

CURRENT CASES

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Introduction

The last year has provided no shortage of exciting and interesting tax cases that tax practitioners can learn from. Accordingly, the purpose of this paper is to review a select number of cases that we felt were important to highlight. Each case begins with a short summary followed by the facts, judicial reasoning and the take-away message.

Swirsky¹

Summary

Owner-manager remuneration is important to many businesses, especially family businesses. Swirsky emphasizes the importance of distinguishing between different forms of owner-manager remuneration in certain circumstances. In a nutshell, this case involves a question of interest deductibility wherein the Federal Court of Appeal held that interest was not deductible as the shares were not acquired to earn income.

Facts

Due to a downturn in the real estate market and failing partnership relations, the taxpayer, Mr. Swirsky, became concerned about creditors seizing the family owned corporation, Torgan (the "Corporation"). At this time (1991), the Corporation was the main source of income for Mr. Swirsky and his family. Mr. Swirsky's accountant devised a plan whereby Mr. Swirsky would sell some of the shares in the Corporation to his wife who would borrow monies to acquire such shares. Mr. Swirsky used the proceeds from the sale of the shares to repay his outstanding shareholder's loan to the Corporation. By using the monies to repay the shareholder loans, Mr. Swirsky assured that such monies would not be available to creditors and he avoided subsection 15(2) of the Act as the shareholder loans were repaid within the requisite time limitation.

Subsequent to the transaction, a valuation was also obtained and the sale of the shares was adjusted so that only the amount of shares needed to fully repay Mr. Swirsky's outstanding shareholder loan were sold. Thus, the main goal of creditor-proofing was achieved with the plan. The credit-proofing transaction was repeated twice more in the next few years.

The Corporation used the cash to purchase a guaranteed investment certificate and the interest on this investment was used to partially off-set the interest payable by Ms. Swirsky on the loan that was used to fund her share purchase. The additional interest owed on the bank loan by Ms. Swirsky (and the guarantee fee for the loan) were charged to Mr. Swirsky's shareholder loan account. Due to the attribution rule in subsection 74.1(1) of the Act, the interest charges were claimed as losses by Mr. Swirsky. Subsection 74.1(1) of the Act attributes income and losses on property transferred between spouses to the spouse who actually transferred the property. The intended use of the attribution rule did not appear to affect the Court's decision in this case.

The Corporation did not pay taxable dividends for a number of years after the transactions but did pay a capital dividend of \$2.5 million to Ms. Swirsky in 1999. The Corporation paid a taxable dividend in 2003 to Ms. Swirsky which was attributed to Mr. Swirsky. The Minister denied Mr. Swirsky's interest deduction for the 1996 through 2003 taxation years.

¹ *Swirsky v. R.*, 2013 TCC 73, affirmed 2014 FCA 36.

Judicial Reasoning

The Tax Court of Canada (the “TCC”) upheld the Minister’s denial of the interest and guarantee fees claimed by Mr. Swirsky. In order to obtain an interest deduction, the Supreme Court of Canada (the “SCC”) noted four conditions in *Shell Canada Ltd. v. R.*:² the amount must be paid or payable in the year; the amount is paid or payable pursuant to a legal obligation; the borrowed money is used to earn non-exempt income from business or property; and the amount must be reasonable. The SCC in *Entreprises Ludco ltee c. Canada*³ stated that the test for determining the purpose of interest deductibility is whether considering all of the circumstances, the taxpayer had a reasonable expectation of income at the time the investment was made.

The Court notes that there is no evidence, prior to 1999 that the Corporation had any history of paying dividends and that monies were extracted from the Corporation by way of bonuses and loans. Interestingly, Mr. Swirsky argued that the fact there was a creditor proofing transaction was evidence in and of itself of the belief that the Corporation had future earning potential. Mr. Swirsky’s testimony did not help his case as he testified that income did not come from the shares in the Corporation but rather the Corporation itself. In reaching their decision, the Court noted that there was no evidence of discussion or consideration being given to an income earning purpose to the share acquisition. Further, the Court noted that Mr. Swirsky did not make any representations or promises to his wife that dividends would be paid on the shares.

The TCC briefly considered the Crown’s argument made under subsection 74.5(11) of the Act noting that any inquiry under this provision would be factual and would focus on the main reasons for the transfer. However, the Court dismissed this argument because the Crown raised the argument late in the proceeding and thus pursuant to *Anchor Pointe Energy Ltd. v. R.*,⁴ the Crown bore the onus of proving that one of the main reasons for the transfer of the shares was to reduce tax – an onus the Crown did not meet. Further the TCC stated that the general anti-avoidance rule (the “GAAR”) found in section 245 of the Act did not apply to the transaction as it was not shown that the primary purpose of the transaction was to obtain a tax benefit.

The Federal Court of Appeal (the “FCA”) upheld the decision that Mr. Swirsky should not be allowed an interest deduction as his wife did not acquire the Corporation’s shares for the purpose of earning income. In short, the FCA agreed with the TCC that Ms. Swirsky did not have a reasonable expectation of earning income when she acquired the shares. Mr. Swirsky challenged the TCC decision on the basis that the Court relied too heavily upon Ms. Swirsky’s stated subjective intention with respect to the acquisition of the shares and not enough on the objective manifestations of that intention. The FCA responded by noting that there was no evidence of a dividend having been made prior to 1999, bonuses are not related to shareholdings; family expenses were paid by the Corporation and treated as loans regardless of whether the family members held shares; there was no dividend policy in place; the transaction was designed so that Ms. Swirsky would not have to pay interest out of her own pocket; and it could be inferred that Ms. Swirsky had a reasonable expectation of receiving a capital dividend. It should be noted that paragraph 20(1)(c) of the Act only allows interest to be deducted to the extent that it was incurred to earn taxable income and as such, a capital dividend does not qualify.

The Message

The taxpayer was not able to deduct his interest in this case due to incorrect legal form. In other words, future interest charges of the Corporation would have been deductible if the Corporation had previously paid the excess income in the form of dividends rather than paying salaries and bonuses. The Corporation was actually a good investment as it generated a consistent surplus. It is typical of many family owned Corporations to solve a negative shareholder loan balance at the end of the year by simply paying a bonus, however, caution to this approach should be exercised. In situations like this we recommend that practitioners establish their intention clearly in the documents that implement the transaction.

² [1999] 3 S.C.R. 622.

³ 2001 SCC 62.

⁴ 2007 FCA 188.

It should be remembered that the test for interest deductibility is the taxpayer's reasonable expectation of receiving income from the business or property at the time the property is acquired, not what occurs subsequently. However, the TCC appears to look to events subsequent to the acquisition of the shares when considering Mr. Swirsky's interest deductibility. For instance, the Court notes that dividends were not paid prior to 1999; however, the initial share transfer occurred in 1991 and as such, this is the relevant point in time for the initial acquisition. Each acquisition of shares should also have been looked at separately in the Court's analysis as the reasonable expectation of income could have theoretically been different for the shares acquired in different years. In short, the Court appears to justify their position using hindsight.

We query whether there is an implied expectation that individuals holding common shares of a private corporation have an expectation, other than to earn dividends, from the shares since there is no ready market for private share sales and often such sales are restricted in the articles of the corporation.

A.P. Toldo Holding Corp.⁵

Summary

The ability of an entity to claim an interest deduction is an important consideration for practitioners in corporate restructuring transactions. In Toldo, interest was incurred on promissory notes that were used to fund a share re-purchase for cancellation. The shares acquired were subsequently cancelled by the corporation. In short, the interest was held not to be deductible by the TCC because the property was not used to earn income.

Facts

In Toldo there were two issues under appeal, interest deductibility and the deductibility of professional fees, both incurred in respect of a corporate reorganization. The assets of the taxpayer, Toldo, consisted mainly of shares of other corporations. Toldo controlled twelve other corporations. Prior to 2006, Toldo was owned by three family members, Mr. Toldo, his sister and his father. A dispute arose between family members and a settlement was negotiated which resulted in the sale of the sister's shares (the "Subject Shares") to Toldo. In ten separate transactions, the Subject Shares were transferred to Toldo. Half of the payment for the Subject Shares was made in cash while the other half was funded by promissory notes. It appears that Toldo used loaned funds from its subsidiary corporations to fund the initial payment of the Subject Shares. Toldo later borrowed from the bank to satisfy payment of the promissory notes. Interest on both the promissory notes and bank loan totaled approximately \$1.2 million. The Subject Shares were cancelled immediately upon their purchase.

