Tax Notes

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EVIDENTIARY AND PROCEDURAL MATTERS IN THE TAX COURT OF CANADA

- –Donald G.H. Bowman, Counsel in the Tax Department with the Toronto Office of Dentons Canada LLP

Wolters Kluwer regularly features Dentons Canada LLP articles examining cases and topics of special interest.

Justice Diane Campbell of the Tax Court of Canada has rendered a trilogy of judgments in which she reiterates and applies a number of principles of practice, procedure, and statutory interpretation in the judicial determination of fiscal matters. They are a breath of fresh air.

The three cases are *Bekesinski v. The Queen*, 2014 DTC 1066 (T.C.C.) (judgment rendered on January 31, 2014) ("*Bekesinski I*"); *Bekesinski v. The Queen*, 2014 DTC 1169 (T.C.C.) (judgment rendered on July 28, 2014) ("*Bekesinski II*"); and *Health Quest Inc. v. The Queen*, 2014 GTC 52 (T.C.C.) (judgment rendered on June 30, 2014) ("*Health Quest*").

The three cases contain as thorough a discussion of important principles of statutory interpretation, determination of credibility, expert testimony, and expert reports as one is likely to encounter in one place.

The principles are expressed simply, articulately, accurately, and commonsensically. The issues in the three cases are simple to state but their resolution required a good deal of horse sense. In *Bekesinski II*, the issue was whether the appellant had backdated his resignation as a corporate director. *Bekesinski I* was a preliminary motion to determine whether an expert witness report on the date when the appellant's resignation as a corporate director was signed was admissible. *Health Quest* had to do with whether certain types of footwear were subject to HST.

The principles expressed and applied by Justice Campbell may be summarized as follows.

1. In the case of doubt on a factual issue or on a matter of legal interpretation, the benefit of doubt must go to the taxpayer. Despite *Stubart* many judges ignore the principle.

2. The civil standard of proof required (as is the case in all tax matters except in criminal prosecutions for tax evasion under such provisions of the *Income Tax Act* as section 239) is a balance of probability and not proof beyond a reasonable doubt. Where the transgression is serious (but not criminal) the standard is not higher than the civil standard, but if the explanation of the conduct is improbable it requires closer scrutiny.

3. The pleadings by the respondent in *Bekesinski II* were, according to Justice Campbell, "sloppy".

Paragraph 48 of the reasons in *Bekesinski II* reads as follows:

> These pleadings are sloppy and inadequate and detrimental to the Respondent's success. Because of the advantage that the Respondent receives from the practice of pleading facts that are assumed to be true, jurisprudence has established that those assumptions must be accurate and precise so that the taxpayer knows exactly the case to be met. The assumptions omit those very facts upon which the Respondent's position is based, that is, that the Resignation had been backdated and was not authentic. Nor was there any reference to due diligence on the part of the Appellant. Had those facts been included, the onus would have been on the Appellant initially to demolish those facts. However, the critical assumption was only that the Appellant was a director of the Corporation. The appellant would have had a much more difficult case to meet, had the Respondent paid more attention to its pleadings. The Appellant's responsibility was to adduce sufficient evidence to demolish the assumed fact that he was a director of the Corporation. It is not the Appellant's obligation to adduce evidence to demonstrate that the Resignation was not backdated. When the burden shifted to the Respondent, the Respondent was unable to prove, on a balance of probabilities, that the Resignation was backdated and the Appellant remained a director.

This conclusion has the effect of shifting the onus to the respondent and it re-emphasizes the respondent's obligation to plead the basis of the assumptions precisely, clearly, and completely.

4. *Bekesinski I* also reiterates what one would have thought obvious, that the report of an expert that a party proposes to call as a witness must set out not only the conclusions that the expert reached, but also the facts and reasoning relied upon in arriving at those conclusions. In paragraphs 27, 28, 29, and 30 of *Bekesinski I* the Court states:

