cause, manner or thing whatsoever existing to the present time with respect to any and all claims arising from all services provided by DMCT to Prinova through to and including December 31, 2007...

In late 2011, Prinova learned that based upon the manner in which DMCT had structured the butterfly transaction, which apparently did not comply with the relevant provisions of the Income Tax Act, Prinova could be liable for income tax of approximately $1.24 million. As a consequence, Prinova incurred substantial costs in obtaining a rescission order. In May 2012, Prinova filed a notice of action against DMCT seeking an order setting aside the Release and claiming damages in the amount of $3 million for negligence, breach of contract, misrepresentation, and breach of fiduciary duty. DMCT moved for summary judgment to dismiss the action on the basis that the claim was barred by the Release.

The OCA relied on Bank of Credit and Commerce International SA v. Munawar Ali, [2001] UKHL 8, in which the House of Lords stated that a release given by a party will release a claim that the party neither knew nor could have known, nor even imagined, so long as the language is clear. The OCA held that the language in the Release was clear and referred to all claims for services rendered up to the end of December 2007. The OCA concluded that since the new claim was in relation to the services provided by DMCT before the end of 2007 it was covered by the Release. The OCA stated that the parties intended to wipe the slate clean in respect of that work.

This case illustrates the importance to the parties to a release of paying close attention to the intended scope of the release and the language used to give effect to that scope; claims that are not known will be released where the language clearly provides for that result.

— Yaroslava Nosikova

Property Law 101: A Deductibility Case Which Hinged on Understanding Property Rights

Armour Group Ltd. v. The Queen, 2017 DTC 1040 (Tax Court of Canada)

As alluded to in the title, this case concerned a payment made by the taxpayer to the province of Nova Scotia, the deductibility of which ultimately depended on an understanding of the parties’ property rights.

The taxpayer characterized as a lease cancellation payment $2.24 million of a total payment of $2.4 million made by it to the province, and deducted $2.24 million as a business expense in computing its income. The Minister reassessed the taxpayer to deny the deduction on the basis that the payment was made to acquire real property from the
province, and so was a non-deductible capital expense.

The taxpayer had previously entered into a long-term lease with the province to lease land owned by the province in order to redevelop the land for use as office space (the "Province Lease"). The property was to revert to the province after expiry of the Province Lease term. Under the agreement, the province was required to lease from the taxpayer a certain percentage of the buildings that the taxpayer built each year. The province failed to lease the required percentage of office space and the taxpayer brought an action against the province, which was settled.

The settlement entitled the taxpayer to $2.4 million from the province to be paid as follows: the province gave the taxpayer an assignable option to purchase the land and buildings, together with an assignment of the Province Lease and all rights of reversion in the land and buildings, for $2.4 million, to be paid by credit against the $2.4 million payable to the taxpayer by the province pursuant to the settlement. If the taxpayer or its assignee did not exercise this option, the province would pay the taxpayer $2.4 million as a lump sum; $2.4 million was the fair market value of the property at that time.

The transactions undertaken by the taxpayer and the position that it took were based upon the premise that the $2.4 million value was comprised of $2.24 million, being the present value of the income stream under the lease, and $160,000, being the present value of the residual interest in the land after expiry of the term of the lease.

The taxpayer assigned all of its rights under the option to a related corporation, "ADL", except for the Province Lease, which was to be cancelled concurrent with the exercise of the option by ADL. A condition of the assignment was that ADL would grant the taxpayer a new lease on the same terms as the Province Lease, except that the rent would be a nominal amount. Concurrent with the transfer to ADL and exercise of the option by ADL, the taxpayer cancelled the Province Lease for consideration payable to the province of "$10.00 and other good and valuable consideration".

The taxpayer paid $2.4 million to the province by credit against the $2.4 million which had been payable to it by the province under the settlement. The taxpayer took the position that $2.24 million of this payment was for cancellation of the Province Lease (i.e., that the "$10.00 and other good and valuable consideration" payable on cancellation of the Province Lease was $2.24 million) and that $160,000 of the payment was for the residual interest acquired by ADL. Consistent with this position, ADL issued a promissory note to the taxpayer for $160,000.

In light of the above, the taxpayer deducted $2.24 million as a business expense under section 9 and paragraph 18(1)(a) of the Income Tax Act, which deduction was disallowed by the Minister.

The Tax Court rejected the taxpayer’s characterization on the basis that the taxpayer must have paid for the transfer of the fee simple interest to ADL, as otherwise ADL could not have leased the property to the taxpayer. A fundamental tenet of property law is that one cannot give what one does not own.