Judicial Reasoning

Toldo asserted that it should be able to deduct the interest expense as a normal business expense of a holding corporation because it was in the business of financing and earning income from investments in the subsidiary corporations and/or carrying on a banking business. The TCC noted that Toldo had no employees in which to carry on the business of banking and that the financial statements showed that Toldo was a recipient of funds from the subsidiary corporations. Thus, the TCC concluded that Toldo did not establish even a *prima facie* case that they carried on a business of loaning monies.

⁵ *A.P. Toldo Holding Corp. v. R.*, 2013 TCC 416.

The SCC in *Gifford v. R.*,⁶ stated that where interest does not occur “on account of capital” it may be deducted as long as it meets the requirements outlined in paragraphs 8(1)(f) and 18(1)(a) of the Act and such deductibility is not precluded by another section of the Act. Thus, Gifford can allow interest to be deducted pursuant to section 9 of the Act in certain limited circumstances. Since the evidence did not prove the money was borrowed in the course of a money lending business then its deductibility is precluded by paragraph 18(1)(b) of the Act. The TCC stated that the purchase of the Subject Shares for cancellation did not relate to any other business carried on by Toldo. Therefore, the interest must meet the requirements of paragraph 20(1)(c) of the Act in order to be deductible.

It was argued that Toldo should be allowed an interest deduction pursuant to the “fill-in-the-hole” theory set out in *Trans-Prairie Pipelines Ltd. v. Minister of National Revenue*⁷ and *Penn Ventilator Canada Ltd. v. R.*⁸ In *Trans-Prairie*, the corporation issued bonds that were used to redeem preferred shares and the interest deduction was allowed under the theory that the bonds replaced the preferred shares which were used to finance the business. In *Penn Ventilator*, the corporation purchased and cancelled some of its common shares in order to solve a shareholder dispute that was disrupting the business of the corporation and that posed a threat to the corporation’s liquidity. In the latter situation, the interest deduction was allowed as an exceptional circumstance.

For interest to be deductible under clauses 20(1)(c)(i) and 20(1)(c)(ii) of the Act the interest must arise from borrowed monies used for the purpose of earning income or an amount payable for property acquired for the purpose of gaining or producing income, respectively. The TCC stated that the Court should not ignore the direct use of the acquired property under either clauses 20(1)(c)(i) or 20(1)(c)(ii) of the Act, but in exceptional circumstances it may be appropriate for the Court to allow an interest deduction where there was an indirect effect from the acquisition of the property on a taxpayer’s income-earning capacity. The TCC held that there was no direct use of the borrowed funds to earn income as the Subject Shares were purchased and cancelled. The TCC noted there was insufficient evidence of the corporation’s business and how the shareholder dispute impacted the corporation’s business. Further, the TCC noted that at the time the debt incurred, Toldo did not have any capital to return or retained earnings and thus the Court did not need to consider whether there was a “fill-in-the-hole” scenario that would constitute an exceptional circumstance.

The professional fees were associated with the corporate reorganization and thus the TCC held that these fees were incurred on account of capital and thus were not deductible pursuant to paragraph 18(1)(b) of the Act.

The Message

This well-reasoned decision is another reminder for practitioners to carefully consider whether interest will be deductible when they borrow funds to undertake a corporate reorganization. As the Subject Shares were acquired for cancellation, the property acquired was extinguished and thus the property was incapable of producing income and thus interest on the funds borrowed to acquire the property was not deductible. Gifford essentially limits a deduction under section 9 of the Act to banks and other similar entities whose business is that of lending money. While it may have been possible for *Toldo* to argue a situation analysis to *Penn Ventilator*, the taxpayer simply did not bring forth enough evidence to demonstrate how the shareholder dispute was jeopardizing the corporation’s income earning potential.

⁶ 2004 SCC 15.

⁷ (1970) 70 D.T.C. 6351 (Can. Ex. Ct.).

⁸ 2002 D.T.C. 1498.

Black

Summary

Many practitioners have clients who are subject to double taxation as residents of two countries. Even if clients are not residents of two countries, it is common for individuals and entities to have income from multiple countries. Generally speaking, the country where an individual earns income has the first right to tax this income as it is derived from that country; however, Canada may also have a right to tax the income since Canadian residents are taxed on their worldwide income regardless of where they earn the income. Thus, tax treaties are important in providing double taxation relief to individuals. At a basic level, treaties are agreements between countries where one country contracts out of the right to tax in certain pre-determined situations. Ordinarily the Treaty would prevail over the Act because of the legislation that implements the Treaty into Canadian law. For example, the Canada-U.K. Income Tax Convention Act 1980, states that this is the case to the extent of any inconsistency between the Act and the Treaty.

Unfortunately, Black was not able to avail himself to the benefits of Canada's tax treaty with the United Kingdom (the "Treaty") as the TCC ruled that the Treaty gives preference or priority for taxation but it does not apply to override Black's domestic tax obligations to Canada. Mr. Black has filed an appeal to the FCA.

Facts

Mr. Black was factually resident in both Canada and the United Kingdom during 2002 and as such potentially subject to tax by both countries. The TCC defined the issue at hand as whether the Treaty overrides the provisions of the Act so as to prevent the Crown from assessing the applicant under Part I of the Act on certain amounts of income, including the following types: duties of offices and employment performed in Canada; taxable benefits; taxable dividends; interest; and deemed interest on amounts loaned from corporations. The Crown argued that the Treaty did not prevail over the Act in this particular situation since the Treaty only prevails when there is conflict or contradictions between the Act and the Treaty.

By virtue of Article 4(2)(a) of the Treaty, commonly referred to as the tie-breaker rules, Mr. Black was deemed to be a resident of the United Kingdom and was liable to taxation therein. However, Mr. Black was not domiciled in the United Kingdom. Persons who are resident but not domiciled in the United Kingdom are only subject to taxation on non-source income that is remitted to or received in the United Kingdom. The parties agreed that according to the Treaty, Mr. Black is not required to pay tax in the United Kingdom until such time as the income is remitted to or received in the United Kingdom. Thus, if Mr. Black was not liable for tax in Canada under the Treaty or the Act, then he was not liable for tax anywhere on the majority of the income at issue.

Judicial Reasoning

The TCC notes that it is the Vienna Convention that requires the ordinary meaning to be given to the terms of the treaty in their content and in the light of its object and purpose. The SCC in *Crown Forest Industries Ltd. v. R.*⁹ stated that tax treaties should be given a liberal interpretation with a view to implementing the true intentions of the parties. The TCC stated that when interpreting the Treaty and its interaction with the Act that they must adopt a liberal and purposive approach, not a mechanical approach.

⁹ [1995] 2 S.C.R. 802.

The TCC held that the phrase “resident of a Contracting State” is defined in the Treaty, but for purposes of the Treaty only and not for purposes of the Act. The TCC then held that there is no inconsistency between a resident for purposes of the Act and a resident for purposes of the Treaty. In reaching this holding, the TCC relies on the test for inconsistency expressed by the SCC in *Friends of the Oldman River Society v. Canada (Minister of Transport)*.¹⁰ the statutes must be either so contradictory that following one law would require breaching the other or the two laws are unable to stand together. The TCC then went on to state that there is no provision that deems a person not to be resident in Canada once it has been determined they are resident of the United Kingdom for purposes of the Treaty.

Simply, the Treaty simply gives taxing preference to one state’s claim of taxation but does not extinguish the other state’s claim. In other words, the fact that a person is resident in the United Kingdom for purposes of the Treaty does not affect their status under Canadian law for non-treaty purposes. The TCC held that income is considered under the Treaty on an item-by-item basis and thus Canada will not lose its right to tax Mr. Black on items of income not subject to the Treaty.

The TCC notes that if Mr. Black had remitted his income to the United Kingdom, he would have been able to take advantage of Article 21 of the Treaty. The parties made submissions on subsection 250(5) of the Act but the TCC declined to comment on this provision as it was enacted in a later taxation year than the one at issue.

The TCC considered Article 27(2) of the Treaty and states that the purpose of this article is to allow the state of source to tax income that has not been remitted to the person’s country of residence. The TCC held that a resident of Canada, like Mr. Black, is subject to tax on their worldwide income which includes income from employment in a third state, one that is not subject to the Treaty.

The Message

The TCC appeared to adopt a results-based approach, holding that since Mr. Black was not subject to a comprehensive tax system, as his income was not remitted to or received in the United Kingdom, he should not be able to benefit from the Treaty. Accordingly, the majority of his income (interestingly determined on an item-by-item basis) was subject to tax in Canada. The approach of the TCC appears to be questionable as they looked at each type of income separately to determine who had taxing authority. While the TCC did consider the residency tie-breaker provisions in Article 4 of the Treaty, the TCC spoke to income on an item-by-item basis and looked to the specific Treaty provisions dealing with each respective type of income to determine how such income should be taxed. This approach appears to bring into question how one should interpret a treaty, as one may have thought that the tie-breaker provisions in the Treaty, which determined Mr. Black to be resident of the United Kingdom, would have been determinative of his taxing position, thus giving the United Kingdom (and not Canada) the right to tax all income. It should be noted that the Article 4 residency provisions precede those provisions in the Treaty which speak to specific types of income.

