Introducing CaseNotes

Moodys
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As tax practitioners, a good chunk of our careers are spent keeping up-to-date on changes in tax law. Changes can arise from legislative amendments, case law that helps to interpret complex statutes or interpretations on legislation from the tax administrator—the Canada Revenue Agency (Canada) or the Internal Revenue Service (United States). In the midst of keeping current, we routinely come across interesting material that we share with clients and colleagues. It occurred to us that this material should be routinely and broadly shared. And thus, the lightbulb went on—why not create a companion to our firm's blogs that is regular and recurring—bi-weekly—and essentially shares with our friends our recent learnings that are relevant to our clients. Accordingly, welcome to CaseNotes—our firm's attempt to share with you in short, recurring, and in plain English as possible, our lightbulb moments. We hope you enjoy it!

- **Colitto v. The Queen, 2016-3168(IT)G, by Dallas Kleckner**

In the recent Tax Court of Canada decision of *Colitto v. The Queen*, the Court was tasked with examining the interplay between section 160 and 227.1 of the *Income Tax Act* (the "Act"). Each section, described further below, permits the Minister of National Revenue (the "Minister") to collect tax debts owed by one taxpayer from another provided certain criteria are met. In the instant case, Mr. Colitto was assessed under the director liability provision of section 227.1 for failing to remit source deductions on behalf of his corporation. Subsequently, a transfer of property between Mr. Colitto and his spouse, Ms. Colitto, prompted the Minister to issue a notice of assessment against Ms. Colitto under section 160 for Mr. Colitto's purported tax liability. Prior to this decision, the application of these provisions, in combination, had not received judicial consideration.

Facts:

- February 2008 to August 2008 – Corporation fails to remit source deductions;
- May 2, 2008 – Mr. Colitto transfers an interest in real property to his wife Ms. Colitto for nominal consideration;
- October 10, 2008 – Corporation is issued Notice of Assessment;
- November 23, 2010 – Direction to enforce writ for the unpaid tax debt is filed with Federal Court;
- January 4, 2011 – Writ of seizure executed by Sheriff and returned unsatisfied;
- March 28, 2011 – Mr. Colitto assessed under section 227.1 of the Act; and
- January 13, 2016 – Ms. Colitto assessed under section 160 of the Act.

Issue:

Is Ms. Colitto jointly and severally liable with Mr. Colitto pursuant to section 227.1 and paragraph

160(1)(e) of the Act in respect of the May 2, 2008, transfers of property?

Held:

No. Section 160 requires the transferor to be liable for tax in the [transferor's] taxation year in which the transfer is made. However, until such time that the preconditions set out in subsection 227.1(2) are met, no liability exists.

Discussion:

Sections 160 targets situations whereby a tax debtor transfers property to a non-arm's length person and the consideration paid for said property is less than fair market value. Subsection 227.1(1) provides the authority upon which the Minister may assess directors for the failure to remit certain amounts (i.e. source deductions) provided the preconditions in subsection (2) are satisfied.

The determination of liability in the instant case was dependent upon whether an assessment under section 227.1 was in respect of Mr. Colitto's taxation year in which the property was transferred. More specifically, the Court was required to opine on the timing of liability under section 227.1, and how that timing relates to an assessment under section 160. The Court reviewed relevant caselaw, including *Livingston v.* Canada, 2008 FCA 89 ("Livingston"), a binding Federal Court of Appeal decision in which the court pronounced a four-part test when determining liability under subsection 160(1).

The Court discussed at length the first criteria in the *Livingston* decision, being, that "[t]he transferor must be liable to pay tax under the Act at the time of transfer". Whether a liability existed [to the transferor, Mr. Colitto] at the time of transfer required the Court to undertake an in-depth statutory interpretation of section 227.1. Ultimately, the Court held that the text used in subsection 227.1 was unambiguous, requiring the preconditions in that section be satisfied prior to establishing liability. The Court also declared that there was also no language in that section to suggests that the liability, once established, should apply retroactively.