> [27] By definition, "full statement" implies that exact facts and arguments, complete in extent and every particular, respecting the expert's proposed evidence in chief shall be set out in the affidavit. This means that Ms. Vallière's Report, which, by her own admission in the *voire dire*, does not contain the underlying data collected, quantitative analysis employed and the ratios calculated to support her stated opinion, is deficient as it does not contain a full statement of her proposed evidence in chief as mandated by Rule 145. As noted in the jurisprudence from other jurisdictions, such a deficiency compromises the Appellant's ability to prepare for cross-examination and to properly instruct its own expert witnesses. This leaves the Appellant at a distinct disadvantage and, as caselaw from other jurisdictions has noted, is not consistent with the spirit and purpose of similarly worded expert evidence rules. These rules exist to facilitate trial preparation and to decrease time and expense in matters involving experts. This is the common theme of the expert evidence rules across jurisdictions. Adequate notice of the evidence prevents 'trial ambush' and the potential prejudice that may result to the opposing party.
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> [28] According to the *voire dire* evidence, Ms. Vallière's Report provided the general methodology she adopted together with her opinion. Although the present Rule 145 does not specifically require that a report disclose data, analysis and ratios, which Ms. Vallière admitted underlies her opinion, by the plain and obvious meaning of "full statement" and in light of the object and purpose of Rule 145, procedural fairness demands that an expert report include such underlying facts and assumptions. This Court, in the case of *Mathew*, held that an expert has an obligation to communicate those facts and assumptions which are relied upon in formulating an opinion contained in a report. British Columbia courts have held that fairness requires notice to an opposing party of not only the expert opinion but, again, its underlying facts and assumptions to facilitate a just, speedy and inexpensive determination of every proceeding on its merits. Similarly, the Ontario Court of Appeal in *Marchand*, at paragraph 38, held that the purpose of expert evidence rules is to "facilitate orderly trial preparation by providing opposing parties with adequate notice of opinion evidence to be adduced at trial."
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> [29] In respect to specific content of expert reports, caselaw has consistently held that data, analysis and calculations relied upon to formulate an opinion must also be included. Providing this information by disclosing an expert's working files at trial has been held not to satisfy the requirements of the British Columbia Rules (*Goerzen*). The Ontario Supreme Court—High Court of Justice in *Transmetro* also concluded that the phrase "substance of the proposed testimony," referenced in the Old Ontario Rules respecting expert evidence, included supporting documents, calculations and other engineering background materials relied upon by an expert in formulating his opinion. Similarly, the Federal Court of Appeal in *Karam v. Canada (National Capital Commission)* (1977), [1978] 1 F.C. 403 (Fed. C.A.), held that, where an expert affidavit does not adequately explain an expert's reasoning, such expert should not be allowed to supplement the affidavit with verbal testimony until a supplementary affidavit has been filed and the opposing party has time to consider it.
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> [30] An expert opinion must be supported by underlying facts, calculations, research, documents, hypotheses or whatever it is the expert is relying upon to formulate his or her opinion. Such information must be stated and included in the report, otherwise the opinion is simply that: an unsupported opinion. Ms. Vallière's Report fails to comply with the form that Rule 145 dictates a report shall take. Further, as noted in Haughian, at paragraph 33:
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> … it is not simply a matter of form. It is not for plaintiff's counsel, or for that matter the court, to piece together various documents and attempt to determine what the report actually consists of. …

Every counsel calling an expert, and every expert, should read these passages before writing a report.

5. Justice Campbell did not agree to adjourn the trial to permit the respondent's counsel to correct the obvious defects and omissions. She simply excluded the report. She stated implicitly that Crown counsel are big boys. They should know better.

6. The Court repeated in her reasons the well-established principle that expert reports may be based on hearsay evidence but, while the inclusion of such assumptions in the report may be acceptable as a means of justifying the conclusion, it does not prove the truth of the facts relied on. If such facts are essential to the party's case they must be proved on an appropriate evidentiary basis.

7. The so-called “assumptions” which the Minister pleads and on which it is alleged the assessment is based must not be assumptions of mixed fact and law or assumptions of principles of law. They must be clearly only assumptions of fact. This is self-evident on the basis of simple fairness.

8. The Court deals at some length with the question of onus of proof. In *Bekesinski II* the respondent was left out in the cold—no expert report and wholly defective pleadings. Justice Campbell doubted the authenticity of the resignation, but she based her conclusion on the evidence before her, not on her own speculative conjecture. In paragraphs 52 and 53 of *Bekesinski II* she states:

> [52] I question the authenticity of the Resignation but, without the appropriate evidence before me, I must allow the appeal. The Respondent made a series of litigation choices which have resulted in my conclusion. The assumptions of fact contained in the Reply lacked clarity and precision that may have better stated the facts specific to the Respondent’s position, that is, that the Resignation had been backdated and was not an authentic document. Due to the lack of precision, the onus on the Appellant was limited to showing he was not a director of the Corporation during the relevant period. Incorrect choices were then made respecting the content of the proposed Expert Report on ink dating that was to be used to support the Respondent’s position that the Resignation had been backdated. Some of the exhibits also lacked relevancy to the specific issue. For example, copies of corporate searches, (Exhibit R-4) had been conducted outside the taxation years in question. In addition, as pointed out during cross-examination of the Respondent’s witness, none of the documentation, supporting Ms. Barlow’s testimony that the Appellant was advised in writing that he could be facing director’s liability, was introduced into evidence.
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> [53] In the end, I must deal with what is before me in evidence, despite my belief that the Resignation has been backdated.

