CaseNotes for July, 2019

Moodys Tax
July 8, 2019

- **Kau v. The Queen, 2018 TCC 156, by Aasim Hirji**

Section 116 of the Act provides rules that protect the Canadian government's ability to collect tax on capital gains on a disposition of "taxable Canadian property". "Taxable Canadian property" includes real property situated in Canada, Canadian resource-related property and the shares of corporations where the value is principally derived from Canadian real property or resource property.[1] When a non-resident of Canada disposes of, for example, a residential property, a notification requirement is triggered, whereby the disposition has to be reported to the Canada Revenue Agency ("CRA") either before the disposition or within ten days after the disposition. If no notification is made to the CRA and a compliance certificate has not been issued, the purchaser is required to withhold 25% of the purchase price and must withhold on that amount at closing and remit that amount to the CRA within 30 days. In order to obtain a compliance certificate, the vendor must have notified the CRA and remitted 25% of the estimated capital gain.[2]

Subsection 116(5) assigns the tax liability to the purchaser, on behalf of the non-resident vendor, of 25% of the purchase price, unless, *inter alia*, after reasonably inquiry, the purchaser had no reason to believe that the non-resident person was not resident in Canada.

In *Kau v. the Queen*[3], the Tax Court of Canada discussed what constitutes a "reasonable inquiry". The purchaser of an Ontario property (the "**Taxpayer**"), retained an Ontario lawyer to handle a real estate transaction for him. The vendor was also represented by a lawyer in Ontario. The Court noted that the Taxpayer knew the property was an investment property of the vendor, and that the Vendor did not live there. Furthermore, the vendor's address on the sale was located in California.

Prior to closing, the Taxpayer's sent to the vendors lawyer a standard requisition letter, specifying 26 requisitions required for purposes of closing the transactions, including satisfactory evidence of compliance with section 116 of the Income Tax Act. Shortly thereafter, the closing documents were revised to indicate they would be signed in California.

Shortly before closing, the Vendor signed a one sentence "unsworn statement", being titled an "affidavit" (though it was unsworn). The Vendor stated ""I am not a non-resident of Canada within the meaning of section 116 of the Income Tax Act (Canada) and nor will I be a non-resident of Canada at the time of closing."[4]

The Court noted that the Taxpayer himself did not make enquiry into the residency of the vendor,

however, he did, “entirely reasonably”, engage his solicitor to act in his best interest in efficiently bringing this real estate transaction to his successful conclusion (which includes compliance with section 116 of the Act). The Court then looked to determine whether the Taxpayer’s lawyer had satisfied this obligation.

The Court looked to the fact that what the Taxpayer’s lawyer did was the basic inquiry they would have expected in any event, pursuant to the Ontario Real Estate Association standard form language in clause 20. The Court went further to note that in this instance, the lawyers actions would have been “adequate” if there had not been “red flags signaling a potential that residency was outside Canada”, and that the response received was insufficient (especially with an unsworn statement) to resolve those red flags in the absence of follow up questions. The Court noted that:

> “It is obvious that “reasonable inquiry” entails consideration of not just what was asked, but also of response(s) received. Here, follow-up questions would have been appropriate…. The statutory provision involved, subsection 116(5)(a), calls for and deserves more than a brief, baldly stated affidavit or solemn declaration when there are factual red-flags potentially suggestive of non-residency. The matter should then be pursued, to give due effect to the fiscal concern that Parliament sought to address in its drafting of subsection 116(5)(a).

Ultimately, the Court found that the Taxpayer did not make a reasonable inquiry (as his lawyer did not), which resulted in the Taxpayer being liable for 25% of the purchase price.

Takeaways:

This case serves a cautionary tale to both home buyers and real estate lawyers. If any indicia of non-residency exists (such as an address outside Canada for the vendor), it is necessary to ask follow-up questions, rather than relying on a simple statement of residency. In the absence of such reasonable inquiries, the Canadian resident purchaser will be found liable for the withholding tax of 25% of the purchase price of the property and the real estate lawyer may be liable for professional negligence!

- **Birchcliff Energy Ltd. v. R, 2019 FCA 15, by Jeanne Posey**

In the recent Federal Court of Appeal decision, *Birchcliff Energy Ltd. v R*, 2019 FCA 151, the Court held that the general anti-avoidance rule (“**GAAR**”) contained in section 245 of the *Income Tax Act* (the “**Act**”) applied to restrict losses in a non-acquisition of control transaction.