On January 4, 2011, the Corporation's debt was executed and returned unsatisfied, fulfilling the precondition, and triggering Mr. Colitto's tax liability. In order for subsection 160(1) to apply, the transferor, Mr. Colitto, must have been liable for the tax in <u>his</u> taxation year in which the transfers took place (2008). Given that the liability under section 227.1 did not arise until 2011, the transfers were not caught by section 160 of the Act.

Takeaways:

When reviewing an assessment issued under subsection 227.1(1), or one issued in conjunction with section 160, the taxpayer should confirm the Minister has satisfied the preconditions set out in subsection 227.1(2). Without an amendment to the Act, the combining of these assessments in this manner will likely prevent the Minister from successfully attacking past transfers.

- **Technical Interpretation External T.I.2017-0716451E5 F- Deduction in computing income of a trust, by Jeanne Posey**

Is a distribution by a discretionary trust of taxable capital gains (in excess of the trust's income) a s.105(1) benefit?

Issue:

A discretionary family trust realized a taxable capital gain of $200,000 and incurred a rental loss of $100,000 in the same year. The question posed was whether a trust can deduct, by virtue of paragraph 104(6)(b), the amount of $200,000 corresponding to the taxable capital gain when it is paid or payable to a beneficiary?

As a general rule, amounts included in the income of a beneficiary of a trust under subsections 104(13), 104(14) or 105(2) are deductible by the trust under subsection 104(6) or 104(12). This rule applies to amounts paid, or payable.

Subsection 105(1) of the Act provides that the value of all benefits received or enjoyed by a taxpayer from or under a trust, are to be included in the taxpayer's income except to the extent that the value,

a. is otherwise required to be included in computing the taxpayer's income for a taxation year; or,
b. (generally speaking) has been deducted in computing the adjusted cost base of the taxpayer's interest in the trust under paragraph 53(2)(h).

CRA Response: Depending on the terms of the trust indenture, when an amount paid to the beneficiary exceeds the trust's taxable income for the year and does not represent a distribution of capital property under the Act, the surplus could be a benefit conferred by the trust to be included in computing the income of the beneficiary under subsection 105(1).

Caselaw:

In *Cooper v MNR,* [1989] 1 C.T.C. 66 (FCA), an interest-free loan from a trust to a beneficiary was found not to give rise to a taxable benefit under subsection 105(1). The FCA emphasized the fact that not every receipt that may be called a benefit in general terms would constitute a taxable benefit under the *Income Tax Act*, and the taxation of benefits cannot be imposed by inference.

The Court concluded that prior to the enactment of section 80.4, interest free and low interest loans to employees and shareholders did not attract tax liability. The Court commented on the fact that while it was open to Parliament to include in the value of low-interest loans under a trust within the ambit of s.80.4, it was not done. Therefore, as previously noted by the Court, not every receipt from the trust will be found to be a taxable benefit, and therefore, the determination of when a taxable benefit arises will be a question of fact and law that can only be resolved after a complete examination of the facts, circumstances and documents surrounding the situation.

Takeaways:

Not every receipt by a trust to a beneficiary will constitute a benefit, however, where an amount paid to the beneficiary is in excess of the trusts income for the year, the excess may be conferred as a benefit to the beneficiary and be required to be included in the beneficiaries income for the year without providing the trust with a corresponding deduction, resulting in double taxation. Note that even if a portion of the distribution is considered a taxable benefit under subsection 105(1), it should still be possible to designate the full distribution under subsection 104(21) as a taxable capital gain to the beneficiary.

On its face, the wording of subsection 105(1), is very broad and appears it could construe more than was intended as a benefit. The courts have accorded a more restrictive interpretation to the application of subsection 105(1) as demonstrated in *Cooper.* All facts and circumstances should be considered when determining whether subsection 105(1) indeed applies.