The judgment is a truly commendable application of the frequently ignored adversarial principle of hearing and deciding cases in common law systems. It is reminiscent of the decision of the Scots court in *Thomson v. Glasgow Corporation*, 1961 Scots Law Times 237 per The Lord Justice—Clerk (*Thomson*). This exposition of the adversarial system set out in *Thomson* is cited in *Corsaut v. Canada*, 2005 TCC 112, and in *Francis v. The Queen*, 2007 DTC 903 (T.C.C.). The judicial obligation must be to assign an appropriate role to both the cerebral analysis and the visceral instinct. The respective weight of each will vary from case to case. Some judges are unaware of the distinction and if they are they muddle it.

9. *Health Quest* is a further illustration of the Tax Court’s application of the requirement for complete and accurate pleading of assumptions. The question was whether certain therapeutic shoes should be zero-rated for HST purposes. In paragraphs 31, 32, and 33 of the judgment in *Health Quest*, Justice Campbell said:

> [31] In the present appeal, since the Minister’s crucial assumptions are statements of mixed law and fact, they have placed the Appellant at a distinct disadvantage in determining the case it would have to meet. The Respondent has assumed how the law is to be applied to the facts and has assumed the shoes were not zero-rated pursuant to Schedule VI of the Act. Such an assumption is not one of fact but, rather, states the answer to the precise question that is before me to decide. It consists of the Respondent’s opinion on the applicability of the law to the facts of the appeal. This is precisely the type of assumption the Supreme Court of Canada (*Canada (Director of Investigation and Research)*) had in mind when the Court defined questions of mixed fact and law.
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> [32] The Reply contains no assumptions of fact, or material facts pleaded elsewhere in the Reply, that would do the following: clearly distinguish for the Appellant those features of the footwear for which the Minister alleges HST should have been collected and remitted as opposed to those features of the footwear where HST did not have to be collected. Assumptions (f) and (g) do not assist the Appellant in this regard and merely make a statement as to how the law applies to the facts. As well, there were no other such facts assumed elsewhere in the Reply. Consequently, there is no onus on the Appellant to demolish the Minister’s assumptions, as they are invalid.
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> [33] Where the Minister has not set out any proper assumptions of fact in the pleadings, the onus then reverts to the Minister to establish the correctness of the assessment.

These three cases breathe new life into the practice and procedure in Crown pleadings. They should be read by all tax counsel, particularly Crown counsel. The Crown has an unfair advantage in the pleading of assumptions in tax cases. These cases restore to tax litigation some semblance of a level playing field. It is to be hoped they will discourage and curtail some of the slapdash practices into which the Crown has been permitted to descend.

As former Chief Justice of the Tax Court of Canada, the Honourable Donald G.H. Bowman has extensive experience in resolving tax disputes. He is Counsel to Dentons' National Tax Group and shares his expertise with members of the group as a mentor and adviser. Based in the firm’s Toronto office, Donald works to enhance the firm's ability to reach *early resolution of tax and related disputes for its clients. His practice at Dentons consists of giving advice on tax matters, including tax litigation, to clients, lawyers in the firm throughout Canada, and lawyers in other firms.*

A number of tax lawyers from Dentons Canada LLP write commentary for Wolters Kluwer's Canadian Tax Reporter *and sit on its Editorial Board as well as on the Editorial Board for Wolters Kluwer's* Income Tax Act with Regulations, Annotated. *Dentons Canada lawyers also write the commentary for Wolters Kluwer's* Federal Tax Practice *reporter and the summaries for Wolters Kluwer's* Window on Canadian Tax. *Dentons Canada lawyers wrote the commentary for* Canada–U.S. Tax Treaty: A Practical Interpretation *and have authored other books published by Wolters Kluwer:* Canadian Transfer Pricing *(2nd Edition, 2011);* Federal Tax Practice; Charities, Non-Profits, and Philanthropy Under the Income Tax Act; *and* Corporation Capital Tax in Canada. *Tony Schweitzer, a Tax Partner with the Toronto office of Dentons Canada LLP and a member of the Editorial Board of Wolters Kluwer's* Canadian Tax Reporter, *is the editor of the firm's regular monthly feature articles appearing in* Tax Topics.

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NON-RESIDENT TRUST TAXATION—ISRAELI STYLE

- –Michael Goldberg, tax partner, Minden Gross LLP, MERITAS law firms worldwide

You may have thought we Canadians had it bad with our new section 94,[1]which has significantly broadened the scope of the Act to deem otherwise non-resident trusts ("NRTs") of Canada to be Canadian-resident trusts. You wouldn't be wrong in your feelings, but we don't have anything on the State of Israel's take on NRTs.

In that regard, at least it's still possible to have pure NRTs in Canada. These NRTs, which are sometimes called "granny trusts", can benefit Canadians and so long as no Canadian has made any type of transfer or contribution[2] to the trust, then it will not be taxable under the Act. As a result of the passage of the Israeli Arrangements Law (2013) ("IALAW"), as of January 1, 2014, this category of trust no longer exists under Israeli law.