Paragraph 110(1)(f) of the Act was not mentioned in the decision, but this is the mechanism by which a person who is resident in Canada can take a deduction on their tax return for an amount that is exempt from income tax in Canada because of a provision contained in a tax treaty.

¹⁰ [1992] 1 S.C.R. 3.

Although not enacted in 2002, Article 20A(1) of the Treaty deals with other income stating that such income beneficially owned by a resident not specifically dealt with elsewhere in the Treaty will be taxable only in the place where the person is resident. If this Treaty provision had been in effect for the tax year in question, it appears some of Mr. Black's income would have been liable to tax in the United Kingdom regardless of whether it was remitted to or received in the United Kingdom. However, Article 20A(3) of the Treaty, also not enacted in 2002, allocates taxing authority to the jurisdiction from which specific income arises. Therefore, some of Mr. Black's income may have not been caught by Article 20A of the Treaty, if it was enacted, due to the more specific provision of Article 20A(3) of the Treaty.

Subsection 250(5) of the Act, which deems an individual not to be resident in Canada if that person is resident elsewhere as determined by a treaty, is another provision that would have to be considered should a case on this issue arise for a more current taxation year. Practitioners should be cautious of the potential interaction between subsection 250(5) of the Act and treaties. More specifically, we note that subsection 250(5) of the Act resides in Part XVII of the Act, which is the Interpretation section. Since subsection 250(5) deems a person who is resident in another country under a tax treaty not to be a resident of Canada. We query whether this person is resident for purposes of subsection 2(1) of the Act. It is the position of the CRA that the phrase "for purposes of the Act" does not equate with the phrase "for all purposes of the Act"; however if this is in fact the case then it appears subsection 250(5) of the Act should not be located in Part XVII of the Act.

One cited purpose of tax treaties is to prevent fiscal evasion - it is interesting to consider how this purpose may have affected the Court's decision. One also has to consider whether income that is not taxed by a treaty partner due to their own domestic laws simply becomes available for tax by Canada. If this decision is correct, practitioners with clients who are Canadian residents but who earn income in countries without a tax treaty with Canada, or where income earned is not specifically addressed by the relevant tax treaty with Canada, should be aware of the potential double tax implications.

Graymar¹¹

Summary

Rectification is a powerful equitable remedy that allows the Court to retroactively alter a written contract to accord with the parties' intentions. Rectification can apply in a situation where the parties have reached an agreement but the written form of the agreement does not reflect the parties' intentions. The essence of a rectification application is to have the legal relationships of the parties determined by a court of competent jurisdiction, namely the superior court of the province. Rectification is a powerful tool in a tax context because the legal relationships of the parties are determined prior to the application of tax law, and thus if a taxpayer is able to alter their legal relationships, they may be able to avail themselves to tax treatment that is more favourable. Graymar was not successful in its application for rectification before the Alberta Court of Queen's Bench (the "Alberta Court").

¹¹ *Graymar Equipment (2008) Inc. v. Canada (Attorney General)*, 2014 ABQB 154.

Facts

FRPDI Investments (GP) Inc. (“FRPDI”) through Graymar and other entities invested in a marine contractor business in British Columbia and the purchase price was funded through a lending syndicate. The business did not perform well and thus, a debt restructuring agreement was put in place whereby the partners of FRPDI would contribute additional partnership capital to reduce the debt owing to the lending syndicate. The debt restructuring comprised of at least 141 steps, one of which was an increased subscription by FRPDI in Graymar’s common shares funded by further debt. The purpose was identified as increasing the capital contribution to reduce the debt owed to the lending syndicate and to reduce the interest rate on loans owed by FRPDI to its partners. Subsequent to the debt restructuring, FRPDI did not repay a shareholders’ loan to Graymar within the requisite time period leading to a reassessment pursuant to subsection 15(2) of the Act. Subsection 15(2) of the Act applies where a loan remains unpaid at the end of the taxation year following the taxation year in which the loan was made. FRPDI testified that they were not informed of the tax consequences of not repaying the shareholders’ loan.

Graymar applied to have a resolution authorizing an approximate \$14 million return of capital in respect of its issued common shares to FRPDI given retroactive effect and payment by way of set-off against the \$14 million owing by FRPDI to Graymar pursuant to the shareholder loan also given retroactive effect. Graymar argued the rectification does not defeat the purpose of subsection 15(2) of the Act which is to ensure that corporate funds cannot be loaned either directly or indirectly to avoid or defer tax that would otherwise be payable on shareholder dividend distributions. The Attorney General (the “AG”) submitted that Graymar was attempting to introduce a new bargain which was not previously intended that is necessitated by the lack of due diligence of the professional advisors.

Judicial Reasoning

The Alberta Court noted that section 244 of the *Business Corporations Act (Alberta)*¹² (the “BCA”) which provides for a statutory rectification remedy is not relevant. Section 193 of the BCA provides a provision whereby a corporation can seek Court approval of an “arrangement” which is defined broadly. Section 193 of the BCA was designed to permit modifications of share capital but was later expanded to numerous other arrangements. As a provincial court, the Alberta Court has inherent equitable jurisdiction which is codified in the *Judicature Act (Alberta)*.¹³ Inherent jurisdiction refers to a Court’s ability to provide for an equitable remedy in situations where no alternative forum of relief is available. The Alberta Court notes that inherent jurisdiction is to be exercised to discharge the Court’s function as a court. The Alberta Court is cautious about exercising its inherent jurisdiction stating that it is not necessary to invoke such jurisdiction where an alternative mechanism exists.

The Alberta Court stated that they were able to address questions of operation, interpretation or policy purpose that pertain to the Act if the Act is relevant in a proceeding. This was a quick dismissal of the AG’s argument that the TCC has exclusive jurisdiction over tax matters.

The SCC in *BCE Inc, Re*¹⁴ states that the test for an arrangement proceeding under 192 of the *Canada Business Corporations Act*,¹⁵ a substantially similar provision, is whether after having complied with the procedural elements of the section, the application was put forth in good faith and the arrangement is fair and reasonable. The Alberta Court held that the procedural requirements were met and that the application was put forth in good faith. The Alberta Court stated that a fair and reasonable arrangement is one that has a valid business purpose and resolves in a balanced way the objections of those whose legal rights are being arranged.

¹² R.S.A. 2000, c. B-9.

¹³ R.S.A. 2000, c. J-2.

¹⁴ 2008 SCC 69.

¹⁵ R.S.C. 1985, c. C-44.

The Alberta Court framed the test for rectification as a situation where the terms of the instrument is shown not to accord with the parties' true intention driving its formation. Specifically, rectification restores the parties' original intention by amending the instrument such that it includes the provisions which the parties had intended it to include. However, rectification is not intended to insert terms which are unnecessary to achieve the parties' original aims, but which they would originally have included for other reasons had they been better informed. More formally the test was expressed by the SCC in *Sylvan Lake Golf & Tennis Club Ltd. v. Performance Industries Ltd.*¹⁶ as a set of three criteria that the applicant must demonstrate: the existence and content of an inconsistent prior oral agreement; that the written document does not correspond with the prior oral agreement; and the precise form in which the written instrument can be made to express the prior intention.

The Alberta Court held that Graymar did not adduce any sufficient evidence of a tax motivated transaction, but rather they only introduced evidence of a debt restructuring purpose. Thus, the Alberta Court held that the proposed arrangement lacked a valid business purpose and that it was an attempt to restructure a transaction based on later recognized negative tax consequences. The Alberta Court dismissed Graymar's application.

The Message

While many tax practitioners may not have liked the outcome in this case, it appears that Graymar reconciles with *Juliar v. Canada (Attorney General)*¹⁷ and *771225 Ontario Inc. v. Bramco Holdings Co.*¹⁸ This is especially true if we adopt the Alberta Court's expression of the SCC's direction in *Performance Industries* that rectification is predicated on an intention that was defeated by the parties having recorded their agreement incorrectly and it is not intended to impose a sensible arrangement upon which the parties might have agreed, but for an error in judgment. In *Juliar*, the purpose of the rollover under section 85 of the Act was a tax deferral, a purpose which was not achieved. The document implementing the rollover had incorrect numbers which the Court was able to correct. Contrarily, in *Bramco*, the purpose of the transaction was to avoid income tax and this purpose was achieved; however, the taxpayer was subject to unintended land transfer tax. This case appears to suggest that the parties would have designed the transaction differently if they had turned their minds to the land transfer tax issue. In *Graymar*, the purpose of the transaction was debt restructuring and such purpose was achieved. This case falls squarely into the situation where the parties would have designed the transaction differently if they had considered the tax issue under subsection 15(2) of the Act. The Alberta Court did not find evidence that the parties turned their minds to the tax issue as it appeared not to have been brought to their attention by the professional advisors.