- **Universo Home Construction Ltd. v. The Queen, 2019 TCC 87, by John Schappert**

Facts:

- Mr. Dhesi is owner of Universo Home Construction Ltd. ("**UHCL**");
- Certain land was purchased by Mrs. Dhesi on October 27, 2011 (the "**Land**"). Mrs. Dhesi was registered on title as the legal owner;
- Evidence submitted at trial included two copies of a bare trust agreement describing Mrs. Dhesi's role as nominee, agent and bare trustee in respect of the Land; and UHCL's principal and beneficial ownership in the Land (the "**Trust Declaration")**. The two agreements varied only with regard to the witnesses, the presence of initials on certain pages and the form of Mrs. Dhesi's signature. The execution date was not reflected on either agreement;
- From about October 27, 2011 to January 25, 2013, UHCL was engaged in the construction of a home (the "**Home**") on the Land (Home and Land, collectively the "**Property**");
- During the period October 27, 2011 to January 25, 2013, the Property and all material transactions pertaining to same, including the service of debt in respect of the Land, were reflected on the financial statements of UHCL;
- On January 25, 2013, the Property was sold to an arm's length purchaser who had the intention of occupying the Home as a primary place of residence;
- The statement of adjustments (the "**SOA**") on the sale of the Property credited the New Housing Rebate (the "**Rebate**") to Mrs. Dhesi, the seller;
- The Rebate application was submitted in the name of UHCL and UHCL claimed a GST deduction in respect of the Rebate credited to the Buyer on the sale of the Property; and
- The Minister reassessed UHCL for the reporting period which included the Rebate application and denied the Rebate deduction to UHCL on the basis that UHCL was not the "builder".

Issue:

Whether UHCL's had an interest in the Property sufficient to meet definition of "builder" under subsection 123(1) of the *Excise Tax Act* (Canada) (the "**ETA**"), for the purposes of the rebate deduction under subsection 234(1) of the ETA.

Decision:

UHCL had an interest in the Property and met the definition of "builder" as an effective trust settled legal ownership of the Property upon Mrs. Dhesi and beneficial ownership on UHCL.

Ratio:

- The bare trust memorialized by the Trust Declaration is valid and corroborates UHCL's beneficial interest in the Property.
  - To the extent there is evidentiary uncertainty it is only with regard to the time of execution of the written trust agreement and does not relate to the three certainties of a trust, which are met by this Trust Declaration.
  - The date which the Trust Declaration was executed, although unknown, is not determinative as to whether a trust existed at the time the Land was acquired by Mrs. Dhesi.
- The financial statements of UHCL consistently reflected the separation of legal and beneficial ownership of the Property between Mrs. Dhesi and UHCL, supporting the existence of the trust arrangement.

Takeaways:

An entity's financial records may support the existence of a trust if they have consistently reflected the terms of the trust from the time it was created. The transfer of any interest in land is generally not enforceable if supported only by oral evidence, but a trust transferring a beneficial ownership interest in land may be created orally and later memorialized in writing.

- **Al Saunders Contracting and Consulting Inc. v. the Queen, by Reagan Ruslim**

The recent decisions of the Tax Court of Canada ("TCC") in *Al Saunders Contracting* and *Consulting Inc. v. the Queen*[1] stresses the importance for employers to keep accurate and detailed documentation when providing and paying for travel, subsistence and lodging allowances to employees. Failure to do so may be a contributing factor to violations, fees and penalties, under not only the *Income Tax Act* (Canada) (the "ITA") but also the *Employment Insurance Act* (the "EI" Act) and the Canada Pension Plan (the "CPP").

The facts in this case are straight-forward. They involve an employer acting in good faith and with good intentions. Unfortunately, as will be described herein, these good intentions were not matched with good bookkeeping practices.