Why should you care?

Because, if you have any clients that have trusts and any beneficiary of those trusts has always been or has become an Israeli resident,[3] then:

(1) (1)
unless certain elections (discussed below) are made, IALAW will apply to deem all of the worldwide income of that otherwise Israeli NRT to be taxable in Israel;

(2) (2)
tax treaties between Israel and its treaty partners will likely be inapplicable;

(3) (3)
penalties for failure to comply may be severe; and

(4) (4)
trustees may be personally liable for any failures to comply with IALAW and such violations may constitute felony offences in Israel.

How could Israel enforce its laws against NRTs of Israel and foreign trustees?

An interesting question—but that is no way to run a tax practice. Besides, it's not unusual for trustees to cross borders and for distributions to be made to beneficiaries (including Israeli residents) and, as information sharing becomes ever more integrated, all foreign countries, including Israel, may find new ways to enforce their laws.

What should you do if you think you may have clients in this situation?

You should get in touch with competent Israeli counsel as soon as possible. Assuming you will also be dealing with Canadian issues, finding a qualified Canadian lawyer to work with Israeli counsel to help them manage the complex cross-border issues posed by the legislation will also be critical.

Timing is particularly important because unless an otherwise NRT of Israel that is subject to IALAW elects to identify its Israeli beneficiaries and to choose one of two alternate Israeli taxation regimes[4] **on or before December 31, 2014**, the IALAW will cause the otherwise NRT of Israel to be taxable in Israel on its worldwide income.

The author would like to thank Israeli counsel for reviewing and commenting on earlier versions of this article. All errors and omissions are the author's sole responsibility.

Michael Goldberg, tax partner, Minden Gross LLP, MERITAS law firms worldwide and founder of "Tax Talk with Michael Goldberg", a quarterly conference call about current, relevant and real life tax situations for professional advisors who serve high net worth clients.

FRAUDULENT INVESTMENT SCHEMES

The Canada Revenue Agency ("CRA") provided general comments for taxpayers who are unwitting participants in fraudulent investment schemes, such as Ponzi schemes. Any income that the taxpayer receives from his or her investment in the fraudulent scheme should be included in income regardless of where the funds came from (e.g., even if the funds are from another taxpayer's investment). A deduction may be claimed for a bad debt in respect of investment income from the scheme that was included in income but was never received by the taxpayer. An amount received in cash or otherwise will reduce the bad debt deduction. The CRA noted that the taxpayer may claim a capital loss on the investment that is lost in the scheme. The timing for recognizing a bad debt or a capital loss would be when the scheme is exposed, such as when charges are laid against the perpetrator or at some earlier time depending on the facts. The CRA noted that if the taxpayer incurs a capital loss from shares or debt of a small business corporation the loss could qualify as a business investment loss. If a taxpayer subsequently recovers funds from the scheme through a legal settlement or otherwise, amounts relating to previously deducted bad debts or business losses will be included in income. Recovery of an amount relating to a previously deducted capital loss will be taxable as a capital gain.

—Ministerial Correspondence, July 3, 2014, Document No. 2014-0531171M6

INCOME TAX FOLIOS UPDATE

Effective September 19, 2014, the Canada Revenue Agency ("CRA") introduced two new Income Tax Folios concerning trusts. Income Tax Folio S6-F1-C1, Residence of a Trust or Estate—which cancels and replaces the May 30, 1980 Interpretation Bulletin IT-447, Residence of a Trust or Estate—provides updated CRA views on the determination of residency of a trust for Canadian income tax purposes, as well as for provincial purposes. To this end, Income Tax Folio S6-F1-C1 also clarifies that the residence of a trust is determined by where the business of the trust is carried on (basically, the location where the central management and control of the trust actually take place), as affirmed by the Supreme Court of Canada in *Fundy Settlement v. Canada*, 2012 DTC 5063.

Income Tax Folio S6-F2-C1, Disposition of an Income Interest in a Trust—which cancels and replaces the January 1, 1995 Interpretation Bulletin IT-385R2, Disposition of an Income Interest in a Trust—provides updated CRA views on the disposition of an income interest in a trust, as well as when proceeds are to be included in the transferor's income under subsection 106(2) of the *Income Tax Act*. As well as updating the definitions of "personal trust", "capital interest", and "qualifying disposition" to reflect legislative changes, Income Tax Folio S6-F2-C1 also provides comment on determining proceeds of disposition and the cost of an income interest, and clarifies that an income interest also includes a right to receive income as a trust beneficiary.

As with all newly introduced Income Tax Folios, there is a three-month comment period during which suggestions about content and structure may be sent to the CRA. Feedback on either of the above-mentioned Income Tax Folios may be emailed to folios@cra-arc.gc.ca until December 19, 2014.