Facts:

- Two corporations, Veracel Inc. (“**Veracel**”) and Brichcliff Energy Ltd. (“**Birchcliff**”), amalgamated to form Birchcliff Energy Ltd., (the “**Appellant**”).
- Birchliff, who was in the oil and gas industry, undertook a series of transactions that

resulted in Birchliff amalgamating with Veracel, who was in the Medical Business, in order to acquire Veracel's tax losses.

- The transactions undertaken were complicated and involved the issuance of new Class B shares ("**New Shares**") of Veracel to an unrelated group of investors (the "**New Investors**") who held the shares upon the amalgamation of Veracel and Birchcliff in order to avoid the application of the acquisition of control rules in subparagraph 256(7)(b)(iii) of the Act – by falling into the exception in clause 256(7)(b)(iii)(B) which prevents an acquisition of control where there is a continuity in the interests in the predecessor corporation constituting a majority in the successor.
- By not having an acquisition of control, the application of the loss streaming rules was avoided.
- CRA issued a Notice of Reassessment to the Appellant denying $16,226,489 of non-capital losses claimed in the Appellants 2006 taxation year.

Issues:

Did the Tax Court of Canada (the "**TCC**") err in holding that GAAR applied to the series of transactions in order to deny the use of the non-capital losses?

Held:

The TCC found that the artificial insertion of the New Investors of Veracel, whose share's only purpose was to be converted into common shares, and whose shares had such a short existence that they had to be deemed by the plan of arrangement to be created before the amalgamation, is a manipulation of the shareholding of a predecessor corporation contrary to the object of the rules in subsection 256(7).

The Federal Court of Appeal upheld the Tax Court's decision and the appeal was dismissed.

Discussion:

The sections of the *Act* that were in issue were paragraph 111(1)(a) and paragraph 256(7)(b). Paragraph 111(1)(a) permits the carryback and carryforward of unused business losses, however, subsection 111(5) of the *Act* limits the ability to carry back (or forward) these losses when a corporation is subject to an acquisition of control.

Generally, when two unrelated companies amalgamate, the effect of the paragraph 256(7)(b) is to deem one of the two predecessor corporations to have acquired control of the other immediately before the amalgamation. On an amalgamation, it deems control of the new corporation to have been acquired, thereby streaming the losses of the acquired corporation against income of the amalgamated corporation from the same or a similar business as that in which the losses were incurred. However, there is an exception to paragraph 256(7)(b) in clause 256(7)(b)(iii)(B). The purpose of the exception is to avoid the acquisition of control of a particular predecessor corporation where there is a continuity of the shareholders interest in the predecessor corporation constituting a majority of the shareholders' interests in the successor.

The test for *de jure* control was confirmed in *Duha Printers (Western) Ltd. v The Queen,* 98 DTC 6334 and looks at whether the majority shareholder enjoys "effective control" over the affairs of the corporation, as demonstrated by having a majority-voting control over the corporation, which following the issuance of the New Shares of Veracel to the New Investors, there was.

However, in the present case, there was no continuity in the interest of the person or persons who owned the shares of the loss corporation (Veracel), prior to the commencement of the series of transactions, except for the continuity that was artificially created by issuance of the New Shares to the New Investors for the briefest amount of time , permitting the transaction to rely on clause 256(7)(b)(iii)(B) in an unintended manner which frustrated the object and purpose of the provision, to which GAAR could then apply.

The TCC accepted the Crown's argument that GAAR applied and as such, the tax consequences are to be determined as is reasonable to deny the tax benefit. Consequently, control of Veracel was deemed to have been acquired immediately before the amalgamation of Veracel and Birchliff, restricting the losses in question.

The Appellant appealed to the Federal Court of Appeal who affirmed the TCC's decision.

Takeaways:

While tax planning does not necessarily bring the GAAR into play, Birchcliff reinforces the fact that loss trading between unrelated parties is likely to be successfully challenged under the GAAR.