Thus, the Tax Court held that the appropriate characterization of the arrangements was that the taxpayer paid $2.4 million for transfer of the fee simple interest in the property to ADL, using a $2.4 million credit under the settlement. In exchange, ADL gave the taxpayer the right to enter into a new long-term lease for nominal rent. Since the leasehold interest was a capital asset, the court held the taxpayer’s payment was on capital account, and therefore non-deductible.

The taxpayer has appealed the decision of the Tax Court to the Federal Court of Appeal.

— Amanda Laren

BC Court Rejects Attempt To Rely on Business Corporations Legislation To Remedy Faulty Tax Planning

Greither Estate v. Canada (Attorney General), 2017 DTC 5078 (British Columbia Supreme Court)

This decision involved an attempt to rely on British Columbia’s business corporations legislation to remedy an apparent tax planning error that resulted in an unexpected deemed dividend on the sale of property by a non-resident taxpayer. The British Columbia Supreme Court did not grant the relief sought as the statutory provision in question can only apply in certain limited circumstances that do not include faulty tax planning. In obiter, the British Columbia Supreme Court also confirmed that faulty tax planning cannot be corrected using the equitable remedy of rectification where the agreement between the parties was correctly recorded in the relevant documents but resulted in an unexpected
and undesired tax consequence.

The underlying assessment that the taxpayer sought to avoid arose as a result of a failure to consider the deemed dividend rule that generally applies when a taxpayer that is not resident in Canada sells shares of a corporation resident in Canada to another corporation that is resident in Canada and with which the non-resident taxpayer does not deal at arm’s length. Generally speaking, under section 212.1 of the Income Tax Act (the “Act”), the non-resident taxpayer is deemed to receive a dividend from the purchaser corporation in an amount equal to the fair market value of the non-share consideration received by the non-resident taxpayer from the purchaser corporation, less the paid-up capital of the transferred shares.

The assessment arose from a transfer of shares in a corporation known as 627291 B.C. Ltd. (“627291”), a real estate holding company that owned real property in Burnaby, BC. 627291 had issued two common shares, one of which was owned by Karoline Greither, a non-resident person. Karoline’s share in 627291 had an adjusted cost base and paid-up capital of $1. Karoline passed away on May 16, 2013, and immediately before her death, the fair market value of her 627291 share was $1,951,458. As a result, Karoline was deemed to have disposed of her share in 627291 immediately before her death for $1,951,458 of proceeds and her estate was deemed to have acquired that share at a cost of $1,951,458. Accordingly, Karoline Greither’s estate paid tax on the capital gain that arose on the deemed disposition of Karoline’s share in 627291 and held such share with an adjusted cost base of $1,951,458.

The Greither estate wished to sell its share in 627291 to a non-arm’s length corporation, Flora Manufacturing and Distributing Ltd. (“Flora”). The tax lawyer advising the Greither estate believed that the Greither estate could receive from Flora, as consideration for its share in 627291 and without triggering a deemed dividend, a $1,951,457 promissory note and a $1 preferred Flora share. The tax lawyer considered that the only potential exposure of the Greither estate to additional Canadian tax would arise because of an increase to the fair market value of the 627291 share after Karoline’s death. It is likely that the tax lawyer’s analysis revolved around the rules governing a non-arm’s length transfer of shares by a Canadian-resident person other than a corporation in section 84.1 of the Act, which generally allows non-share consideration to be received for a share without triggering a deemed dividend as long as the non-share consideration received for the share is not worth more than the greater of that share’s paid-up capital and its adjusted cost base. However, as the Greither estate was not resident in Canada, section 212.1 was applicable and section 84.1 was not. Under section 212.1 of the Act, the adjusted cost base of the share that is sold is irrelevant. As a result, on the disposition of the Greither estate’s share in 627291 to Flora, the Greither estate was deemed to receive a dividend equal to the difference between the value of the non-share consideration and the paid-up capital of its share in 627291.

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The Greither estate sought an order of the British Columbia Supreme Court to correct the “corporate mistake” that resulted in the unexpected deemed dividend and tax liability. Instead of receiving a $1,951,457 promissory note and a $1 preferred Flora share in exchange for its share in 627291, the Greither estate asked the court to “rectify” the relevant documents so that the Greither estate would receive a $1 promissory note and a $1,951,457 preferred Flora share. If the court granted this remedy, no deemed dividend would arise because the value of the non-share consideration received for the share in 627291 would be equal to the paid-up capital of said share.

Counsel for the Greither estate confirmed that the estate was not seeking the equitable remedy of rectification, but rather, was seeking a discretionary statutory remedy under section 229 of the Business Corporations Act (British Columbia) (“BCA”). Section 229(2) of the BCA allows the court to, among other things, “correct or cause to be corrected, to negative or to modify or cause to be modified the consequences in law of a corporate mistake or to validate any act, matter or thing rendered or alleged to have been rendered invalid by or as a result of the corporate mistake.” Although it is not entirely clear why the Greither estate did not seek the equitable remedy of rectification, it is reasonable to infer that the Supreme Court of Canada decision in Canada (Attorney General) v. Fairmont Hotels Inc., 2016 DTC 5135 (SCC), which made equitable rectification more difficult to obtain, led the Greither estate to seek statutory rather than equitable rectification.

