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ROBERT WILLIAM "BOB" MCMECHAN: "SAYING GOOD-BYE TO A STANDOUT COLLEAGUE"

By David W. Chodikoff, Editor of *Taxes & Wealth Management*, Tax Partner, Miller Thomson LLP.

Bob passed away on August 7, 2016. He was only 64 years old but, by any measure, Bob lived a full life.

I met Bob when he was still with the Department of Justice. That was many years ago. He was humble, funny, very hard working and bright. His accomplishments attest to these character traits. I attended Bob's funeral in Ottawa and was struck by the diversity of his interests. There were things that I only had some passing notion of. It was evidence of the depth and breadth of his impact on so many people. This was a large church and it was full of Bob's admirers, friends and family. He would have been embarrassed by the richness of his positive impact on the people around him.

Stepping aside for a moment to write about the "non-tax" Bob; did you know that Bob founded a running club in Ottawa called the Lickety Splits? Stories were shared about how Bob would encourage anyone to run with him, and weather — be it freezing cold, as it tends to be in Ottawa — be damned. Apparently, even all bundled up, Bob was ready for a good run and stayed positive throughout the efforts. Bob competed in many marathons and actually participated in an Ironman competition in B.C.

At the memorial, we heard about Bob's love of cycling from his neighbour and cycling pal. He was a regular and committed rider. From a brother-in-law, we heard about Bob's love of the outdoors, camping, travelling and experiencing the world.

He was a family man and had a close relationship with his children, grandchildren and extended family.

Turning back to the law, Bob was an exceptional tax litigation lawyer. Bob was a former General Counsel with Tax Law Services of the Department of Justice of Canada. He was also at one time a Senior Rulings Officer with Revenue Canada. Bob conducted the first major transfer pricing litigation in Canada (known as *Smith Kline*). In 2011, he was inducted as a Fellow of the Litigation

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Counsel of America (LCA) Trial Lawyer Honorary Society, and in the following year, he was named among In House Counsel Magazine's list of top Canadian lawyers. Bob was an author and scholar. He recently completed his doctorate of laws at Osgoode Hall and then published a superb book entitled, *Economic Substance and Tax Avoidance: An International Perspective*. (Carswell).

One of Bob's last projects was looking after his partner, Allison. She was diagnosed with a giant brain aneurysm. Allison's diagnosis, medical odyssey and remarkable recovery were chronicled by Bob in a book that he wrote with Allison entitled *Allison's Brain*. It is truly an incredible story. The book won the 2015 National Indie Award for Excellence in the "Inspirational" category.

This last accomplishment is where this tribute ends because Bob was exactly that type of person: inspirational and a role model to us all. I miss him. And I know that many others will continue to do so, too.

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TRUST INTERESTS AND FAMILY LAW RIGHTS — WHAT ESTATE PLANNERS NEED TO KNOW AFTER *TREMBLAY* AND *MUDRONJA*

By Rosanne T. Rocchi, Partner, Miller Thomson LLP

This article, written by Rosanne Rocchi of Miller Thomson LLP's Toronto Private Client Services Group, first appeared in the Miller Thomson LLP Wealth Matters publication in June 2016. The article was also included as part of the information and materials provided to delegates who attended the 2016 STEP Annual Conference in Toronto. The article provides a highly pertinent—and important—discussion of current family law issues relating to trust interests and common tax and estate planning strategies in Canada today.

INTRODUCTION

Since the enactment of the *Family Law Act* ("FLA"), courts have struggled with determining, firstly, if and when the interest of a spouse in a discretionary trust qualifies as "property" as defined in the FLA for purposes of equalization of net family property ("NFP") and secondly, how that property interest is valued.

Family law legislation varies from province to province, but it has been difficult to find any significant body of law in Canada addressing how to deal with interests in trusts. Other jurisdictions such as the U.K., Australia and New Zealand have extensive jurisprudence on the issue, as well as legislation that addresses the accountability of a spouse for a trust interest, both as a beneficiary and in terms of the bundle of rights that are reserved, whether as a Trustee, as a protector or as holder of a power to appoint.

Estate planners need to know when the rights reserved will result in the value of the trust property being included in a spouse's NFP under the FLA.