Further, it should be noted that section 193 of the BCA appears to be worded to operate prospectively with the Court approving an arrangement to be implemented. Section 193 of the BCA is silent on the ability of the Court to approve an arrangement and give it retroactive effect. The Alberta Court's comments on inherent jurisdiction are interesting as the Court stated that such jurisdiction should not be invoked where there is an alternative mechanism for relief – query whether the applicant should have simply argued the application based on inherent jurisdiction and not also on section 193 of the BCA. In their analysis, the Alberta Court appears to commingle the tests under section 193 of the BCA and that for rectification stating that if the applicants are entitled to rectification, they would be entitled to approval of the arrangement under section 193 of the BCA. The only reason it may have been necessary to additionally invoke section 193 of the BCA was if there was not a contract in existence that could have been amended and the parties needed to add a separate contract to address the tax issue under subsection 15(2) of the Act.

¹⁶ 2002 SCC 19.

¹⁷ 99 D.T.C. 5743 affirmed 2000 D.T.C. 6589. Leave to appeal to the SCC was refused (2001 CarswellOnt 1805).

¹⁸ (1994), 17 O.R. (3d) 571 affirmed by (1995), 21 O.R. (3d) 739.

Interestingly, none of the contracts comprising the debt restructuring transaction were put before the Alberta Court as evidence. The Alberta Court stated that they were able to treat the debt restructuring as a single transaction for determining the availability of rectification. Query whether rectification can be applied to a group of contracts as it is normally thought to apply on a contract by contract basis.

The bottom line is that professional advisors must carefully consider how they frame an application for rectification and ensure that they can present evidence to demonstrate the parties' intention. Further, practitioners must carefully consider all the potential tax consequences of a transaction undertaken as it does not appear to be possible to later amend a transaction for considerations not addressed, as was the case here, as opposed to possibly being able to amend those considerations that were improperly addressed.

Pallen Trust¹⁹

Summary

Rescission, although less frequently used by practitioners, is another equitable remedy. Black's Law Dictionary defines rescission as "a party's unilateral unmaking of a contract for a legally sufficient reason, such as the other party's material breach, or a judgment rescinding the contract".²⁰ The petitioner, Pallen Trust, argued that there was a mistake of law in interpreting subsection 75(2) of the Act. Pallen Trust, was successful on a petition before the British Columbia Supreme Court (the "BCSC") to have two dividends rescinded and as such, Pallen Trust was able to avoid a tax liability of approximately \$550,000.

Facts

Mr. Pallen was approached by Meyers Norris Penny LLP with a plan designed to reorganize his corporation to take advantage of a well-known tax product plan (the "evil trust" plan) that relied on subsection 75(2) of the Act. The plan was predicated on the understanding that whenever property was transferred to the trust, subsection 75(2) of the Act would tax all income/loss and gains from the property (or property substituted therefor) to the person who transferred the property to the trust, not the trust itself. Subsection 75(2) of the Act was thought to apply on any transfer to the trust, whether for fair market value or not. The plan was designed to achieve some asset protection as well as minimizing or eliminating some income tax payable. Specifically, when dividends were paid to Pallen Trust, they would not be subject to tax since the dividends would be deemed to be income of the transferor (a corporation) and as such a deduction pursuant to subsection 112(1) of the Act would be available (inter-corporate dividend). Pallen Trust could add the dividend to its trust capital without immediate tax implications and then distribute the money tax free to the trust beneficiaries.

In 2011, the TCC decided *Sommerer v. R.*,²¹ which was subsequently affirmed by the FCA, and these decisions held that subsection 75(2) of the Act does not apply when property is sold to a trust at fair market value. Since the property had been sold to the trust in this plan for fair market value, rather than simply gifted to the trust, the Sommerer decisions meant that subsection 75(2) of the Act was not applicable meaning that the dividends would be taxed in the hands of the trust at the top marginal rate applicable to individuals.

Judicial Reasoning

The BCSC begins by noting that rescission is an equitable remedy available in circumstances that include a unilateral mistake, whether a mistake of fact or a mistake of law. The Court stated that it was not material whether the beneficiaries of Pallen Trust were aware of the mistake or not. Pallen Trust seeks to rescind dividends paid by the corporation to it as a shareholder. The BCSC treats the dividends as a voluntary disposition of property for purposes of evaluating whether rescission can be granted.

¹⁹ 2014 BCSC 305.

²⁰ *Black's Law Dictionary*, Ninth Edition, Bryan A. Garner as Editor in Chief (United States of America: Thomson Reuters), 2009.

²¹ 2011 TCC 212, affirmed 2012 FCA 207.

The Crown argued that the test for rescission of a voluntary disposition is guided by an English case, *Gibbon v. Mitchell*²² and that the transaction must be assessed to determine whether it was a mistake as to the transaction's effect, a situation for which rescission can be granted, or a mistake as to the transaction's consequences, a situation for which rescission cannot be granted. The Crown's argument was that the negative tax consequences of the dividend transaction are not something for which the BCSC can grant rescission. The Crown's main argument is that rescission should not be available as a means to effect retroactive tax planning.

*Futter & Anor v. Revenue and Customs*²³ ("Pitt") is a decision of the Supreme Court of the United Kingdom that analyses the development of the equitable jurisdiction to the English courts to set aside a voluntary disposition and the BCSC looks to this decision for the requisite legal test: whether the donor has given property under some mistake of a serious character that renders it unjust for the donee to retain the given property. *Pitt* goes on to state that a mistake of law which is basic to the transaction is included in the mistake doctrine.

The BCSC stated that the analysis in *Pitt* is persuasive and thus, adopts the test expressed in this case. While the transactions were undertaken for asset protection purposes, the BCSC finds as a fact that the transactions were tax driven. The payment of a large dividend, approximately \$1.84 million, demonstrated that the tax implications were basic to the transactions. The BCSC further finds as a fact that tax professionals in Canada understood that subsection 75(2) of the Act would apply regardless of how property was transferred to a trust. The BCSC then goes further to infer that the CRA would not have likely contested the tax position of Pallen Trust prior to the *Sommerer* decisions.

The BCSC held that rescission is possible as the tax implications of the transaction were basic, there was a causative mistake, the mistake was significant and there is no prejudice to any third party. The BCSC appeared to grant rescission based on the unfairness at play as they note that the CRA would not have likely adversely assessed this transaction at the time the transaction was undertaken.

The Message

From a procedural perspective, it is interesting to note that the Crown did not raise an objection to the fact that the petitioner was Pallen Trust, the recipient of the dividends, as opposed to the corporation which was the party who actually declared and paid the dividends. One has to question how a shareholder can undo a dividend payment since dividends, as a matter of corporate law, are declared at the sole discretion of a corporation. Even if a shareholder refuses to accept a dividend payment, the dividend is legally declared by a corporation and a shareholder cannot undo this declaration.

At first blush, it appears that the taxpayer's situation in *Graymar* is more sympathetic than the taxpayer's situation in *Pallen Estate*. In *Graymar*, the taxpayer's advisors made an oversight in a multiple step transaction that was complex and they were not able to avail themselves to equitable relief. In contrast, in *Pallen Trust*, the taxpayer knowingly undertook an aggressive tax plan and the Court granted the taxpayer equitable relief. We suggest the difference lies in the legal tests for rectification and rescission.

The legal test for rescission appears to be a lower standard than the legal test for rectification. This point is evidenced by the fact that rescission, unlike rectification, can be granted on a unilateral basis. Further, rescission can be granted on a wider basis than rectification as it can be granted on a mistake of fact or a mistake of law. However, it appears rescission will not be an effective tool in a wide number of circumstances as it only allows the transaction to be undone, it does not allow the transaction to be amended retroactively like rectification. For instance, rescission would not have been effective in *Juliar* or *Bramco* as the transactions would have been undone completely. As a take-away, it is important to note that rescission is a tool available to practitioners as a potential way to solve a client's problem in the appropriate circumstances.

²² [1990] 1 W.L.R. 1304 (Eng. Ch. Div.).

²³ [2013] UKSC 26.