- **Samaroo v. Canada Revenue Agency 2019 BCCA 113, by Jason Lau**

Facts:

  - This is an appeal by the Canada Revenue Agency ("CRA") against a trial judgement in which it was found liable for malicious prosecution and a breach of the Taxpayers' s. 7 *Charter* rights.
  - Mr. Tony Samaroo and Mrs. Helen Samaroo (the "Taxpayers") were subjected to a criminal trial based on allegations of tax evasion in which $1.7 million of income went unreported between 2004 and 2006.
  - The Taxpayers were later acquitted of all charges after the criminal trial judge found that the Crown's case was flawed, weak, and the amount of tax evaded "highly uncertain".
  - Subsequently, the Taxpayers filed an action for malicious prosecution against the CRA. The trial judgement found in favor of the Samaroos.

Decision:

The appellate judge ruled in favor of the CRA, and the malicious prosecution action was dismissed.

Ratio:

A prerequisite element of malicious prosecution is that it must have been undertaken without reasonable and probable cause (*Kvello v. Miazga*, 2009 SCC 51). In this respect, the appellate judge found that the trial judge erred in application of the law on two fronts. Namely (i) the analysis of *actus reus* was based on the mechanics of the alleged tax evasion scheme (i.e. the so-called "till tape theory" posited by the auditor that was central to the criminal proceedings, but

was unable to be proven by the Crown) rather than a broader consideration of whether there was sufficient evidence for reasonable and probable cause to initiate prosecution, and (ii) the burden of proof was reversed, having been placed upon the defendant as opposed to the plaintiff.

In respect of (i), the appellate judge found that the evidence at hand (taxable income inconsistent with accumulated savings, and the holding of cash in spite of carrying large amounts of debt) was sufficient reasonable and probable cause that the Taxpayers were appropriating cash from their business; this is not to say that they were guilty, but rather there was evidence that *could* have objectively resulted in a conviction. In respect of (ii), the appellate judge found Mr. Samaroo's explanations regarding the evidence in (i) to be implausible and more importantly, hinged on his credibility. The latter was detrimental to the plaintiff's case as in *Miazga*, "the Supreme Court of Canada was clear that one ought not base a finding of an absence of reasonable and probable cause on the outcome of a criminal trial that could turn materially on a credibility assessment".

Takeaways:

Undoubtedly the trial case made headlines in no small part due to the aggressiveness of the CRA auditor, who the trial judge found to be "argumentative, evasive, inflexible and reluctant to concede what clearly should have been conceded". Yet despite the above, the success of the malicious prosecution action rested on the Samaroos' ability to demonstrate that there was an absence of reasonable and probable cause, and not so much the auditor's behavior; because the Taxpayers were unable to demonstrate the former, the latter became a non-factor and CRA's appeal was successful.

- **Dépatie v. The Queen, 2019 TCC 123, by Dallas Kleckner**

In the recent Tax Court of Canada decision of *Dépatie v. The Queen*, 2019 TCC 123, the Court reaffirmed that for the purposes of determining whether debt was acquired for the purposes of earning income, in respect to subparagraph 40(2)(g)(ii) of the ITA, there is no need for income to flow directly to the taxpayer from the loan.

Facts:

- Marie-Claude Dépatie (the "**Taxpayer**") is the daughter of Diane Dépatie ("**Diane**")
- Diane was the sole shareholder and director of Les Cantines Nurec Inc. (the "**Corporation**"), which until 2002, carried on business of operating cafeterias.
- In 2002, Diane and her two daughters (collectively the "**Family Members**"), joined forces and started using the Corporation for the purpose of operating a restaurant business (the "**Business**").
- The Family Members were also employees of the Corporation.
- The Business was operated through a building purchased by the Family Members, each of which held an undivided interest in the building.
- The arrangement between the Family Members consisted of a verbal agreement to operate the Business as a partnership, and that each would receive a vote and an equal share of the profits.
- The Family Members made loans to the Corporation for working capital, however, no formal documentation was prepared.

- It was the intention of the Family Members to charge interest on the loans and the accounting records of the Corporation were consistent with that intention.
- The Business (operating through the Corporation) incurred losses from 2008 to 2013 and ultimately failed.
- Between 2002 and 2013, the Taxpayer advanced $233,279.42 to the corporation to operate the business, of which $128,104.34 was unrecoverable (the "**Loan**").
- In her 2013 tax return, the Taxpayer claimed a business investment loss ("**BIL**") in respect of the Loan.
- The Minister of National Revenue disallowed the BIL on the basis that, among other things, the loss from the disposition of debt was deemed nil pursuant to subparagraph 40(2)(g)(ii), as it was not acquired by the Taxpayer for the purposes of gaining or producing income from a business or property.