Facts:

The appellant, Al Saunders Contracting and Consulting (the "Employer" or the "Appellant"), employed several employees in the 2013 and 2014. The Employer is a heavy equipment contracting company which specializes in the construction and maintenance of roads and highways. Its main office was in Sundre, Alberta.

Throughout 2013 and 2014, most of the Appellant's work occurred in the areas of Waterton Lakes National Park, part way through the Saskatchewan River, the crossing of highway 93 between Banff and Jasper National Parks and along the Karanakis Trail. This significant project involved ten (10) employees of the appellant Employer working 12-hour days throughout a working area with a radius of about 160 km.

Given the lengthy distances involved, the Appellant instructed its employees to stay at their work sites rather than commuting to and from work. To help compensate its employees for their personal expenditures for these overnight stays, the Appellant provided the following “Allowances”:

a. a subsistence allowance;
b. a truck allowance comprised of both a flat-rate and a per kilometer rate; and,
c. a board and lodging allowance of $150 per night.

Unfortunately, the documentation related to these three allowances were not the most detailed or accurate. As noted by the Wong J:

> “While I have done my best to distinguish amongst the allowances, it is clear that the distinctions were unclear from the outset.[2]”

Wong J. further went on to acknowledge that she:

> “…found Mr. Saunders to be a very credible witness and well-intentioned with respect to his employees. However, the manner in which the Appellant’s records were kept made it difficult to corelate his testimony with the available documentation.[3]”

The CRA Cometh:

The Appellant paid the Allowances to the employees in the normal course throughout the 2013 and 2014 taxation years. However, it did not include these payments of the Allowances or report them for tax purposes. Accordingly, no income taxes were withheld or remitted by the Appellant. Additionally, the requisite CPP and EI source deductions were not taken nor remitted.

Issue:

This issue before the Tax Court of Canada was whether the Allowances paid by the Employer were taxable as income and therefore subject to the appropriate source deductions under the paragraphs 6(1)(b) and 6(6) of the ITA, the *EI* and the *Canada CPP*. Paragraph 2(3)(a.1) of the *Insurable Earnings and Collection of Premiums Regulations*, SOR 97-33 provides that any amount excluded as income by virtue of paragraph 6(1)(a) or (b) or subsection 6(6) or (16) of the ITA is excluded from insurable earnings under the *EI* Act. Meanwhile, section 12 of the CPP states that a person’s contributory salary and wages for a year is his or her income from pensionable employment calculated in accordance with the Act, including deductions.

Analysis:

In her decision, Wong J. addresses a multiplicity of facts involving different sums paid pursuant to the different heads of “Allowances”. Wong J. noted that the distinction between the three different Allowances was not as clear as it should have been due to the Employer’s failure to maintain adequate books and records as mandated by the ITA[4].

Subsistence Allowance:

Despite the evidentiary challenges, Justice Wong did find in favour of the Employer with respect to the subsistence allowance as these were found to meet the criteria for travel allowance pursuant to subparagraph 6(1)(b)(viii) of the ITA.

Truck Allowance:

The Court did not rule in favour of the Employer with respect to the truck allowance as these amounts were comprised of both a fixed amount and a per kilometer amount. Thus, these amounts were found to be unreasonable vis-à-vis paragraphs 6(1)(b)(x) and (xi) of the ITA and therefore taxable.

Lodging and Trailer Allowance:

The CRA field auditor found that since the employees stayed in their own trailers rather than hotels, a reasonable rate of $60 per night was found to be a reasonable sum. Unfortunately, this sum was much lower than the $150 per night the Appellant provided its employees. Accordingly, this difference was considered income and therefore taxable.

Takeaways:

1. all employers should maintain proper books and records; and,
2. all should make sure any benefits paid to employees are reasonable and tracked in accordance with the applicable requirements of the ITA[5].

[1] See 230 and 230.1 of the *ITA.* See also section 87 of the *EI* Act, and section 24 of the *Canada Pension Plan.*

[2] Supra note 1, at para 40.