Effective September 12, 2014, the Canada Revenue Agency ("CRA") updated Income Tax Folio S1-F2-C2, Tuition Tax Credit, to reflect legislative amendments pursuant to S.C. 2014, c. 20 (formerly Bill C-31). The updates to the Folio (which replaced and cancelled Interpretation Bulletin IT-516R2, Tuition Tax Credit) impact the calculation and transfer of unused tuition, education, and textbook tax credits, and are effective for the 2014 and subsequent taxation years.

Also effective September 12, 2014, the CRA revised and updated Income Tax Folio S1-F1-C2, Disability Tax Credit, to reflect the 2014 indexed amounts as well as legislative amendments effective for the 2014 and subsequent years. As well, the Folio is revised at paragraph ¶2.2(c) to clarify the certification required from medical practitioners. The updates to the Folio (which replaced and cancelled Interpretation Bulletin IT-519R2, Medical Expense and Disability Tax Credits and Attendant Care Expense Deduction) impact the calculation and transfer of the unused amount of certain tax credits, and are effective for the 2014 and subsequent taxation years.

A list of changes to any Folio can be found in its respective Chapter History section. These listings can be found on CCH Online under the Federal Income Tax heading and the subheading Income Tax Folios, Bulletins, and Circulars.

REPORT ON THE PUBLIC CONSULTATION FOR THE PROPOSED REGISTRATION OF TAX PREPARERS PROGRAM

- –Maureen Vance CPA, CA, Tax Software Consultant, Wolters Kluwer

Last January, the Honourable Kerry-Lynne D. Findlay, Minister of National Revenue, launched a consultation process with taxpayers and the tax preparer community on the proposed Registration of Tax Preparers Program (“RTPP”).

The consultation period ended at the end of May 2014 and the CRA has now published a report with the results of these consultations. The full report can be read on the CRA website at http://www.cra-arc.gc.ca/gncy/cmplnc/rtpp-pipdr/cnslttnppr-rslts-eng.html#h1.

In the report, the CRA indicates that it received significant feedback on the proposed RTPP through various consultation forums. The report notes that the resolution of several key issues raised during the consultations will be important to the development, implementation, and success of the RTPP, including the following:

- defining errors more precisely and clarifying the type of error that would be linked to tax preparers;
- ensuring existing registration systems are leveraged so that new registration processes and numbers are not needed to support the RTPP;
- allowing registration to occur at the appropriate level within a tax preparation business;
- determining whether education or tax competency standards should be considered as part of the RTPP;
- ensuring decisions related to sanctions and redress procedures are carried out in a timely and objective manner; and
- improving services and support for tax preparers to help reduce errors.

In addition, the CRA indicates that a strong desire was expressed for it to continue working with stakeholders in the tax preparation industry to resolve these issues as the program is further developed and implemented.

While the consultation paper indicated that the CRA expected to launch the program during the 2016-2017 fiscal year, the report does not refer to any time frame for implementation. The CRA indicated that options are being developed for CRA senior management to consider and that it will continue to work with external stakeholders as final program decisions are made, after which the legislative and policy framework will be advanced to support implementation of the RTPP and the internal infrastructure will be developed. Progress on this initiative will be communicated through periodic updates to the CRA website.

SUBMISSION BY THE CBA/CPA JOINT COMMITTEE ON TAXATION

In its submission dated September 26, 2014, the Joint Committee on Taxation of the Canadian Bar Association (“CBA”) and Chartered Professional Accountants of Canada (“CPA”) provided comment on the federal government’s August 29, 2014 draft legislative proposals. Representing (at times reiterated) concerns of the professional financial and legal community, the key emphasis of the committee’s comments was on the 2014 federal Budget’s proposed amendments to trust and estate rules. Addressed to the Tax Legislation Division of the Department of Finance, the joint submission covered issues including: (1) grandfathering and transitional provisions regarding the elimination of the immigrant trust rules; (2) how, what, and when a trust may make or amend a designation of an amount in respect of a beneficiary; (3) implications of proposals regarding trusts' deemed disposition of property as a consequence of the death of an individual, in the context of spousal/common-law partner trusts, joint partner trusts, and *alter ego* trusts; (4) the "anti-stuffing" anti-avoidance rule in the definition of the term "testamentary trust"; (5) definition and election regarding preferred beneficiaries in the context of qualified disability trusts; and (6) the treatment of capital and terminal losses in the context of an estate that is not a graduated rate estate. A complete version of the CBA/CPA submission can be found online under the "Canadian Tax Reporter Commentary" entry in the table of contents.

