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THE 2015 CRA ROUNDTABLE AT THE CTF ANNUAL CONFERENCE

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The 2015 Canadian Tax Foundation's 67th Annual Conference was held in Montreal from November 22 – 24, 2015. At the conference, the Canada Revenue Agency (the "**CRA**") participated in an extensive roundtable discussion covering a number of issues related to its interpretation of the *Income Tax Act* (Canada) (the "**Act**"). Included in the discussion were an update on the CRA's administrative position on certain deferred share unit ("**DSU**") plans, the treatment of a taxpayer's refundable dividend tax on hand ("**RDTOH**") account in circumstances where the corporate tax return is filed late, and the CRA's views on the application of the proposed amendments to section 55 of the Act. These issues and the CRA's responses are discussed below.

The CRA representatives at the roundtable were Randy Hewlett and Stephane Prud'homme, who were joined by private practitioners Bruce Ball of BDO Canada LLP and Mark Jadd of Dentons Canada LLP. Anne-Marie Levesque of the CRA also gave a brief presentation on current issues related to objections to assessments.

DSU

A DSU plan is a form of deferred equity compensation plan where, pursuant to an agreement between a corporate employer and an employee, the corporation agrees to make a payment to the employee only after the time of the employee's death, retirement, or loss of office or employment, and the amount which may be received under the agreement depends on the fair market value of the corporation's shares over a particular period. A DSU plan is a prescribed exemption from the definition of "salary deferral arrangement" ("**SDA**") in subsection 248(1) of the Act and is permitted in accordance with paragraph (*l*) of that definition and subsection 6801(d) of the *Income Tax Regulations*. A plan that fails to qualify as a DSU plan risks falling into the broad definition of SDA. Where a plan is an SDA, subsection 6(11) generally requires an income inclusion on a current basis in the hands of the employee (and potential withholding obligations to the employer).

Another exemption from the SDA rules is found in paragraph (*k*) of that definition, which excludes amounts that are paid within three years (a "**paragraph (*k*) plan**"). In the past, the CRA had provided advance income tax rulings on a conversion of a paragraph (*k*) plan to a DSU plan without triggering tax. At the roundtable, the CRA was asked why it has stopped issuing such rulings and whether there was a change in its administrative position such that conversions were no longer permitted. The CRA noted in response that a conversion of rights under a paragraph (*k*) plan to rights under a DSU plan would effectively mean that the plan fails to satisfy either test. In the first instance, a paragraph (*k*) plan that becomes a DSU plan would therefore permit the payment of an amount beyond the three year window. Conversely, the conversion of a DSU plan to a paragraph (*k*) plan could result in payments being made out of the plan otherwise than on the death, retirement, or loss of office or employment of the individual. In the view of the CRA, this would be an inappropriate result. The CRA is of the view that the operation of these provisions does not permit the terms of a plan to provide the flexibility to convert from a paragraph (*k*) plan to a DSU plan, or vice versa. Accordingly, the CRA will not accept any plan that provides a taxpayer with such conversion rights.

The second question addressed by the CRA on DSU plans related to the integration of the DSU plan rules with certain U.S. deferred equity plans permitted under section 409A of the United States Internal Revenue Code (a "**409A plan**"). In many cases, a U.S.-based employer will seek to have Canadian employees participate in an existing 409A plan to provide for equal treatment of employees and ease of administration. Under a 409A plan, upon the occurrence of certain events, a distribution out of the plan is permitted without the death, retirement, or loss of office of the employee. For example, if there is a change in control of the employer, or an unforeseeable emergency, distributions can be made. In the CRA's view, any plan that allows for distributions to be made prior to the death, retirement, or loss of office or employment of the taxpayer cannot be a DSU plan. The CRA did note, however, that certain plans can qualify as DSU plans and 409A plans, provided that the full range of distribution events permitted under 409A plans are not in the plan terms.

RDTOH and Late-Filed Returns

Under section 129(1) of the Act, a corporate taxpayer must file a tax return for the year in which it is claiming a dividend refund within three years of the end of the year in which the refund arose. Where this limitation is missed, RDTOH can become unrecoverable unless the taxpayer is able to pay another taxable dividend at a later time to trigger a refund. The courts have been clear that this three-year filing deadline is absolute. However, in at least three instances which have received judicial consideration, the CRA has taken the position that the original taxable dividend reduces the RDTOH balance although the dividend refund cannot be paid due to the three-year limitation having expired. See *Tawa Developments Inc. v. The Queen* (2011 DTC 1324), *Presidential MSH Corporation v. The Queen* (2015 DTC 1101), and *Nanica Holdings Limited v. The Queen* (2015 DTC 1111). The CRA was asked at the roundtable if it would continue to assess taxpayers on the basis that a dividend refund that is unrecoverable due to a late-filed return nonetheless reduces the corporation's RDTOH balance.