One query is whether the Court would have been so willing to grant rescission if the CRA had proceeded with their assessment based on both subsection 75(2) of the Act and the GAAR (section 245 of the Act) as it would have been more difficult for the petitioner to show there was a mistake of law in whether GAAR applied to the transaction.

G & J Muirhead Holdings Ltd.²⁴

Summary

The TCC decision in *G&J Muirhead Holdings Ltd.*, an informal procedural case, dealt with whether a one-person service company was carrying on a personal services business (“PSB”). The decision did not create new laws; however, the decision serves as a useful reminder of the risks associated with the PSB rules and also makes clear that courts are reluctant to consider intention in PSB cases.

In most circumstances, taxpayers are subject to tax based on legal relationships. The PSB rules are an exception to this rule because the legal form adopted is ignored – the fact that a worker provides their services through a corporation (“WorkerCo”) to another corporation (“OilCo”) is disregarded.

A worker runs afoul of the PSB rules where the answer to the following hypothetical question is yes: if WorkerCo did not exist, would the worker be an employee of OilCo? This hypothetical question arises from the definition of a PSB, “personal services business”.²⁵

If WorkerCo carries on a PSB, the consequences are significant. WorkerCo’s entitlement to the small business tax rate will be denied and WorkerCo will be prohibited from deducting most expenses incurred to earn income. If WorkerCo has significant taxable income and several years are in dispute, the tax bill can be crippling.

In most cases, the hypothetical question posed by the PSB definition is answered based largely on whether, if we ignore the legal character of the relationship chosen by the parties, the worker’s relationship with OilCo is more accurately characterized as a contractor relationship or, alternatively, as an employment relationship. The leading case on the distinction between employees and independent contractors remains *Wiebe Door Services Ltd. v. MNR*²⁶ as modified by *67112 Ontario Ltd. v. Sagaz Industries*²⁷ and *Royal Winnipeg Ballet v. Canada*.²⁸

The distinction between an employee and independent contractor is not obvious. There is no single distinguishing factor; however the following are relevant:

- (a) Control;²⁹
- (b) Tools;³⁰
- (c) Chance of profit or risk of loss;³¹

²⁴ *G&J Muirhead Holdings Ltd. v. R.*, 2014 TCC 49.

²⁵ A PSB is carried on by a corporation in a taxation year means a business of providing services where:

- (a) an individual who performs services on behalf of the corporation (in this definition and paragraph 18(1)(p) referred to as an “incorporated employee”); or
- (b) any person related to the incorporated employee is a specified shareholder of the corporation and the incorporated employee would reasonable be regarded as an officer or employee of the person or partnership to whom or to which the services were provided but for the existence of the corporation; unless
- (c) the corporation employs in the business throughout the year more than five full-time employees; or
- (d) the amount paid or payable to the corporation in the year for the services is received or receivable by it from a corporation with which it was associated in the year.

²⁶ 87 D.T.C.

²⁷ [2001] 2 S.C.R. 983.

²⁸ 2006 FCA 87.

²⁹ Control of the manner in which the work is completed – *Is the worker told when, where and how to do the work?*

³⁰ Ownership of tools needed to complete the work – *Is the worker provided with all or most of the tools necessary to complete the work?*

- (d) Integration;³² and
- (e) Intention.³³

As is often the case when the Act disregards legal relationships, the characterization of a worker as either a contractor or employee, and more specifically whether a corporation is carrying on a PSB, is frequently litigated in the TCC. Rarely do all of the factors point in a consistent direction, leaving room for disagreement. The CRA and the jurisprudence offer a wide range of questions to consider when working through each of the factors.³⁴

Facts

Gordon Muirhead (“Gordon”) and his wife incorporated G & J Muirhead Holdings Ltd. (“Muirhead”) in 2002. In 2008, Muirhead’s only employee was Gordon, who was under a contract with Harvest Operations Corp. (“Harvest”) to provide oil well site and facilities services. Harvest contracted Muirhead for oil field services since 2003 and, although exclusivity was not required by Harvest, Harvest was Muirhead’s only client. All services provided to Harvest by Muirhead were provided by Gordon working full-time for Muirhead.

Judicial Reasoning

The TCC determined that Muirhead was carrying on a PSB. This conclusion was based mainly on the “control” factor. The TCC concluded that “Harvest’s control over the work to be performed by Mr. Muirhead could hardly have been greater.”³⁵ The following facts were identified by the Court as facts, under the control heading, that pointed in the direction of a traditional employment relationship:

- Harvest dictated the hours of work;
- Harvest set the hourly rate;
- Only hours actually worked were paid for;
- Harvest determined the number of wells to be checked at the site each day;
- Gordon reported each day to the Harvest foreman and his supervisor at the well site;
- Gordon was required to abide by Harvest’s code of business conduct and ethics;
- Gordon said Harvest could discipline him if he did not perform appropriately or if it had concerns with his work;
- Gordon had to report to Harvest if he was sick or wanted to schedule time off;
- Harvest conducted evaluations of the work performed by Gordon in the same manner as was company policy for its employees;
- Harvest had employees doing the same type of work;
- Gordon’s training was on-the-job; and
- No off-site training was required by Harvest nor was any outside training required to maintain any credentials to perform the work.

The TCC identified the following facts and held that the “chance of profit / risk of loss” was also a factor that indicated the existence of a PSB:

- Gordon had a non-negotiable hourly rate (including an overtime rate), fixed hours, and a schedule of work on a full-time basis;
- Harvest was the only company to which Gordon provided services and work;

³¹ The extent to which the worker has a chance of profit or a risk of loss – *Is the worker’s compensation fixed such that: (i) there is little opportunity for meaningful swings in income, up or down; and (ii) are expenses (health, dental, travel, meals, marketing etc.) either covered or reimbursed?*

³² Integration of the worker into the payor’s business – *Is there only one business being carried on (that of OilCo) and the worker is part of that business, rather than carrying on their own separate business?*

³³ The intention of the parties – *Do the parties lack evidence to substantiate an intention to carry on two separate businesses?*

³⁴ See, for example: CRA, RC4110, “Employee or Self-Employed?” online: <http://www.cra-arc.gc.ca/Epub/tg/rc4110/rc4110-12e.pdf>.

³⁵ *Supra*, note 1 at paragraph 19.

- In the event that he did not want to work for Harvest any longer, he would have to give at least 30 days' notice to Harvest;
- Gordon had no opportunity to increase his revenues beyond the 80 hours every two weeks committed with Harvest, plus any overtime;
- There was no evidence of significant overtime ever earned or expected and his revenue from Harvest was not affected by any efficiency or time saving on his part; and
- There was no material economic risk beyond being out of work on 30 days' notice and still owning his truck, which could continue to be used in Gordon's other businesses and for personal use.

With respect to intention, the TCC refused to consider the intention of the parties as a relevant factor. Thus the TCC ultimately found against the taxpayer, concluding that "if the existence of Muirhead Holdings is ignored and Mr. Muirhead were working directly for Harvest, Mr. Muirhead or anyone else performing those services could only reasonably be considered to be Harvest's employee".³⁶

The Message

The facts as described by the TCC in this decision reveal an unusually high degree of control by the production company over the worker. Producers will typically not have this much control over independent contractors and their corporations. Many oil field services workers providing services through a corporation will be able to distinguish their circumstances from those of Muirhead. However, if a worker has all of these hallmarks of control, their corporation may well be carrying on a PSB and, as such, they may choose to take the conservative approach of leaving little taxable income in the corporation and only claiming deductions that are eligible for employees. It is unfortunate that such a common situation is subjected to a high degree of uncertainty; however, such uncertainty arises directly from the legislative decision to disregard legal relationships in favour of a difficult to predict 'government knows best' hypothetical relationship.

The TCC has struggled with the degree to which intention should be relevant in PSB cases and clarity is still needed on this long-standing issue. Although it is clear that the intention to create WorkerCo must be ignored (as this is expressly required by the PSB rules), it is not clear that the parties' intention should be entirely ignored. Indeed, the essence of the analysis is whether the worker intended to carry on a separate business. Hopefully future cases will acknowledge some relevance for intention under the PSB rules and perhaps the line to be drawn is between form and substance: it is irrelevant that the parties adopted the legal form of an independent contractor relationship but it is highly relevant whether the parties in substance intended that two separate businesses exist.

In the oil and gas sector, it is common that parties intend that two separate businesses exist in order to share the risk associated with a market downturn. When a downturn hits, both OilCo and WorkerCo face the risks associated with the lack of work, rather than OilCo facing a severance liability that could end the company. If the facts of a particular case are that OilCo provides compelling evidence that under no circumstances would they have hired the worker as an employee because of the risks involved, such intention seems not only relevant, but may be a complete answer to the hypothetical question asked by the PSB rules: if WorkerCo did not exist, would the worker be an employee of OilCo?