[3] Ibid, at para. 38.

[4] 2019 TCC 86, 2017-4393(EI), 2017-4381 (CPP).

[5] For additional guidance, see Employer's Guide – Taxable Benefits and Allowances T4130(E) Rev. 18 at:

https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/t4130/employers-guide-taxable-benefits-allowances.html.

- **Brian Hurd Dentistry Professional Corporation v. The Queen, by Aasim Hirji**

In *Brian Hurd Dentistry Professional Corporation v. Her Majesty the Queen* ("Hurd"), the Tax

Court of Canada was faced with an appeal on the tax treatment of orthodontic supplies under the *Excise Tax Act* (the "Act"). However, the Court also addressed the intersection between the law and CRA administrative policies. In *Hurd*, there were two central issues on appeal, whether the Appellant was making a single supply or multiple supplies for GST purposes, and second, whether those supplies were zero-rated or exempt supplies (as defined in the *Excise Tax Act*). The distinction between the two is crucial, as input tax credits (ITCs) may not be claimed in respect of exempt supplies.

In December 2004, the CRA provided a policy directive ("Eligibility by an Orthodontist for Input Tax Credits") discussing the eligibility of dentists and orthodontists to claim ITCs on their supplies. The CRA stated

For administrative purposes, the Canada Revenue Agency ("CRA") accepts that orthodontists who claim input tax credits on a periodic basis can use an estimate of 35% of the cost to the patient of the orthodontic treatment to represent the 'consideration' for the supply of the orthodontic appliance. This administrative approach was formulated on the basis that this estimated amount is the maximum charge that can be made for an orthodontic appliance.

Based on the administrative policy, the Appellant provided examples of patient contracts. The Appellant had patients sign a single contract, and the total fee charged to the patient included the cost of the orthodontic appliance. The appliance cost was referred to in the contract as the "appliance portion….of the fee", and was calculated separately as 35% of the total fee, following the CRA directive.

As a result of being able to allocate 35% of the cost as a "zero-rated supply", the taxpayer was able to claim ITCs in respect of this amount. If the entire amount had been characterized as an exempt supply, there would have been no ITC available to the taxpayer.

On audit, the CRA reassessed the taxpayer stating that there was only one supply, which was an exempt supply, and therefore the taxpayer would not be eligible for ITCs. The Tax Court agreed, finding that there was a single supply of orthodontic treatment to each patient. In regards to CRA policy, the Court stated:

In respect to the Appellant's reliance on the CRA directive and policy in this regard, although it may be a guideline it is not binding on this Court. I believe it to be incorrect and misleading to taxpayers… In the end, the CRA policy statement is simply wrong and more importantly misleading and cannot be defended in the manner the Respondent would have me do. I simply reject it and I do not intend to follow it.

Despite following CRA policy, the taxpayer was found to make a single exempt supply, and was not able to claim ITCs. This case highlights the important distinction between the law and CRA policy, which has been discussed in jurisprudence prior to *Hurd*. The Federal Court of Appeal has previously stated "*in law, the Information Circulars of the Canada Revenue Agency are nothing more than administrative policy statements. They are not finally determinative of the meaning of a provision of the Act."*[1]

Takeaways

This case is a good reminder that taxpayers need to proceed with caution when following CRA policies. Although some administrative concessions may be made in certain areas, this does not prevent the CRA from acting against such policies to the detriment of a taxpayer.

Although this is a GST case, there may be implications to income tax as well. With the new Tax on Split Income Rules (“TOSI”), the distinction between provision of “service” and “goods” is important because if 90 percent or more of the business income is from the “provision of services”, the shares of the company cannot be an “excluded share”, which would otherwise prevent the TOSI rules from applying. This case suggests that it may not be that easy to separate out the sale of goods from a business that is primarily a service business.

[1] Bozzer v. Her Majesty the Queen, 2011 FCA 186 at para 23