CRA RELEASES ADDITIONAL INFORMATION REGARDING THE SMALL BUSINESS JOB CREDIT

On September 16, 2014, the Canada Revenue Agency ("CRA") provided additional information regarding the recently announced Small Business Job Credit (the "Credit"). The Credit is a two-year measure that will be of interest to the almost 90% of small businesses whose employer Employment Insurance ("EI") premiums it is designed to lower. Importantly, the CRA clarified that parties are required to either record the Credit as business income or treat it as a reduction of EI expense when filing a business return for the year in which the Credit is received. The CRA also reiterated that it will automatically assess eligibility and calculate the amount of the Credit using EI information from businesses' 2015/2016 T4 information returns; the Credit will also automatically be recalculated when there are any amended, cancelled, or additional T4 slips. No credit will be allowed where the original T4 return or any amended, cancelled, or additional slips are received after January 1, 2019 or January 1, 2020 (for 2015 and 2016 returns, respectively).

Entities are eligible to receive the credit if in 2015/2016:

(1) (1)
they deducted EI premiums from remuneration paid to employees (or paid the worker's share of EI premiums in certain situations) and remitted both those premiums and the business share of EI premiums to the relevant payroll program ("RP") account;

(2) (2)
they filed the information in the RP account for 2015/2016 and reported the income and deductions on a T4 slip; and

(3) (3)
their total employer EI premiums paid for all RP accounts in 2015/2016 was $15,000 or less.

Where their employer EI premiums for all RP accounts under their business number ("BN") were not more than $15,000 in each of the 2015 and 2016 years, registered charities and non-profit organizations are eligible to receive the Credit.

The mechanics of the Credit are such that employer EI premiums will be recalculated from the 2015 and 2016 legislated rate of $1.88 to $1.60 per $100 of insurable earnings, with a refund of any amount past outstanding balances in payroll accounts. As well, an equivalent rate of $0.28 is to be applied to the EI premium in Quebec, owing to the different EI rates applicable under the Quebec Parental Insurance Plan. The CRA will determine entity eligibility for the Credit by adding the employer EI premiums for all RP accounts under a given BN, with the amount of the Credit assigned to each RP account being generally proportional to the amount of employer EI premiums paid into each account.

FOCUS ON CURRENT CASES

This is a regular 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.

LARGE RECEIPT HELD TO BE NON-TAXABLE

***Henco Industries Limited v. The Queen*, 2014 DTC 1161 (Tax Court of Canada)**

Justice Campbell Miller recently handed down his decision in *Henco Industries Limited*. The decision will be of interest to tax practitioners as it concerns several important substantive issues, such as the scope of paragraph 12(1)(x) of the *Income Tax Act* and the nature of inventory, as well as certain procedural issues, such as the applicability of the parole evidence rule in tax cases.

The taxpayer in the case was a corporation that owned three pieces of land in Caledonia, Ontario, which pieces are referred to as "DCE", "Seneca", and "Morrison". The taxpayer had been developing DCE with a view to selling it to home builders. In 2006, the property was the subject of a dispute between the Ontario government and certain members of the Six Nations of the Grand River, who claimed that DCE had been used as a native burial ground and objected to the site's development as a residential neighbourhood. The dispute eventually led to protests, the occupation of DCE, and, at times, violent clashes with the Ontario Provincial Police ("OPP"). The taxpayer obtained an injunction ordering the protesters to leave the property, but the protesters refused and the OPP was unwilling to force them to move. Midway through the crisis, the Ontario government made a $650,000 payment to the taxpayer that the government described in a letter as being in respect of the "costs and expenses" incurred by the taxpayer in connection with the occupation of DCE. Later, the Ontario government entered into an agreement with the taxpayer requiring the government to make a further $15.8 million payment in exchange for DCE, including a commitment by the taxpayer to cease carrying on business; to request that the injunction it had obtained be lifted; and to refrain from taking further legal action against any person in connection with the property. At about the same time, the taxpayer decided to sell Seneca and Morrison to a related corporation on a taxable basis (although the reasons for judgment do not specify the reason for the sale).

In filing its tax return, the taxpayer took the position that the $650,000 payment was a non-taxable capital receipt and that the $15.8 million payment gave rise to a deduction in computing its cumulative eligible capital. The taxpayer also took the view that the gain on the disposition of Seneca was a capital gain, since the taxpayer had acquired the property for the purposes of building and operating a golf course, and that the property's value at the time of the sale was $800,000. Morrison, on the other hand, was treated by the taxpayer as inventory with a value of $1 million. The CRA reassessed the taxpayer on the basis that the $650,000 and $15.8 million payments were income; that the values of Seneca and Morrison (presumably for the purposes of section 69) were $850,000 and $1.4 million, respectively; and that the amount received on the sale of Seneca was on income account.