Guindon³⁷

Summary

Guindon addresses the important distinction between a civil penalty and a criminal sanction. To illustrate the distinction, think of an extreme example of a criminal sanction such as imprisonment. When someone is found guilty of murder, we put him or her in prison for years. Society demands a harsh penalty for several reasons – to improve public safety, to specifically deter the guilty person from reoffending, and to generally deter all individuals from committing a similar offence. We want the penalty to be so significant and intimidating that members of the public at large are deterred from committing the offense.

³⁶ *Supra*, note 1 at paragraph 36.

³⁷ *Guindon v. R.*, 2013 FCA 153 reversing 2012 TCC 287. This case is scheduled to be heard by the SCC as per 2014 CarswellNat 654.

A person accused of a criminal offence has enhanced procedural and substantive rights as compared with a person charged with an administrative penalty. Such elevated rights include a presumption of innocence; protection against self-incrimination; greater disclosure of the Crown's case; trial in a criminal court rather than in the TCC; the onus of proof is on the Crown instead of the taxpayer; and, the higher standard of proof of "beyond a reasonable doubt" is used rather than the "balance of probabilities" standard that applies in most civil cases.

Under the Act, a wide spectrum of potential enforcement mechanisms exists, from minor civil penalties to criminal sanctions that can lead to imprisonment. At one end of the spectrum, for example, is a late-filing penalty – clearly a civil penalty and not a criminal sanction. If you file late, you may be assessed a relatively small financial penalty. At the other end of the spectrum is the criminal sanction that applies to those found guilty of tax evasion. A person accused of tax evasion is at risk of a significant financial penalty and a prison term of up to two years. The severity of this punishment makes it clear that the penalty for tax evasion is a criminal sanction, which gives rise to enhanced rights when one is investigated for or charged with tax evasion.

The main issue in *Guindon* is whether the penalty imposed under section 163.2 of the Act is a civil penalty or a criminal sanction. *Guindon* is the first case to address this important distinction in the framework of section 163.2 of the Act. The TCC concluded that the penalty was a criminal sanction, the FCA disagreed and the issue is scheduled to be heard by the SCC late in 2014.

Facts

The Appellant in this case was a family law lawyer with little tax expertise. She was persuaded by her cousin, who was one of the two principals and promoters of a proposed charitable donation program, to provide a favourable legal opinion with respect to the charitable donation receipts to be issued.

Specifically, a trust was to be established in Ontario, called the Global Trust of Canada (the "Trust"). A lawyer and resident of the Turks and Caicos was to be the settlor. The Trust was to be established for the benefit of a class of individuals who were both residents and non-residents of Canada and who had indicated a willingness to support charitable organizations. KGR Tax Services Ltd. ("KGR"), a company incorporated in the Turks and Caicos, was to be the Trustee of the Trust. This company was owned by the promoters of the charitable donation program. The settlor was to acquire timeshare units in a Turks and Caicos resort. After acquiring the timeshare units, the settlor was supposed to gift the units to the Trustee who would then sell the units to the beneficiaries of the Trust, in return for a vendor take-back charge in the amount of \$3,248 per unit. The beneficiaries would donate the units to a registered Canadian charitable organization and would receive donation receipts for the fair market value of the donated units, which was estimated to be \$10,825 per unit.

In reality, no timeshare units existed and no trust was settled. However, the Appellant was not aware that this proposed structure was not established and she yielded to the pressure of the promoters who dishonestly asserted that the structure was fully in place. Relying on the false representations of the promoters, the Appellant signed a favourable legal opinion. The legal opinion indicated that she had reviewed the relevant legal documents, but she had not. Instead, she relied only on the assurances of the promoters.

In addition to giving the legal opinion, the Appellant was also the President of a charity that agreed to participate in the program and, in her capacity as President; she signed many charitable receipts that were issued to donors. This added to her culpability because, at the time she signed charitable receipts, she knew that the legal opinion was unreliable – although she was not aware that the promoters had lied, she was aware that when the legal opinion stated that it was based on a review of the relevant legal documents, such statement was not true.

On August 1, 2008, the Minister assessed the Appellant for penalties under subsection 163.2(4) of the Act, in the amount of \$546,747 in respect of false statements made in the context of the charitable donation arrangement. The Appellant appealed the assessment.

Judicial Reasoning

The Appellant was assessed a penalty in the amount of \$546,747 and this amount was calculated by adding up the amounts of the penalties under subsection 163(2) of the Act to which each of the 134 other donors would have been liable. It was the view of the TCC that the penalty under subsection 163.2(5) of the Act has the potential of increasing – without limit—depending on the number of “other persons” involved. The TCC agreed with the Appellant that where, as here, “the penalty is unlimited and is imposed on a third party, it seems evident that its purpose is to redress a wrong done to society and consequently ceases to be a purely administrative matter of one of internal discipline.”³⁸

In the TCC’s view, both the damage to reputation and the personal damage occasioned by a penalty under section 163.2 of the Act were undeniable and could affect the Appellant’s life for years to come. The TCC ruled, based on the rationale enunciated in *R. v. Wigglesworth*,³⁹ that section 163.2 of the Act should be considered as creating a criminal offence. As a result the TCC lacked jurisdiction to hear the case, and the penalties were vacated.

Federal Court of Appeal

The FCA reversed the TCC’s ruling on the basis that Ms. Guindon had not followed the proper process in challenging section 163.2 of the Act, by failing to provide notice of a constitutional question, and so the TCC lacked the jurisdiction to make the order it did. Although this was a complete answer to the appeal, the FCA went on to consider the merits of the issue and held that advisor penalty proceedings are not criminal in nature and do not impose “true penal consequences.”

The FCA applied the *Wigglesworth* test, but reached a different conclusion than the TCC. The FCA viewed advisor penalties for the provision of false information as an aspect of the self-compliance that is fundamental to the administration of the tax system. The penalties were not to condemn morally blameworthy conduct, but to ensure that the tax system works properly by maintaining discipline and compliance.

In summary, the FCA made the following determinations:

- Section 163.2 of the Act is aimed at maintaining discipline, compliance, or order within a discrete regulatory and administrative field of endeavor rather than at redressing a public wrong done to society at large and hence does not attract Charter⁴⁰ protection.⁴¹
- Section 163.2 of the Act prescribes a fixed formula for the calculation of the penalty. In contrast, the offence provisions of the Act require the judge to determine the amount of a fine or the length of imprisonment by assessing the moral blameworthiness or turpitude of the conduct, including any mitigating circumstances.⁴²
- The size of the penalty alone does not dictate whether section 11 of the Charter applies. The Court confirmed that sometimes administrative penalties must be large in order to deter conduct detrimental to the administrative scheme and the policies that it furthers.⁴³

The Message

The SCC has granted the Appellant’s application for leave to appeal and the matter is tentatively scheduled to be heard on December 5, 2014. The SCC will determine whether section 163.2 of the Act imposes a criminal sanction and the Court may also provide guidance that applies beyond the tax context to help determine the important distinction between administrative penalties and criminal sanctions.

³⁸ *Supra*, note 6 at paragraph 62.

³⁹ [1987] 2 S.C.R. 541.

⁴⁰ Section 11 of the *Canadian Charter of Rights and Freedoms* is the section of the Canadian Constitution that protects a person’s legal rights in criminal and penal matters. Such rights include: the right to be informed of the offence; the right to be tried within a reasonable time; the right not to be compelled to be a witness and the right to be presumed innocent.

⁴¹ *Supra*, note 6 at paragraph 42.

⁴² *Supra*, note 6 at paragraphs 44-45.

⁴³ *Supra*, note 6 at paragraph 46.

Section 163.2 of the Act was enacted in 2000 and it was initially recommended by the Mintz report in 1997. On the basis of that recommendation, the government intended to enact a civil penalty. This intention is evident in the heading given to this section: “Misrepresentation of a Tax Matter by a Third Party.” Despite this intention, when the section was enacted, the legislative text was drafted more broadly than initially recommended. Many practitioners took issue with the broad language of the provisions and identified factors, such as the severity of the punishment that arguably made the penalty as enacted a criminal sanction rather than a civil penalty.

Since the penalty was enacted in 2000, there has been uncertainty regarding whether a person accused under section 163.2 of the Act is entitled to the enhanced rights available to those charged with a criminal offence. Since enacted, the penalty has resulted in over \$63 million in penalties assessed, as reported in the 2014 *Spring Report of the Auditor General of Canada*.⁴⁴

When the Auditor General is publishing statements that acknowledge the deterrent purpose of the penalties in section 163.2 of the Act, and identifying that the massive penalties have likely had the effect of modifying behavior generally, it may make it easier for the Appellant to establish that the penalty is a criminal sanction. The government makes similar public statements regarding the number of taxpayers charged with tax evasion and the staggering amount of penalties assessed against evaders; however, the government does not appear to make such a public display regarding the number of people assessed and the revenue generated from late filing penalties.