The CRA acknowledged that in light of the case law it would no longer assess taxpayers on the basis that unrecoverable dividend refunds reduce RDTOH balances. In addition, the CRA added that in considering the Part IV tax liability of a connected corporation that receives a dividend from a corporation with RDTOH, it would only assess Part IV tax on the recipient where the payer corporation actually received its dividend refund. The CRA noted that it will continue to monitor the impact of the recent decisions in this particular context, as well as in the context of interpreting other provisions in the Act which include the concept of dividend refund.

Section 55

The CRA representatives at the roundtable spent a significant portion of the discussion on their interpretation and administrative positions surrounding the proposed amendments to section 55 of the Tax Act.[1] The 2015 Federal Budget included a significant overhaul of the anti-capital gains stripping rule in section 55 of the Act. While ostensibly targeted at transactions that utilized stock dividends to inflate the adjusted cost base of shares of a corporation or otherwise manipulate the safe income of a group of corporations, the draft legislation (which was subsequently released on July 31, 2015 for public comment) contained far-reaching changes. Of particular concern to taxpayers and their representatives is the elimination of the related party safe harbour for inter-corporate dividends in paragraph 55(3)(*a*) of the Act. Under the proposed legislation, that safe harbour will apply only to deemed dividends arising under subsection 84(2) or 84(3).

[1] These changes were discussed by the author in Tax Topics No. 2257 "Proposed Amendments to Section 55 Contain Unwanted Surprise" (June 11, 2015).

The CRA addressed several questions on the application of the proposed amendments.

First, the CRA was asked to discuss its views on the application of proposed clause 55(2.1)(*b*)(ii)(A), which would trigger the application of subsection 55(2) where a dividend has been paid on a share and one of the purposes of the dividend was to effect a significant reduction in the fair market value of any share. Since every dividend results in reduction in the fair market value of a share (since assets have been transferred to the shareholder), the CRA was asked to describe the factors or tests they would consider in deciding whether a reduction of value is significant.

The CRA noted that numerous factors will be looked at, including the actions taken by the parties to the dividend and their motivation. The CRA noted that, in the case of an ordinary dividend, it is not a results-based test (as it would be in the case of a deemed dividend under subsection 84(3)). The CRA stated that the question to be asked is "what does the taxpayer intend" to achieve with the reduction in value and what benefit does this confer on the taxpayer. The CRA noted that, for example, a dividend which created losses on a share used to shelter a gain would provide an indication that the purpose test was met. This reasoning seems somewhat perplexing – effectively looking at the results to determine the purpose, which suggests we are back into a results test. The CRA stated that in its view, this would be consistent with the Supreme Court of Canada's interpretation of purpose tests more generally in *Ludco* (2001 DTC 5505).

The second question the CRA considered was the application of the new rules to an intra-group loss consolidation plan between related or affiliated corporations involving the payment of dividends between the corporations. The CRA confirmed that it would not apply subsection 55(2) to such dividends and that it has provided this opinion in recent rulings.

Third, the CRA was asked a question on whether non-participating, non-voting preferred shares that allow for discretionary dividends could have safe income attributed to them. Due to the change in paragraph 55(3)(*a*) noted above, the importance of safe income in inter-corporate dividends in related-party contexts has greatly increased. In this question, it was assumed that no safe income would be attributed to the discretionary dividend share. However, the CRA was asked for its views on the impact on the other classes of participating shares.

The CRA noted that a discretionary dividend that has no accrued gain cannot reasonably have safe income attached to it, since no part of the corporation's safe income can reasonably be attributed to the growth on that share (as there is no such growth). Accordingly, any dividend on such shares would need to be considered in light of the purpose tests to determine if subsection 55(2) should be applied.

The CRA was of the view that the dividend nonetheless results in the reduction of safe income to the other shares since the capital gain on those shares would be reduced by the dividend and the portion of the income that was paid out as a dividend no longer supports the capital gain.