Miller J began his analysis by giving his reasons for certain evidentiary rulings handed down at trial. The first concerned the admissibility of extrinsic evidence concerning the dispute with the protesters under the parole evidence rule, which prohibits the use of verbal testimony in interpreting a written contract except to the extent that the contract contains a patent or latent ambiguity. Miller J held that the rule did not prevent the Court from considering evidence concerning the context and factual matrix surrounding a contract, and that even if this were not the case the contract in this matter was ambiguous. Miller J also questioned whether it was appropriate to apply the parole evidence rule in cases in which the objective is not to determine the rights and obligations of the parties under a contract but, rather, to ascertain their intentions in making or receiving payments for tax purposes. The second evidentiary issue concerned whether or not affidavits in an unrelated proceeding sworn by certain Ontario officials regarding the dispute with the protesters and press releases issued by other officials could be admitted into evidence under the "public documents" exception to the hearsay rule. Miller J wrote that the purpose for this exception was to prevent busy officials from being required to testify in situations in which they could not reasonably be expected to provide any more guidance on a matter than what was already expressed in the relevant document. Miller J concluded that this reasoning supported the admissibility of the press releases but not the affidavits.

Turning to the substantive issues in the case, Miller J considered the nature of the $650,000 payment. According to the Minister, the payment must be included in the taxpayer's income under paragraph 12(1)(x). Miller J disagreed, stating that the payments could not be considered to have been received "in the course of earning income from a business". While Henco was still "in business" at the time it received the payment, it was not in a position to earn income from that business due to the occupation. In the alternative, Miller J held that the payment did not qualify as "assistance [...] in respect of an outlay or expense" within the meaning of subparagraph 12(1)(x)(iv). While the government had referred to the payment as being in respect of expenses incurred in connection with the dispute with the protesters, that was Ontario's view, but not necessarily that of the taxpayer. In addition, there had been no requirement to use the payment for any particular purpose, and the taxpayer was not required to account for the amount of expenses actually incurred.

The next issues dealt with by the Court concerned the sale of the Seneca and Morrison properties. Miller J held that the taxpayer had not met its burden of proving that it intended to develop and operate a golf course on the Seneca property. Thus, Seneca was inventory and the disposition of the property was on income account. That said, an expert valuation obtained by the taxpayer supported the view that its value had been $800,000, so that value was accepted by the Court rather than the $850,000 as maintained by the Minister. With respect to Morrison, the expert report before the Court supported the Minister's claim that the property was worth $1.4 million, rather than $1 million as maintained by the taxpayer. The sole evidence tendered in support of the taxpayer's valuation had been its general impression of the damage caused by the dispute with the protesters. This was not sufficient to demolish the Minister's assumption.

Regarding the $15.8 million payment, Miller J wrote that four questions needed to be answered:

(1) (1)
was the payment received in exchange for DCE;

(2) (2)
if so, did DCE constitute inventory or capital property;

(3) (3)
if the payment was for something other than DCE, was it on income or capital account; and

(4) (4)
if the payment was on capital account, must it be deducted in computing the taxpayer's cumulative eligible capital.

With respect to the first question, Miller J held that the $15.8 million payment was not for DCE. The property was essentially worthless at the time of the payment, making it unlikely that the government would pay $15.8 million in order to obtain it. According to the Court, the government's real purpose was to extinguish the taxpayer's right to sue it or take steps to enforce the injunction it had obtained, thus inflaming the crisis. The taxpayer's goal, on the other hand, had merely been "to salvage what it could from the destruction of its business". In *obiter*, Miller J added that if the $15.8 million payment had been for DCE, it would have resulted in the realization of a capital gain. DCE was no longer inventory at the time the payment was made as it was a "useless, worthless piece of land that had no market" and was "legally useless for development." While the property could not properly be described as an "investment", property that was neither inventory nor an investment constituted capital property "by default".

Having determined that the $15.8 million payment was not for DCE, Miller J considered whether it constituted a capital receipt. Relying on a series of cases dealing with contract termination payments (e.g., *PE Ben Industries Co.*, *BP Canada Energy Resources Co.*, and *River Hills Ranch Ltd.*), Miller J held that the $15.8 million payment was on capital account because it had compensated the taxpayer for the total "destruction" or "sterilization" of a capital asset (namely, its business). It had not simply replaced isolated amounts that would otherwise have been included in the taxpayer's income.

Miller J concluded by considering the taxpayer's argument that the $15.8 million payment had not reduced its cumulative eligible capital (i.e., the taxpayer had decided to object to its filing position in this regard). An election had been filed by the taxpayer to have the mirror image test in the former version of section 14 apply to its 2006 taxation year. Applying this test, the Court concluded that the $15.8 million payment, if made by the taxpayer, would not have constituted an eligible capital expenditure. From the perspective of the Ontario government, the payment could not have been considered to have been made for the purpose of earning income as required by the definition of the term "eligible capital expenditure" in subsection 14(5), and the same was clearly true if the taxpayer's perspective were adopted, since the payment had ultimately resulted in the destruction of its business. The result was that the $15.8 million was completely non-taxable.