A court only has authority to make an order under section 229(2) of the BCA if a “corporate mistake” has occurred. A “corporate mistake” is defined by section 229(1) of the BCA to mean an omission, defect, error, or irregularity that has occurred in the conduct of the business or affairs of a company as a result of which one or more specific events listed in section 229(1) has occurred, namely:

(a) a breach of a provision of the BCA, a former Companies Act or the regulations under any of them has occurred;
(b) there has been a default in compliance with the memorandum, notice of articles, or articles of the company;

(c) proceedings at or in connection with any of the following have been rendered ineffective: (i) a meeting of shareholders; (ii) a meeting of the directors or of a committee of directors; or (iii) any assembly purporting to be a meeting referred to in (i) or (ii); or

(d) a consent resolution or records purporting to be a consent resolution have been rendered ineffective.

The Greither estate argued that something akin to double taxation would result if it were required to pay tax on the deemed dividend (after having paid tax on the capital gain that arose from the deemed disposition resulting from Karoline’s death), such that it would be equitable for the court to rectify the transaction using its discretionary power under section 229 of the BCA.

In this regard, the Greither estate relied on two categories of cases in which rectification was granted under section 229 of the BCA (or its equivalent). The first of these categories involved applications for rectification as a result of issues involving the conduct of annual general meetings or that involved voting irregularities or issues with those companies. The second of these categories involved rectification to remedy mistakes that led to unexpected tax liabilities.

Regarding the first category of cases described above, the court concluded that such cases concerned a defect in a proxy, voting irregularities involving proxies, and a dispute regarding the validity of a proxy and its effect on the tabulation of votes at an annual general meeting. As all of these cases arguably involved events set out in section 229(1)(c) of the BCA, they were not, in the court’s view, directly analogous to the Greither estate’s situation.

Regarding the second category of cases described above, of which there were two, the court considered that at least one of them (Lau v. Canada (Attorney General), 2015 DTC 5020 (BCSC)) involved a default in compliance with the company’s articles as described in section 229(1)(b) of the BCA. The other case in this second category (Prospera Credit Union (Re), 2002 DTC 7601 (BCSC)) involved an amalgamation with several steps, certain of which were not carried out as intended. As a result of the failure to carry out these steps of the amalgamation as intended, the petitioner in Prospera Credit Union would have lost significant tax savings absent rectification. Although the court in Greither Estate did not explain which of the provisions of section 229(1) was applied in Prospera Credit Union, a review of the decision in Prospera Credit Union indicates that the amalgamation was to be carried out in accordance with the terms of the amalgamation agreement which had been approved by special resolution of the members of companies to be amalgamated at class meetings of each company. In Prospera Credit Union, the court was satisfied that the failure to carry out the terms of the amalgamation agreement was an error or omission which rendered the proceedings at the class meetings ineffective. As such, the facts in Prospera Credit Union would fall under the current section 229(1)(c).

The court in Greither Estate reviewed the evidence and concluded that, in contrast with the cases cited by the Greither estate, none of the specific events listed in section 229(1) had occurred in the circumstances surrounding the sale of the Greither Estate’s share in 627291 to Flora. The Greither estate’s failure to structure the transaction in a tax-efficient manner did not amount to a breach of the BCA or any of the other events listed in section 229(1) that trigger the court’s discretionary authority under section 229(2). As such, the cases cited by the Greither estate were readily distinguishable and did not apply.

Although the Greither estate did not seek the equitable remedy of rectification, the court held that, even if sought, the court would not have granted such relief. The court’s reasoning was based on the Supreme Court of Canada decision in Fairmont Hotels, which clarified that, where an instrument accurately records an agreement, the equitable remedy of rectification is not available to modify the instrument even if the tax consequences flowing from the agreement are more onerous than expected. As the Supreme Court of Canada held in Fairmont Hotels (at para. 39), courts “rectify instruments which do not correctly record agreements. Courts do not ‘rectify’ agreements where their faithful recording in an instrument has led to an undesirable or otherwise unexpected outcome.” In the Greither estate’s situation, the parties agreed that the Greither estate’s share in 627291 would be sold to Flora in exchange for a $1,951,457 promissory note and a $1 preferred Flora share. That agreement was correctly recorded in the relevant documents. Consequently, the equitable remedy of rectification was not available even if the agreement produced an unintended tax liability.

— Theodore Stathakos
Whose Opinion Matters?