The fourth question the CRA considered on the proposed changes to section 55 was on the deliberate use of share redemptions to enable a corporation to fit into the paragraph 55(3)(*a*) related-party exemption. As noted above, under the proposed rules, 55(3)(*a*) will no longer apply to cash dividends paid on a share. Accordingly, one workaround for this issue would be to convert certain of the shares to redeemable shares equal to the desired dividend and simply redeem the shares, triggering a dividend under subsection 84(3) which would then presumably be protected by the 55(3)(*a*) safe harbour. The CRA's response was helpful; they noted that the purpose of these proposed rule changes was to address transactions which resulted in the artificial generation or manipulation of tax basis, or the reduction of the fair market value of a share which potentially resulted in a fabricated loss. The CRA appears to take the view that the limitation in paragraph 55(3)(*a*) was to prevent the use of a dividend in kind that created basis from relying on the related party exemption. Although the CRA did not explicitly condone the intentional use of share redemptions, it was nonetheless noted that since a redemption or cancellation of shares does not normally result in an increase in tax basis (indeed, basis in the redeemed or cancelled shares is lost) such transactions would not appear to be problematic from the point of view of section 55. This was subject to the caveat that the use of redemptions to create or stream cost basis would not be acceptable. An example of an inappropriate result given by the CRA was the redemption of shares using a note, which was then contributed back to the corporation for new shares having high tax basis. This would be unacceptable planning in the view of the CRA, and if the paragraph 55(3)(*a*) exemption otherwise did apply, presumably they would seek to reassess using the general anti-avoidance rule.

The fifth question on the new section 55 rule concerned the use of dividends to achieve creditor proofing. For example, an operating company would pay a dividend to a holding company out of surplus funds. Those funds could be invested elsewhere by the holding company, or even loaned back to the operating company on a secured basis. Absent the related-party safe harbour in paragraph 55(3)(*a*), subsection 55(2) could apply to the dividend. There is no plan to sell and in fact any sale may occur at the holding company level.

The CRA noted that it would be a question of fact in each case where a so-called "lumpy" dividend was paid whether subsection 55(2) could apply. The CRA said to provide comfort it would be a "healthy practice" to maintain safe income on an ongoing basis.

Additional Questions

A number of additional questions were also presented to the CRA at the roundtable.

The CRA was asked for its view on provincial trust residency in light of recent case law. The CRA stated that it would continue to look at the principles expounded in the *Fundy Settlement* (2012 DTC 5063) decision to determine the residency of a trust for provincial tax purposes, in particular looking to determine the true controlling mind of the trust using the "central management and control test".

The CRA also updated its position on "private health services plans". The CRA stated that the eligibility of the plan would be determined based on whether 90% or more of the plan's expenses qualify for the medical expense tax credit. This rule came into effect on January 1, 2015.

The CRA advised that it would continue to consider limited liability companies as corporations for Canadian tax purposes. In addition, it is evaluating the status of Florida limited liability partnerships and limited liability limited partnerships. While a formal position has not been reached, the CRA is leaning towards a position that such entities are corporations for Canadian tax purposes. A decision is expected in the coming weeks.

In addition, the CRA announced that the GAAR committee has concluded that certain surplus stripping techniques relying on section 55 to convert a dividend to a capital gain are unlikely to be successfully challenged under the GAAR. The CRA was not happy with this result and has raised the issue with the Department of Finance.

The CRA also stated that under the foreign affiliate upstream loan provisions, a winding up of a foreign affiliate which has made an upstream loan to a Canadian shareholder would result in an income inclusion for the Canadian taxpayer. In the CRA's view, the upstream loan rules do not permit an alternative interpretation. The CRA has raised the matter with the Department of Finance.

Finally, the CRA discussed an issue involving the application of the thin capitalization rules where the loan to the Canadian taxpayer is denominated in a foreign currency. The CRA had previously taken the position that the loan should be converted to Canadian dollars every time that a thin capitalization computation had to be made – with the result that thin capitalization ratios could be breached from time to time. The CRA announced that this position was no longer tenable with the introduction of section 261 and its position now is that a loan should be converted to Canadian dollars for thin capitalization purposes at the time the loan is made.

The CRA concluded the roundtable by providing its view that expenses to travel to a warm weather climate, even under the guidance of a medical doctor, would not qualify for the medical expense tax credit.

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.