Issue: Was the Loan made by the Taxpayer to the Corporation for the purposes of earning income from a business or property?

Held: Yes.

Analysis:

The Court reviewed the relevant sections of the ITA, namely, subsection 38(c), paragraph 39(1)(c), subparagraph 40(2)(g)(ii), and section 50. Given the above facts, the Court focused its attention on subparagraph 40(2)(g)(ii), that is, whether the Loan was made by the the Taxpayer for the purposes of gaining or producing income from a business or property.

The Court noted that the advances made were without documentation, specific terms of interest, or without any conditions of repayment. In addition, the Taxpayer failed to demonstrate the reporting of any interest income in her person tax return, or whether she had taken any active steps to recover the interest owed. Regardless of the lack of formality, the Court found an agreement existed between the Family Members and that the Loan did have a commercial objective, which was to earn income from the Business. In providing said Loan, the Taxpayer ensured herself, among other things, income from employment and a share in the profits realized through carrying on the Business.

In arriving at its decision, the Court, at paragraph 31, cited the following excerpt from *Byram v. Canada*, 1999 DTC 5117:

> [16]…while subparagraph 40(2)(g)(ii) requires a linkage between the taxpayer (i.e. the lender) and the income, there is no need for the income to flow directly to the taxpayer from the loan.

Even though the Taxpayer was not a shareholder, the Court found a sufficient link between the Loan and the income earning potential of the company. The requirement of an income earning purpose was therefore met, removing the Taxpayer from the ambit of subparagraph 40(2)(g)(ii).

Takeaways:

When considering the income earning purpose set out in subparagraph 40(2)(g)(ii) of the ITA, even an indirect purpose may be sufficient to avoid its application.

- **Applewood Holdings Inc. v R, 2019 TCC 34, by Cory Chan**

Facts:

  - *Applewood* involved a car dealer that was a distributer of credit insurance products and received a commission of over 50% of the insurance premium. The role of the car dealer was to "up sell" the insurance products and explain coverage for the clients.
  - The Court held that the predominant element of the supply was an exempt supply of arranging for the insurance.
  - The Taxpayer was successful in a trial scheduled over 2 days but heard over 1.5 days on November 8 and 9, 2018. The appeal was fully allowed and costs were awarded to the Taxpayer.
  - The tax in issue in the appeal was $33,802; however, there were 15 other Taxpayers whose appeals were held in abeyance pending resolution of this lead appeal (bringing the total of tax in issue to over $660,000.00).
  - The Taxpayer then brought a motion for an award of costs consisting of $153,806.
  - The Crown agrees the Taxpayer should be entitled to a bit more than Tariff costs and argues twice the Tariff costs of $10,178 (or $20,355) inclusive of disbursements should suffice.

Issue:

What costs are the Taxpayer entitled to?

Decision:

The Taxpayer was entitled to $20,000 of legal fees and $3,592 of other expenses.

Ratio:

Rule 147 of the *Tax Court of Canada* grants the Court complete discretion in determining the amount of costs, their allocation and the persons required to pay them. Rule 147(3) sets out the factors that the Court may consider in exercising such discretion which must be considered on a principled basis.

The objectives of an award of costs are compensation and contribution, and not punishment, except where there is an abuse of process.

Takeaways:

Although the Taxpayer and the Crown agreed that the volume of work was significant for both parties to the appeal, the Court held that the Taxpayer's claim for 350 hours of work, the equivalent of ten 35 hour work weeks, for a one and one-half day trial where a partial agreement statement of facts, a joint book of documents and written submissions in argument were filed

seemed somewhat excessive, notwithstanding the lead appeal context of the matter. Taxpayers should always assess the amount of work required for a trial and the estimated cost to determine whether it is reasonable to proceed with the appeal.

Even though the decision may have real and a broad precedential value to an entire industry and is a leading case that would impact other cases before the Courts, it may still not fall under the mantel of "national significance". It appears that the threshold for a case to be of "national significance" is very high.

This case may dampen taxpayers' willingness to appeal CRA assessments. It serves as a reminder that even in cases where there is a high probability of success, the Courts are still reluctant to award full costs or anything close to.

[1] Subsection 248(1) of the Act

[2] It should be noted that section 150 of the Act requires the non-resident to file a Canadian income tax return in respect of the disposition regardless of whether there is a certificate in place or not.

[3] *Kau v. the Queen,* 2018 TCC 156

[4] Ibid at para 8