*Kaul v. The Queen, 2017 DTC 1059 (Tax Court of Canada)*

In *Kaul*, the Tax Court considered the extent to which experts engaged by a party at the time of a transaction can appear as witnesses in a Tax Court appeal to provide opinion evidence in relation to that same transaction.

A leading case on the admissibility of evidence at trial from a “participant expert” is the Ontario Court of Appeal’s decision in *Westerhof v. Glee Estate* (2015 ONCA 206). The central interpretative issues in *Westerhof* revolved around the 2010 amendments to Rule 53.03 of the Ontario *Rules of Civil Procedure*, which imposed specific requirements on the contents of the reports to be filed by experts who would be called upon at trial. More particularly, the issue addressed by the Ontario Court of Appeal was whether the obligations under Rule 53.03 were applicable to all witnesses whose testimony might be considered expert opinion evidence.

The Ontario Court of Appeal confirmed that medical witnesses, such as treating physicians, can be qualified as participant experts and can form an expert opinion based on their participation in the underlying events. Such participant experts are permitted to testify on: (i) the facts that gave rise to the litigation based on the expert’s participation, and (ii) his or her opinion based on his or her skills, knowledge, and experience, without having to satisfy the requirements in Rule 53.03.

By allowing participant experts to testify on their opinion as well as the underlying events, the Ontario Court of Appeal reasoned that such an approach allows for the parties to avoid extravagant litigation costs, long delays, and an unnecessary number of experts.

In *Kaul*, the Tax Court of Canada had the opportunity to apply the principles of the *Westerhof* case in a tax appeal context in relation to two donors in a buy-low-donate-high donation program. The program was operated by numerous entities. These entities would purchase artwork at a low price and then engage an appraiser to independently appraise the subject artwork prior to having donor participants donate it to a registered charity.

The issue related to the admissibility of evidence from a professional appraiser who prepared an appraisal at the time of the relevant transaction. The sole issue on the merits of the case was the fair market value of the artwork that had been purchased for the purpose of the donation program.

The donors had initially sought to qualify the appraiser as a conventional litigation expert at trial on the issue of the fair market value of the donated artwork. Although the donors had complied with the obligations set out in Rule 145 of the *Tax Court Rules* — the tax Court equivalent of Rule 53.03 of the Ontario *Rules of Civil Procedure* — the Tax Court would not allow the appraiser to testify as a Rule 145 expert because she lacked the requisite impartiality given her extensive involvement with the art donation program that was at the heart of the appeal. The taxpayers then initiated a pre-trial motion to qualify the appraiser as a participant expert to allow her to testify at trial to her original appraisal report.

Ms. Yeomans was the primary licenced appraiser for the buy-low-donate-high donation program. She was paid by the hour to conduct the appraisals and her compensation was not dependent on the value at which the artwork was appraised. It appears that she conducted the appraisals independently and without bias; she was, nevertheless, fully aware of the donation program and the fact that the appraisal would need to be approximately $1,000 per art piece for it to be advantageous for the donors.

Even though Ms. Yeomans could not function as an independent expert in the context of these appeals given her direct involvement in the transactions and the original appraisals, the question was whether she could nevertheless still be qualified as a participant expert.

To answer that question, the Court applied the *Westerhof* case, which appears to require the Court to consider whether Ms. Yeomans had been “engaged by or on behalf of a party to the litigation”. The Court concluded that, in this case, Ms. Yeomans was engaged by the legal entity that operated the program. However, the Court went on to say that even if Ms. Yeomans had been engaged by the taxpayers, she would only be disqualified from serving as a participant witness if she had been engaged by the taxpayers for the purpose of litigation. Here, Ms. Yeomans originally appraised the artwork more than a decade ago for a purpose other than the litigation. Also, a party does not “engage” an expert simply by calling upon them to testify. In the present case, the donors never interacted with Ms. Yeomans — the representatives of the entities that operated the donation program did — and the donors only involved Mrs. Yeomans
The Tax Court further noted that the probative value and weight attributable to a witness’ testimony — whether an expert or not — is left up to the court. The judge will consider the circumstances of the case to decide if the participant expert is credible. However, the court noted that in most cases, a participant expert’s firsthand knowledge of the underlying events of the case combined with their professional integrity offers the best available evidence.

For the above mentioned reasons, the Chief Justice of the Tax Court of Canada allowed Ms. Yeomans to testify as a participant expert on her original appraisal report.

This decision raises several questions. If the court’s view is that “the opinion evidence of participant experts constitutes in many cases the best evidence available”, does that not suggest, *prima facie*, an implicit bias on the part of the courts? Was Ms. Yeomans actually independent at the time she appraised the artwork? The Crown may have the opportunity to call upon an independent expert, but will the court give less weight to the opinion of an independent expert than to that of a participant expert where the two conflict? It will be interesting to know the answers to these questions. However, they may not outweigh the important and positive impact of permitting evidence from a participant expert on the fair administration of justice.