CURRENT ITEMS OF INTEREST

Registered Plan Directorate announces new registered plan limits for 2016.

On November 20, 2015, the Registered Plans Directorate announced that:

- the money purchase limit for registered pension plans for 2016 will increase to $26,010, up from $25,370 in 2015;
- the 2016 defined benefit (DB) limit will increase to $2,890, up from 2.818.89 for 2015;

- the maximum pensionable earnings limit for 2016 will increase to $54,900, up from $53,600 in 2015;
- the deferred profit sharing plan limit for 2016 will increase to $13,005, up from $12,685 in 2015; and
- the RRSP contribution limit for 2017 will increase to $26,010, up from $25,370 for 2016.

Canada Revenue Agency announces new position on private health services plans

On November 25, 2015, the Canada Revenue Agency ("CRA") announced that it has taken a new position on what qualifies as a private health services plan ("PHSP"). The CRA now considers that a plan is a PHSP as long as all **or substantially all** of the premiums paid under the plan relate to medical expenses that are eligible for the medical expense tax credit ("METC"). The CRA's old position was that **all** medical expenses covered under a plan had to be eligible for the METC for the plan to qualify as a PHSP. The new position came into effect January 1, 2015. All or substantially all generally means 90% or more. Therefore, in most cases, 90% or more of the premiums paid under a plan have to be for coverage of medical expenses that are eligible for the METC.

RECENT INCOME TAX INTERPRETATIONS

This is a regular feature summarizing recent noteworthy income tax interpretations issued by the Minister of National Revenue. Copies of these interpretations can be found in the Wolters Kluwer online Federal Income Tax service, under Window on Canadian Tax.

Test Wind Turbines

In September 2013, the CRA confirmed that the wind turbines that a taxpayer planned to build and install at a location were "test wind turbines" within the meaning of this term in Regulation 1219(3). Two years later, it was asked if the above interpretation was still valid if the turbines were built and installed at a different location. The CRA confirmed that the original interpretation was still valid if no changes were made to the original project and all conditions, limitations, qualifications, and comments included in the original interpretation were still applicable.

— *External Technical Interpretation,* ¶13,178

Location of Services Rendered by a Foreign Call Centre

The CRA confirmed that a Canadian resident corporation which had outsourced the operation of its call centre to a foreign entity would not have to deduct Canadian withholding tax from the service fees paid to the entity since the services would be rendered outside Canada. The nature of those services involved operators all based in a foreign country receiving and processing all phone calls from the corporation's Canadian customers. Therefore, the services would be deemed rendered in a foreign country, not in Canada, and the fees would be exempt from any Canadian withholding tax.

— *External Technical Interpretation,* ¶13,181

T4A Reporting of Elementary or Secondary Scholarship

The CRA confirmed that any school that has granted a scholarship to an elementary or secondary school student has to report the scholarship amount on form T4A. The form has to be distributed to the recipient and the CRA even if the amount is excluded from the recipient's income under section 56(3)(*a*)(ii) of the Act.

— *External Technical Interpretation,* ¶13,186

RECENT CASES

Misrepresentation by taxpayer allowing minister to reassess beyond normal reassessment period

The taxpayer exercised certain stock options during the 2006 and 2007 taxation years but failed to report the option benefits on his tax returns for those years. The minister initially assessed both returns as filed, but in 2011 issued a reassessment for both years. The taxpayer appealed from those reassessments on the basis that his failure to report the option benefits was due to an erroneous understanding of the applicable rules, and that there was no misrepresentation due to neglect or carelessness such as would permit the minister to reassess the returns beyond the normal reassessment period.

The appeal was dismissed. The parties agreed that there was no wilful default involved in the taxpayer's failure to report as required, and therefore the issue for determination by the Court was whether the misrepresentation which occurred was attributable to neglect or carelessness. The Court noted that, where such neglect or carelessness is alleged, the minister bears the burden of proving, on a balance of probabilities, that both elements were present and that the misrepresentation occurred through a lack of reasonable care.

The appellant argued that his erroneous understanding of the tax law was a reasonably held belief not borne of neglect or carelessness. The jurisprudence provides, however, that an honest mistake of law can lead to a finding of neglect or carelessness. In the Court's view, a reasonably informed person, such as the taxpayer, is expected to exercise the degree of reasonable care that a wise and prudent person would in the same circumstances. The test to be applied is an objective one, and the Court held that it would not have been reasonable for a wise and prudent person to remain ignorant of the law in the taxpayer's circumstances. In the Court's view, the taxpayer should have at least raised the issue of the taxation of the stock options with his professional advisers, but he failed to do so.