Groupe Enico inc.⁴⁵

Summary

On October 23, 2013, a judgment of the QCCS granted \$4 million in damages to two taxpayers that were subjected to an abusive audit. The Court determined that Revenu Québec (“RQ”) had abused its power and had conducted its audit, reassessments, and collection activities in bad faith.

Facts

In October 2005, RQ initiated an audit after receiving a letter, which it later destroyed, from a disgruntled former employee of the corporate taxpayer, Groupe Enico inc. (“Groupe Enico”). Subsequently, an audit was commenced against the taxpayer.

On October 15, 2007, a reassessment was issued for additional tax, interest, and penalties of more than \$450,000. In the end, the Court concluded that such reassessment was the result of malicious and intentional behavior. A RQ auditor was found to have created fictitious entries to inflate the amount of the reassessment. In addition, a RQ internal memo, issued only two weeks after the reassessment, identified that RQ was aware that the actual undeclared income was only \$50,000 not \$450,000.

⁴⁴ Available online at: http://www.oag-bvg.gc.ca/internet/English/mr_20140506_e_39384.html. See specifically: “3.35 Third-party civil penalties came into force in 2000. They are meant to deter third parties from making false statements or omissions in relation to income tax or goods and services tax / harmonized sales tax matters that result in non-compliance with the *Income Tax Act* or *Excise Tax Act*. [...]”

3.37 For the period from the 2009-10 to the 2012-13 fiscal years, the Agency recommended the application of third-party penalties in 118 cases to the Third-Party Penalty Review Committee. The third parties included some promoters of RRSP strips. Of the 118 cases,

48 cases were approved to apply third-party penalties,

22 were denied, and

48 were still being assessed at the end of the audit period.

Of the 48 cases in which third-party penalties were approved, the total value of penalties assessed was \$63.3 million (the median penalty was approximately \$440,000). Although it is not possible to measure the extent to which penalties were a deterrent, their use probably has had some impact on the behaviour of promoters and tax preparers. [Emphasis added.]

⁴⁵ *Groupe Enico inc. c. Quebec*, 2013 QCCS 5189.

Notwithstanding that RQ knew the reassessed amount was inflated, RQ took more than nine months to adjust the reassessment and took aggressive steps to collect the entire amount of the inflated reassessment. In February 2008, RQ's collection department seized Groupe Enico's line of credit. The bank then recalled the taxpayer's line of credit, which naturally led to employees departing, when their salary was unpaid, and also led to concerned clients and suppliers moving their business away from Groupe Enico.

Before RQ's egregious conduct, Groupe Enico had been profitable and was expanding. In November 2010, Groupe Enico ceased operations. RQ representatives unsuccessfully attempted to leverage insolvency proceedings to force the Groupe Enico to drop its civil claim against RQ.

Judicial Reasoning

The QCCS identified that RQ had employed several delay tactics in the civil lawsuit and that RQ had deliberately destroyed documents. In the civil trial, RQ chose not to call the main auditor as a witness and Groupe Enico had to hire a private investigator to track down the auditor and compel his attendance. The QCCS found that RQ's objective was to exhaust the taxpayer financially and to prevent a trial on the merits. Further, the QCCS held that RQ had engaged in willful misconduct, bad faith, and abuse of power in dealing with the taxpayer.

The RQ income tax auditor's testimony confirmed that the RQ auditors had revenue quotas that were directly linked to the auditor's employment income. The QCCS also found a link between the quota system to the reprehensible conduct of the auditors. Although some files of the auditors had been destroyed, many internal RQ communications were still available and were disclosed at trial to help demonstrate that RQ agents knew early in the process that the reassessments were falsely and greatly inflated. In the end, the taxpayers successfully demonstrated that RQ's conduct was grossly negligent and reckless as to predictable consequences.

The Court granted about \$1.1 million in damages to the company's founder and shareholder and \$2.75 million to Groupe Enico. Out of the total damages award, \$2 million arose from punitive damages and this amount was grounded in the Quebec *Charter of Human Rights and Freedoms*,⁴⁶ which allows punitive damages for "unlawful and intentional interference" with various rights, including the peaceful enjoyment of property. Under the *Civil Code of Quebec*,⁴⁷ punitive damages "may not exceed what is sufficient to fulfil their preventive purpose," but the Court in this case held that a serious deterrent was required in part because a public body such as RQ should exemplify a high standard of conduct and because many meritorious claimants probably never make it to trial.

The Message

Success in an action for punitive damages against RQ or the CRA will remain as an extremely rare event. A substantially more common remedy to modify improper behavior of tax officials, where the taxpayer believes a tax official has acted unreasonably as a matter of administrative law, will be to apply for judicial review.

In the recent FCA decision *Canada v. JP Morgan Asset Management (Canada) Inc.*,⁴⁸ the FCA confirmed that it is appropriate to seek judicial review where a taxpayer believes that the tax authority has failed in one of the following ways:

- failure to act lawfully when making information demands in tax audits;
- failure to issue or send notices of assessment, reassessments or determinations when the tax legislation imposes a positive duty on officials to do so in a timely fashion;
- failure to pay refunds with interest in a timely manner when such amounts are not in controversy before the TCC, the amount is not being contested by the CRA and tax legislation permits the payment;

⁴⁶ CQLR, c. C-12.

⁴⁷ LRQ, c. C-1991.

⁴⁸ 2013 FCA 250.

- failure to act lawfully in attempting to collect tax debts; and
- failure to exercise discretion in a reasonable manner in circumstances involving such matters as the waiver of interest and/penalties, the late filing of designations or elections, or the reassessments of individuals beyond the expiry of statutory limitations periods.

However, where the taxpayer believes the conduct of the tax authority is so egregious that civil damages should be pursued, it is a possible, but extremely difficult, remedy to obtain. The conduct of the tax authority in Groupe Enico was extremely egregious and the taxpayer was successful in marshaling all of the evidence needed to prove the alleged conduct of RQ officials had in fact occurred, which is difficult to do against the state, especially when facing tactics such as destruction of records, delay and leveraging financial pressure. In Group Enico, the taxpayer was able to climb a steep hill and persuade the QCCS that the high burden of proof needed to establish unlawful and intentional interference had been satisfied. RQ has appealed the decision.

Duncan Thompson⁴⁹

Summary

The Appellant challenged the Requirement, in part, based on solicitor-client privilege, and sought a determination of whether subsection 231.2(1) of the Act can be interpreted, applied or enforced so as to require a lawyer who is the subject of enforcement proceedings by the CRA to divulge information about his clients, including their names and amounts owing, information that he claimed was protected by solicitor-client privilege. The Appellant also argued that the Requirement constituted an unreasonable search or seizure and thus was contrary to section 8 of the Charter.

Facts

The Appellant is a lawyer who was subject to enforcement proceedings under the Act. In connection with its collection duties, the CRA issued a Requirement seeking information and documents pertaining to the Appellant's income and expenses, and assets and liabilities, including a current accounts receivable listing. The Appellant was not particularly forthcoming regarding his personal finances as he withheld important information regarding his personal finances. With respect to his accounts receivables, he refused to identify his clients on the basis that to do so would violate solicitor-client privilege.

Judicial Reasoning

The Federal Court ordered that the Appellant must comply with the Requirement, and ordered that he provide unredacted financial records to the Minister. The Federal Court noted that the Appellant had conceded that, in the event a client did not pay the Appellant, the Appellant would be entitled to commence a Statement of Claim and, in that context, the Appellant would reveal to the world his client name, regardless of whether such client consented to disclosure.

Federal Court of Appeal

The FCA allowed the appeal in part, but for completely different reasons than advanced by the Appellant. The FCA allowed the appeal only because the Federal Court did not review the accounts receivable listing to ensure solicitor-client privilege did not apply to protect each of the Appellant's clients individually. Indeed, there was no evidence on the record to establish whether the clients were even informed of the ongoing proceedings. The FCA upheld the Federal Court's order that the Appellant produce unredacted versions of all other information and documents.

⁴⁹ *MNR v. Duncan Thompson*, 2013 FCA 197.

The FCA identified that it is the party asserting the privilege that should bear the evidentiary burden to establish the claim and the FCA held that the Appellant had failed to do so. It was insufficient for the Appellant just to raise privilege without providing some evidence and explanation why the clients' names may be protected by privilege.