— *Nicole Platani* 

**Net Worth Reassessments Made After the Normal Reassessment Period Upheld, but Gross Negligence Penalties Vacated**

*Lee v. The Queen*, 2017 DTC 1041 (Tax Court of Canada)

This case involved an appeal against reassessments of income calculated using the net worth method that were made after the normal reassessment period. Gross negligence penalties were applied. The Tax Court of Canada approved of the use of the net worth method in the circumstances and rejected the taxpayer’s argument that the reassessments were statute-barred. However, the Court reduced the amount to be included in the taxpayer’s income using the net worth method after considering detailed evidence about her assets, liabilities, and personal expenses. Further, the Court held that the Minister did not meet the burden of proof regarding the gross negligence penalties. This decision illustrates how the Tax Court usually considers a case involving the use of the net worth method. The decision also illustrates the different onus and standards of proof that apply to the correctness of the reassessments, whether assessments may be brought after the normal reassessment period, and gross negligence penalties.

The taxpayer immigrated to Canada from South Korea in 1975 and spent over 20 years working as a waitress, among other jobs. In about 2000, the taxpayer acquired a retail flower business as she was unable to continue waitressing for health reasons. At around that time, and apparently unbeknownst to the taxpayer, her son was involved in selling marijuana, ecstasy, and cocaine until he was eventually arrested by the RCMP in 2004. Shortly after her son’s arrest, the taxpayer’s home was searched and the RCMP found a document showing a $125,000 term deposit. The RCMP informed the CRA as it suspected that the taxpayer was in possession of her son’s proceeds of crime. This sequence of events led to an audit by the Minister.

In 2008 a CRA auditor met with the taxpayer and requested her books and records. The taxpayer failed to provide them, later testifying that although she kept proper business records, and hired a chartered accountant to handle her tax affairs, her accountant had died in 2005 and she was only able to recover some of her documents due to a flood in her accountant’s basement. As a result of the taxpayer’s inability (or refusal) to provide books and records to the auditor, the Minister completed the audit using the net worth method rather than relying on the taxpayer’s tax returns or her accounting records. This method is permitted by subsection 152(7) of the *Income Tax Act* (the “Act”), which provides that the Minister is not bound by a return or information supplied by or on behalf of a taxpayer. The Minister reassessed on the basis that the taxpayer failed to report a total of about $440,000 of income for her 2002 to 2006 taxation years, inclusive. Additional net tax under the *Excise Tax Act* (the “ETA”) was also assessed using the net worth method, and gross negligence penalties were applied under subsection 163(2) of the Act and section 285 of the ETA. Due to the amount of time that had elapsed, the reassessments were made after the normal reassessment period.

Generally speaking, the net worth method of calculating a taxpayer’s income is based on the inference that, subject to adjustments for non-taxable receipts such as gifts and lottery wins, the sum of (1) an increase to a taxpayer’s net
worth (arising from the acquisition of assets or the payment of liabilities) and (2) the taxpayer’s personal expenses, both occurring in a particular period, represents the taxpayer’s income for that period. Changes to a taxpayer’s net worth arising from the change in value of assets that have not been sold generally do not affect a net worth assessment because an increase in value does not lead to an inference of an unreported source of funds (as no additional asset was acquired) and because mere changes in value (i.e., paper gains or losses) are not taxable until the gain or loss is realized through a transaction. Thus, for example, if during a taxation year a taxpayer acquires assets or reduces her liabilities, and incurs substantial personal expenses, the net worth method assumes (until the taxpayer shows otherwise) that the increase to the taxpayer’s net worth over the year plus her personal expenses represents the taxpayer’s income. As such, appeals regarding net worth reassessments often hinge on detailed evidence regarding the taxpayer’s asset and liability balances at the beginning and end of the relevant periods, as well as evidence about the taxpayer’s spending habits and lifestyle.

In this case the taxpayer adduced evidence to show that the auditor’s calculations did not reflect certain assets, such as business equipment and a vehicle, cash on hand, and loans receivable from family members which were repaid to the taxpayer during the audit period. The taxpayer also challenged the Minister’s valuation of certain investment assets. Some of the taxpayer’s arguments on these points were accepted by the Court, leading to a reduction of the income imputed by the net worth method.

The Minister based the net worth method calculations in part on Statistics Canada averages and data concerning personal expenses because the taxpayer did not provide clear documentary evidence. However, the taxpayer asserted that her lifestyle was much more frugal than the Canadian average. The Court accepted the taxpayer’s evidence that her lifestyle was relatively frugal, and generally accepted the taxpayer’s estimates of her spending on items such as food, shelter, utilities, and other personal expenses.