The Court noted that the purpose of the statutory provisions extending the time period during which the minister can reassess is not punitive in nature. Rather, the purpose is to ensure that in a self-reporting tax system, misrepresentations that occur as a result of honest mistakes do not go unassessed through taxpayer inadvertence. The Court concluded that the minister's right to reassess should not be lost by virtue of an honestly held mistake of law and consequent undisclosed benefits. The minister had met the required onus and established that a misrepresentation due to neglect had occurred. Consequently, the reassessments issued by the minister in 2011 had been issued on a timely basis.

¶49,196, *Robertson v. The Queen*, 2015 DTC 1207

Minister's assessment of adjusted cost base of inherited property affirmed

The taxpayer was one of three beneficiaries of her father's estate. The deceased's will provided that each beneficiary would receive one-third of the residue of his estate, of which the major asset was his residence. In 2000, the taxpayer and her husband made a monetary transfer to another beneficiary and title to the residence was transferred from the estate trustees to the taxpayer and her husband. In 2004, they transferred the property to their son, for nominal consideration. The minister assessed capital gains tax on that transfer, based on the property having an adjusted cost base ("ACB") of $100,930 and proceeds of disposition of $260,000. The taxpayers appealed from that assessment, disputing both the adjusted cost base and the proceeds of disposition used by the minister.

The appeals were allowed in part. The *Income Tax Act* provides that a taxpayer is deemed to have disposed of his or her property immediately prior to death at a cost equal to its fair market value, and that a beneficiary is deemed to have acquired the property at a cost equal to that amount. The Court found, however, that the beneficiary of the property at issue was not the taxpayer, but the estate of the deceased. The taxpayer was entitled to receive one-third of the residue of the estate, and appellate jurisprudence on the issue provides that an entitlement to the residue of an estate does not amount to a property interest in specific estate assets. The property devolved onto the estate, and it was the estate which had an ACB of the property equal to its fair market value immediately prior to the owner's death. The ACB of the property to the taxpayer was the amount of consideration paid by her to acquire sole title to the property, and that amount was assessed by the minister as being $100,930. The Court then considered the fair market value of the property at the time of the 2004 transfer, and settled on a value mid-way between the amounts set by two valuators. The appeal was allowed, and the assessment referred back to the Minister for reassessment on the basis that there was no adjustment to the ACB of the property, but that deemed proceeds of disposition on the 2004 transfer were $236,500.

¶49,200, *Bueti v. The Queen*, 2015 DTC 1213

Application seeking additional information and documentation from minister denied

The taxpayers owned a waste management business, and, in the course of operating that business, made certain expenditures for supplies. They claimed a deduction for those expenditures as business expenses and that deduction was denied by the minister on the basis that the expenditures were for personal rather than business expenses. The taxpayers appealed from that assessment, and, in the course of the litigation, brought an application seeking to have the Court require the minister to provide additional information and documentation related to his assessment, including information involving the tax affairs of third parties.

The application was denied. At the outset, the Court noted that the key to any question on discovery is limited by relevance, which must be broadly and liberally construed, with wide latitude to be given. Relevance is to be determined by reference to the issues set out in the pleadings, and a question is relevant where it might fairly lead to a train of inquiry that may either advance the questioning party's case or damage the case of its adversary. As well, a motions judge ruling on an application should not unduly restrict an examination by excluding questions broadly related to the issues, or seek to impose his or her views of relevancy where the trial judge may, in the context of the evidence as a whole, have a different view. Finally, the motions judge noted that the general principle is that taxpayer information is confidential. While an exception exists in respect of legal proceedings relating to the administration or enforcement of the tax law, the Courts will order disclosure of such information only where that information is relevant to the issues or was relied upon by the minister in making the assessment in issue.

The motions judge then reviewed each of the follow-up questions put by the taxpayer in light of both those principles and the issues raised in the pleadings. The judge concluded that in each case the information sought was not relevant or had not been relied upon by the minister in issuing his assessment, or that the minister had already answered the questions put and did not need to respond further. The minister was therefore not required to answer follow-up questions or produce additional documents.

¶49,197, *Tor Can v. The Queen*, 2015 DTC 1208

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