The FCA found that the information contained in the accounts receivable was of the book-keeping nature, less likely to attract privilege than communications related to giving legal advice. Client names were found to be part of the accounting records and, as such, not generally subject to privilege.

The FCA concluded that the Appellant did not meet the evidentiary burden to establish privilege. Consequently, the Federal Court did not err that the client information required by the Requirement was not subject to privilege as the Appellant has not demonstrated that privilege attached. However, even though the Appellant's arguments were not successful, the FCA allowed the appeal in part as the Federal Court's decision was given prematurely and without due process – the FCA held that the Federal Court should have taken some appropriate steps to verify whether privilege may apply to any of relevant records, which involved giving the clients an opportunity to provide the evidentiary foundation to establish privilege.

The Crown successfully sought leave to appeal to the SCC on the basis that the Federal Court's decision should be reinstated and no further process should be required to inform or involve the Appellant's clients. The Appellant filed a cross-appeal seeking leave for the SCC to address the issue of whether sections 231.2 and 232 of the Act, are constitutionally valid. The SCC declined to hear the cross-appeal.⁵⁰

The Message

The Act provides a definition of privilege in section 232 and that definition expressly excludes "accounting records". The term "accounting records" is not defined, which has led to some uncertainty surrounding this issue. It can generally be stated that there are three categories of lawyers' records:

1. *Traditionally Privileged Records*: Records that are either prepared for the dominant purpose of use in litigation or records that contain any communication, between solicitor and client, for the purpose of providing confidential legal advice. Absent evidence establishing waiver, these records are clearly subject to privilege and these records constitute the vast majority of most lawyers' files.
2. *Trust Accounting Records*: Trust accounting records provide detail regarding any amounts held in trust by the lawyer. These records, in the vast majority of cases, are not subject to privilege. They should only contain factual information and should not directly or indirectly disclose the content of any legal advice.
3. *Other Financial Records*: With respect to other financial records, including client names and billing information, whether privilege exists requires a case by case analysis. There may be instances when privilege will attach to accounting records, if it can be demonstrated that the disclosure of such accounting records would reveal, directly or indirectly, the content of privileged communications. For example, the identity of the client does, in and of itself, disclose some information regarding the legal advice because it discloses the type of legal advice sought by that individual based on the lawyer retained. For example, a citizen seeking advice from a divorce lawyer is likely to expect that the fact that they have sought such legal advice will remain, not just confidential, but be privileged such that the retainer cannot be disclosed without the client's consent.

Now that the SCC has granted leave, it is hoped that some clarity will be provided, not just regarding the extent to which privilege attaches to the third category of records above, but also regarding the process to be followed to determine such privilege. The FCA identified that the clients ought to be informed prior to disclosure in order for them to each have the opportunity to establish the existence of privilege. It seems unlikely that the SCC will adopt a process that strips clients of any right to notice or right to participate in proceedings that may impact their rights.

⁵⁰ 2014 CarswellNat 554.

Chambre des Notaires⁵¹

Summary

The QCCA, in *Chambre des Notaires*, the QCCA determined that subsection 231.2(1) and section 231.7 of the Act, and the exception contained in the definition of “solicitor-client privilege” in subsection 232(1) of the Act, are of no force and effect against Québec notaries and lawyers with respect to documents and information protected under solicitor-client privilege.

Facts

The Chambre des Notaires du Québec (the “Chambre”) (the professional order for notaries) applied for a declaration that the above listed provisions of the Act infringe constitutional guarantees against unreasonable search and seizure. The professional order for lawyers in Québec, the Barreau du Québec, intervened to support the Chambre’s position.

Judicial Reasoning

The Chambre advanced the following arguments:

- Privilege is a fundamental right which is afforded constitutional and quasi-constitutional protection;
- Requirements are seizures authorized by law and the dispositions governing the Requirement regime do not adequately protect the client’s privilege rights. The current process may lead to a violation of privilege without the client’s knowledge or consent; and
- The threat of criminal proceedings, including fines and prison sentences, referred to in the Requirements received by the notaries may prevent clients from making an enlightened decision and puts undue pressure on the notaries to whom these Requirements are addressed.

The CRA and the Attorney General of Canada argued the following:

- Requirements alone do not result in a violation of privilege given that the Minister must receive authorization from a judge before gaining access to information or documents in cases where a notary has not responded to or has refused to comply with a Requirement;
- The mechanism provided for in the Act does not pose any risk in this situation because no privileged information of the taxpayer is disclosed unless the notary discloses it; and
- Granting the Chambre and the Québec Bar’s request would be tantamount to creating a tax haven in the offices of notaries and lawyers in Québec.

QCCS granted the motion brought by the Chambre, declaring sections 231.2 and 231.7 of the Act as well as the definition of “solicitor-client privilege” in subsection 232(1) of the Act to be invalid and of no force or effect with respect to notaries and lawyers in Québec where documents or information protected by privilege are sought. Although the QCCS referred to provincial legislation, the Court did not rely heavily on provincial rules in reaching its conclusion.

The QCCS found that sections 231.2 through 231.7 of the Act do not contemplate that a client will be made aware of the potential violation of their privilege rights and, as such, clients are unable to avail themselves of their rights. Further, the QCCS held that the Requirement mechanism violates taxpayer’s privilege rights as a result of the following:

- A notice of a compliance order application under 231.7 of the Act must only be served on the person against whom the order is sought and not the client;
- The minimum five-day notice period provided when the Minister seeks to obtain a compliance order is too short; and

⁵¹ *Attorney General of Canada v. Chambre des Notaires du Quebec*, 2014 QCCA 552 affirming 2010 QCCS 4215.

- The legislation does not require the CRA to demonstrate that there is no other reasonable method of obtaining the information sought before demanding the information from lawyers and notaries, on threat of criminal production for non-compliance.

According to the QCCS, subsection 231.7(2) of the Act does not provide a legal professional with a reasonable opportunity to object to the Requirement and to preserve the confidentiality of information protected by privilege. Relying on the SCC decision in *R. v. Lavallee*,⁵² where section 488.1 of the *Criminal Code*⁵³ was held to infringe s. 8 of the Charter, the QCCS concluded that the Requirement powers in the Act contravened section 8 of the Charter because:

- The Crown had not adequately ensured the taxpayer's right to benefit from privilege, and
- The Crown had not shown that an infringement of this right was minimal or that it was otherwise justified under section 1 of the Charter.

The QCCA upheld the decision that the impugned provisions were unconstitutional and inoperative in the context of Requirements issued to lawyers and notaries in Québec where the Requirement seeks records that may be subject to privilege. The QCCA emphasised that its holding was limited to such Requirements and that the impugned provisions remained in force and effect for all other Requirements.

The QCCA decision is largely consistent with the lower Court; however, it did modify the orders given by QCCS by specifying that subsection 231.2(1) of the Act only (as opposed all of section 232.1 of the Act) and section 231.7 of the Act, as well as the exception contained in the definition of "solicitor-client privilege" in subsection 232(1) of the Act (rather than the entire definition), were unconstitutional and inoperative with respect to Requirements issued to notaries and lawyers in Québec where the documents and information sought by the Requirement are protected by privilege.

In reaching its decision that these provisions were inoperative, the QCCA rejected the position of the Attorney General of Canada that the CRA's practice was to inform taxpayers that their legal advisor has received a Requirement (notwithstanding the absence of a legal obligation to provide such notice), writing that: "the protection of basic rights should not be dependent upon a reliance on the continuous exemplary conduct of the Crown, something that is impossible to monitor or control."⁵⁴

The Message

In contrast to *Thompson*, discussed above and where the FCA did not go so far as to declare any section of the Act unconstitutional, the QCCA has now, for a limited purpose, struck the same provisions addressed in *Thompson*.

The FCA in *Thompson* expressly declined to place any importance on the QCCS decision in *Chambre de notaires*, which at that time was under appeal. Further, in *Thompson*, the SCC declined to hear the taxpayer's cross-appeal to address the constitutional question and only granted the Crown's appeal to address the privilege question. As such, we have two Court of Appeal level decisions that appear inconsistent in their approach to the constitutional validity of the provisions of the Act that define privilege and that grant the Minister authority to issue and enforce Requirements, in the context of demands for records of lawyers that may contain privileged information.

One consistent factor in these two cases is that the appellant level Court clearly and precisely set out their view that the clients, whose privilege rights may be infringed when a Requirement is sent to their counsel, ought to be informed of the Requirement and should be afforded the opportunity to challenge the validity of such Requirement, if they chose to do so.

⁵² [1990] 1 S.C.R. 852.

⁵³ R.S.C., 1985, c. C-46.

⁵⁴ *Supra*, note 19 at paragraph 122, citing *Lavallee*.