The Court’s evaluation of the taxpayer’s change in net worth and her personal expenses ultimately led to a significant reduction to the net worth assessment. As noted above, the Minister asserted that the taxpayer failed to report a total of about $440,000 of income for the relevant taxation years. During and after the hearing, based on the new evidence presented, the Minister made certain concessions that would reduce the amount of unreported income to about $365,000 for the relevant years. The Court concluded that the taxpayer actually failed to report about $110,000 for those years.

As the Court concluded that the taxpayer did fail to report income, the Court was required to consider whether the Minister was permitted to reassess after the normal reassessment period. To do so, the Minister has the burden to prove, under subsection 152(4) of the Act, that the taxpayer made a misrepresentation that is attributable to neglect, carelessness, or wilful default, or has committed any fraud in filing the return. The Court held that, in a case involving the net worth method, this burden is discharged if it is established on the basis of reliable information that there is a discrepancy between a taxpayer’s assets and expenses, and the discrepancy continues to be unexplained and inexplicable. As a discrepancy of some $110,000 in this case was based on reliable information and continued to be unexplained, the Minister was permitted to reassess after the normal reassessment period.

Regarding the gross negligence penalties imposed under subsection 163(2) of the Act and section 285 of the ETA, the Court reiterated that the burden is on the Minister to establish the facts justifying such penalties. In addition, the Court summarized the law on gross negligence penalties, which clearly requires a greater degree of neglect than simply failing to use reasonable care. In other words, even in a case in which the Minister can prove that it was permitted to reassess after the normal reassessment period, the standard for gross negligence still may not be met. A taxpayer’s negligence must be tantamount to intentional action to justify gross negligence penalties. In this case, the Minister’s imposition of gross negligence penalties was largely based on the allegedly large amount of unreported income, which was significantly reduced by the Court. The reduction to the amount of unreported income as found by the Court, combined with the taxpayer’s evidence that she hired an accountant and provided him with receipts and other necessary books and records to comply with her tax obligations, were sufficient to persuade the Court that the Minister had not satisfied the burden of proof regarding the gross negligence penalties. Accordingly, although the reassessments were upheld regarding a portion of unreported income asserted by the Minister, the gross negligence penalties were vacated.

— Theodore Stathakos
RECENT CASES

Minister required to pay interest on amount refunded to taxpayer

The taxpayer appealed to the Tax Court from a reassessment issued by the Minister of National Revenue. The minister obtained a jeopardy order under section 225.2 of the Income Tax Act (the “Act”) and, pursuant to that jeopardy order, the taxpayer forwarded the amount of $12.75 million to the minister. The jeopardy order was set aside three months later, and the taxpayer requested in writing that the payment made be refunded to him, with interest. The principal amount was repaid, without interest, and the taxpayer brought an application for judicial review of the minister’s decision not to pay interest. The application was dismissed and the taxpayer appealed from that dismissal.

The appeal was allowed. The appellate Court held that if the amount in question was refunded under subsection 164(1.1) of the Act, then the taxpayer would be entitled to interest on the refund paid. The issue for determination, therefore, was whether subsection 164(1.1) of the Act applied. Pursuant to that subsection the minister is required to pay interest where each of the conditions set out in the subsection are met and where no jeopardy order had been granted in respect of the amount assessed. The Court held that the setting aside of the jeopardy order meant that subsection 164(1.1) should be read as if that jeopardy order had never been issued. Since the appellant had appealed the reassessments to the Tax Court and had applied in writing for the refund, the other conditions imposed by subsection 164(1.1) had been met, and the Minister was consequently required to pay interest on the amount refunded. The minister’s decision not to do so was, in the Court’s view, both incorrect and unreasonable, and the decision of the Federal Court upholding the minister’s decision was set aside.

Grenon v. MNR

Appeal dismissed where required election not properly filed by taxpayer

In 2010, the taxpayer disposed of two rental properties and, in her return for that year, declared a taxable capital gain from that disposition. She subsequently filed a T1 Adjustment Request for 2010 in which she claimed an offsetting capital gain deduction. The minister, however, issued a reassessment in which the capital gain deduction was disallowed on the grounds that the taxpayer had not, as required, declared a capital gain or claimed a capital gain deduction resulting from a subsection 110.6(19) election in her return for the 1994 tax year. The Minister’s reassessment was confirmed, and the taxpayer appealed. Counsel for the appellant argued that the taxpayer was entitled to the capital gains exemption on the subject properties and that she had done everything she believed to be necessary to make the election and claim the exemption, and that the capital gain deduction should therefore be allowed.