While the facts in the *Henco* case are rather unique, the case contains many important statements. Of particular interest is Miller J's finding that a payment can be received by a taxpayer in connection with a business without being received in the course of earning income from that business. The Court's suggestion that inventory that becomes worthless and incapable of use ceases to be inventory is also notable, as is its conclusion that a payment received for property that is not inventory is by default a capital receipt. It is unfortunate that the taxpayer's election to have the mirror image test apply prevented

Miller J from commenting on the current version of element E of the definition of "cumulative eligible capital", as it has been criticized by many tax practitioners as being circular and difficult to apply.

Thus far, *Henco* has not been appealed.

—*Ryan Rabinovitch*

RECENT CASES

CERTAIN DOCUMENTS AT ISSUE WERE PRIVILEGED SOLICITOR-CLIENT COMMUNICATIONS, BUT NON-PRIVILEGED DOCUMENTS TO BE DISCLOSED TO CRA

The taxpayers alleged solicitor-client privilege over certain documents requested by the Minister of National Revenue (the "Minister") under a requirement for information issued under section 231.1 of the *Income Tax Act*. The Minister took the position that at least some of the documents were not privileged. The taxpayers identified and marked a number of documents as subject to privilege and forwarded the same to the local sheriff's office. The companies were related as having received legal and accounting advice in the course of reorganization of the businesses.

The taxpayer was required to disclose certain documents while others were protected by solicitor-client privilege. The Court had jurisdiction to rule on this matter. There were different classes of documents reviewed by the Court, some of which were to be disclosed while others were not. Where the material was tied directly to legal advice, it was held to be privileged, whether rendered directly to the clients or to their accountants as a conduit or agent of the taxpayers.

Redhead Equipment Ltd., 2014 DTC 5102

STOCK OPTION BENEFIT RECEIVED BY TAXPAYER FROM EMPLOYER IN NON-ARM'S LENGTH RELATIONSHIP NOT REQUIRED TO BE INCLUDED IN INCOME

In reassessing the taxpayer for 2004, 2005, and 2006, the Minister assumed that the taxpayer's relationship with his corporate employer, Forages Garant, was not at arm's length and denied him the stock option deduction in paragraph 110(1)(d) of the *Income Tax Act* (the "Act") relating to the stock option benefits that he had acquired from Forages Garant and that had been included in his income under section 7 of the Act. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was allowed. No stock option deduction is available under paragraph 110(1)(d) of the Act unless the employer and the employee are at arm's length. In addition, the parties agreed that if Forages Garant and the taxpayer were found not to be at arm's length, no benefit resulting from the taxpayer's disposition of his stock options could be included in his income under section 7. However, the question remained as to whether any stock option benefit could be included in the taxpayer's income as an employee "benefit" under paragraph 6(1)(a) as the Minister was seeking to do. Although separated, the taxpayer and his wife were not divorced and, hence, were still "connected … by marriage" within the meaning of paragraph 251(2)(a). This was because, under the laws of Canada, a marriage is not dissolved except through divorce or death (section 14 of the *Divorce Act*; article 516 of the Quebec *Civil Code* contains the same provision). The taxpayer was not at arm's length with Forages Garant because of the interrelationships of the various shareholders of Forages Garant, including the taxpayer himself. As the parties had agreed, this meant that no stock option benefit could be included in the taxpayer's income under section 7. And, despite the Minister's argument to the contrary, no stock option benefit could be included as a "benefit" in the taxpayer's income under the general employee benefit provisions of paragraph 6(1)(a) either, because of the specific language in paragraph 7(3)(a), which makes paragraph 6(1)(a) inapplicable in this case. Section 7 contains a complete code concerning the inclusion in income of stock option benefits, and this specific legislative treatment prevails over the general provisions of paragraph 6(1)(a) (see *Canada v. Chrysler*, [1992] FCA 370). The Minister was ordered to reassess accordingly.

Mathieu, 2014 DTC 1165

Footnotes

[1] Of the *Income Tax Act* (Canada) (“Act”).
[2] Contributions and transfers have almost unimaginably wide meaning under section 94 of the Act.
[3] There are exceptions that will make the IALAW legislation inoperative if the only Israeli beneficiaries are qualifying new residents in Israel, studying in Israel, or engaged in military service in Israel.
[4] The first regime will only apply to income of the trust attributable to Israeli beneficiaries, which will be subject to Israeli tax at a 25% rate and the second regime will only be applicable to distributions that are made to Israeli residents and will tax such distributions at a rate of 30%. The application of each of these regimes, including the determination of the income of the trust and how it is to be allocated among beneficiaries is complex and evolving. In both cases, ongoing Israeli tax compliance will be required regardless of whether or not tax is payable or distributions are made in any particular year.