The appeal was dismissed. The Court held that the issue for determination was whether the minister was justified in disallowing the capital gain deduction claimed by the appellant. The Court reviewed the steps which were required in order for a taxpayer to perfect a section 110.6 election. It held that, while it was satisfied that the appellant had every intention of complying with the statutory requirements for such election, and even if the requisite forms were filed, it was admitted that the taxpayer had not complied with the additional reporting and filing requirements. Even though the taxpayer had the necessary intent, she did not follow through on the election. In view of the fact that the appellant did not fulfil all of the requirements for such election, the Court’s conclusion was that the minister was justified in disallowing the claimed capital gain deduction.

Estate of McCullock-Finney v. The Queen

The QRA was justified in applying the general anti-avoidance rule to real estate transactions that were almost totally exempted from income tax

The appellants are related corporate members of a group controlled by A and his family. Following a series of transactions that involved the sale of buildings and shopping centres by those members, the Quebec Revenue Agency (the “QRA”) applied the general anti-avoidance rule (“GAAR”) to certain transactions and reassessed the corporations.
GAAR was applied to the so-called “Quebec Year-End Shuffle” (i.e., interprovincial tax planning tool allowing taxpayers to pay little provincial income tax on the capital gains realized in Quebec). This planning technique was based on the adoption by corporations of different taxation year ends for federal and Quebec income tax purposes. The possibility for corporations to elect for a different year end for federal and Quebec purposes was eliminated in 2006, since it allowed them to avoid paying their fair share of income tax. Their assessments involved $728 million of capital gains and $67 million of capital cost allowance recapture. The following issues were also included in the assessments: tax treatment of sale of land, valuation of certain buildings at the end of 1971, deductibility of project expenses, and deduction of certain expenses as legal fees. The QRA claimed that GAAR was applicable to the series of transactions because the conditions had been fulfilled: existence of a tax benefit, existence of an avoidance transaction, and abuse of a tax provision. The transactions were abusive because they contravened the object and spirit of the following rules: (1) rules governing the allocation of business between several jurisdictions; (2) section 7 of the Quebec Taxation Act, which determines the period for which the accounts of a business are considered to determine its assessment; and (3) tax rollover provisions allowing the deferral but not the total avoidance of the tax payable on capital gains or capital cost allowance recaptures. The corporations agreed with the existence of a tax benefit and an avoidance transaction but not with the existence of an abusive transaction.

The appeal was dismissed in the main but two assessments were returned to the QRA for adjustment. The rules fixing the allocation of business activities between provinces were implemented to ensure that the taxable income earned in Canada will be taxed in at least one province. In this case, the capital gains and capital cost allowance recaptures were only taxed for federal, and not Quebec income tax purposes although the related buildings were located in Quebec and the corporations carried on their business in Quebec. Fixing different taxation year ends for federal and provincial income tax purposes to avoid paying provincial income tax was a clear abuse of the rules to determine a year end to calculate a taxpayer's income and tax liability, and to allocate a society’s tax burden between its various jurisdictions. The choice of a different year end for federal and provincial tax purposes allowed the taxpayers to avoid paying Quebec income tax, which is contrary to the object and spirit of the tax provision allowing taxpayers to select their taxation year end. The Court concluded that that there was an abusive tax avoidance allowing the taxpayers not to pay income tax on their capital gains and capital cost allowance recaptures. The QRA was justified in applying GAAR in each situation to eliminate such abusive tax avoidance. Three taxpayers were denied their tax rollovers and two other taxpayers were denied their different taxation year ends, with the QRA being asked to reassess them. The legal fees were deemed not deductible for income tax purposes. Note that the tax treatment of the land sales, the valuation at fair market value of the buildings, and the eligibility of certain expenses incurred on the projects were accepted by the Court.

Développements Iberville Ltée v. Quebec

2017 DTC 5088

**Taxpayers entitled to stock option deductions claimed, on ground that option shares involved were “prescribed shares”**

In December, 2001, the taxpayers were granted options to acquire shares of Cybectec, a CCPC (the “Option Shares”). On January 26, 2007, Cooper acquired practically all of Cybectec’s assets, and two days later the taxpayers took up their options to acquire their Cybectec shares at the option price of 20 cents per share. They resold these shares the same day to Cybectec’s parent corporation for $1.2583 per share, subsequently reporting as income for tax benefit purposes the difference between the option take up price and the proceeds of disposition of the shares. The minister disallowed the taxpayers’ claim for a stock option deduction for 2007 under paragraph 110(1)(d) of the Income Tax Act on the grounds that: (a) they had not assumed the risk necessary to meet the requirements of paragraph 110(1)(d) of the Act; and (b) the fair market value of the Cybectec shares forming the subject matter of the taxpayers’ option was 0.32465 when the option was granted, and not 20 cents, which had been stated to be the fair market value of those shares when the option was granted in December 2001. In dismissing the taxpayers’ appeals (2016 DTC 1085, 2016 CCI 110), the Tax Court of Canada concluded, in essence, that: (a) the Option Shares were subject to the provision that Cybectec was obligated to redeem them on the day that they were issued; (b) as a result they were not “prescribed shares” falling within the two-year non-redemption provision requirement in paragraph 6204(1)(b) of the Income Tax Regulations (the “Two-Year Rule”), and hence did not qualify for the stock option deduction being claimed by the taxpayers; (paragraph 6204(1)(b) includes in the category of “prescribed shares”, shares which the corporation cannot...
"reasonably be expected to redeem, acquire, or cancel" within two years after those shares are issued); (c) the application of the Two-Year Rule mentioned in paragraph 6204(1)(b) was not made inapplicable by the excepting provisions of clause 6204(2)(c)(B) of the Regulations in this case (clause 6204(2)(c)(B) waives the application of the Two-Year Rule in applying paragraph 6204(1)(b) in cases where the principal purpose for providing the right to redeem, acquire, or cancel the shares within two years is to provide the holder with a market for those shares); (d) clause 6204(2)(c)(B) did not apply in this case to relieve the taxpayers from the Two-Year Rule in paragraph 6204(1)(b), in part, because there was no connection between these two provisions; and (e) 20 cents per share was the true fair market value of the Option Shares when the options were granted to the taxpayers. The taxpayers appealed to the Federal Court of Appeal. On appeal, the minister's position, in essence, was that the Tax Court judge was correct in finding that the Two-Year Rule continued to apply in this case to the Option Shares, despite the excepting rules in paragraph 6204(2)(c)).

The taxpayers' appeals were allowed. In addition to pointing out the lack of any logical connection between paragraphs 6204(1)(b) and 6204(2)(c) of the Regulations, the Tax Court judge also concluded, as part of her analysis, that paragraph 6204(2)(c) requires that account be taken of the Two-Year Rule in applying clause 6204(1)(a)(iv) of the Regulations, but not in construing paragraph 6204(1)(b). This conclusion did not accord with the text of paragraph 6204(2)(c). It also failed to recognize the logical connection to be found between paragraphs 6204(2)(c) and 6204(1)(b) by taking into account the operation of clause 6204(1)(a)(iv). Such a connection is evident if, as the taxpayers argued, it is realized that paragraph 6204(1)(b) is an anti-avoidance measure, intended to ensure compliance with the letter and the spirit of clause 6204(1)(a)(iv). The Tax Court judge also failed to take into account the risk sustained by the taxpayers between 2006 and 2007 while they were holding their options to acquire the Option Shares. Also, looked at in another way, since paragraph 6204(1)(b) is intended to prevent the avoidance of clause 6204(1)(a)(iv), the Tax Court judge was not entitled to rely on paragraph 6204(1)(b) to justify disallowing the stock option deduction claimed, in light of the fact that the provisions of clause 6204(1)(a)(iv) had not been contravened. The appeals were therefore allowed, the decision of the Tax Court judge was set aside, and the minister was ordered to reassess on the basis that the taxpayers were entitled to the stock option deduction claimed.

Montminy et al v. The Queen

2017 DTC 5091

Tax Court having jurisdiction over interpretation of section 129 of the Income Tax Act

The corporate taxpayers did not file their returns by the requisite deadline, and the minister applied section 129(1) to decide that, owing to the late filing, no refund could be provided. The taxpayers requested that the minister exercise discretion under section 220 of the Act to extend the time limit in section 129 and to waive the imposition of interest and penalties. The minister denied the taxpayers' requests, and the taxpayers sought relief from the Federal Court, arguing that the minister's decision was unreasonable and seeking to have it set aside. The minister argued that as a matter of law section 129 did not allow such relief to be granted on the application because the Federal Court had no jurisdiction to address the correct interpretation of that statutory provision, and that such authority lay within the jurisdiction of the Tax Court of Canada.

The application was dismissed. The Federal Court held that it was common ground that the Tax Court had jurisdiction over questions of law arising from the Income Tax Act, while the Federal Court had jurisdiction over the minister's conduct in applying the provisions of the Income Tax Act. The Court held that, in order to address the application of the minister's discretion with respect to section 129, it was first necessary to establish that the minister's discretion applied to that provision. The Court found that establishing whether the minister's discretion did apply was a jurisdictional question with respect to an interpretation of the Income Tax Act, which was not within the authority of the Federal Court to decide. That conclusion was supported by jurisprudence of the Federal Court of Appeal, which also involved the interpretation of section 129 and which was a precedent binding on the Federal Court. The Federal Court concluded that the interpretation of section 129 was for the Tax Court to decide, and the applications were dismissed.

Binder Capital v. MNR; Bonnybrook Park v. MNR

2017 DTC 5085
TAX NOTES

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