TRUST INTERESTS AS PROPERTY

In Ontario, the problem arises from the remedial nature of the legislation and the very broad definition of "property". Subsection 4(1) defines "property", in part, as follows:

> "property" means any interest, present or future, vested or contingent, in real or personal property and includes,
>
> (a) property over which a spouse has, alone or in conjunction with another person, a power of appointment exercisable in favour of himself or herself,
>
> (b) property disposed of by a spouse but over which the spouse has, alone or in conjunction with another

person, a power to revoke the disposition or a power to consume or dispose of the property.

The first part of the definition includes the interest of a **beneficiary** under a Trust but paragraphs (a) and (b) relate not to the rights of a beneficiary, but rather to the bundle of rights by which a spouse has the power to control the disposition or consumption of the trust property, whether as a Trustee, protector or holder of a power to appoint.

Trust practitioners believe the definition is overly broad for several reasons.[1] There is no doubt that an individual who has a general power of appointment has a right that is tantamount to ownership of the property.[2] But paragraph 4(1)(a) extends to a power of appointment which a spouse has "alone or in conjunction with another person". The FLA does not provide any guidance as to the identity of the other person, but presumably the intention was that the other persons might be individuals whose compliance the spouse had either the ability or the expectation to compel.[3]

There do not appear to be any reported Canadian cases which have analysed the identity of the co-trustees or whether or not they are truly independent, although *Tremblay,*[4] discussed *infra*, makes conclusions on the issue. U.K. courts have dealt with the issue of control of the trust property by examining the independence of the other trustees, the likelihood of the other trustees exercising independent authority and any correspondence between the parties such as letters of wishes and patterns of distributions of trust property.[5]

In a number of recent decisions of Commonwealth Supreme Courts and Courts of Appeal,[6] the approach taken by the court supports a "substance over form" approach to the problem of division of assets in the context of a divorce. The analysis of the court involves bringing "a judicious mixture of worldly realism and a respect for the legal affairs of Trusts, the legal duties of Trustees…".[7]

In *Charman v. Charman (No. 4)*,[8] the U.K. Court of Appeal considered whether assets held in an offshore trust over which the husband had *de facto* control even though there was a nominally independent Trustee, were "financial resources" of the husband. The court applied the test of "whether the Trustee would be likely to advance the capital immediately or in the future to the relevant spouse".[9]

Subsection 4(1)(b) is also directed to a power which the spouse does not possess alone. It is directed to a revocable Trust or to an act which commences with the disposition of property. It is not arguable that a power of revocation held alone should result in the inclusion of the value of the trust property in the NFP of the holder. In *Tasarruf Mevduati Sigorta Phonu v. Merryl Lynch Bank and Trust Co. (Cayman) Ltd.*,[10] the Privy Council concluded:

> The powers of revocation are such that in equity,…Mr. Demirel can be regarded as having rights tantamount to ownership….There is no invariable rule that a power is distinct from ownership.

However, subsection 4(1)(b) does not require that such a power be held alone. The particular mischief with paragraph (b) is that it is vague, and the word "consume" is not particularly instructive in assessing the use of trust property as the power to "dispose" of the trust property is clearly included in every trust indenture. Finally, because of the breadth of the definition, neither the legislation nor the jurisprudence appears to have taken into account the fact that if such powers are held in a fiduciary capacity, equitable principles would require that the Trustees, in exercising their discretion or such power, must act in a fiduciary fashion.

The result of such broad definitions is to permit inclusion in the NFP of one spouse of the value of a trust interest which is held for the benefit of persons other than the two spouses. Specifically, paragraph (b) is broad enough to include a power to resettle a Trust made in favour of, for example, the children of the marriage. In that instance, if such property is included in the NFP of one spouse, he or she would be required to make a payment to the other spouse even though neither is a beneficiary

1 It appears that, in matrimonial legislation, particularly where courts are given a discretion, there is a tendency to expand definitions of "property". The U.K. Supreme Court has recently warned against applying a different approach to the definition of "property" in the matrimonial litigation and in other areas of law. See *Prest v. Petrodel Resources Ltd.* [2013] 2 AC 415 (UK SC) at paras. 37 and 87.

2 *Francis v. Francis*, 1998 CarswellBC 685 (BC SC). See also in *Re Triffitt's Settlement*, Upjohn J. stated that: "Where there is a completely general power in its widest sense, that is tantamount to ownership".

3 Some guidance could have been provided, such as providing a rebuttable presumption of co-Trustees or co-owners of the power being other family members, a solicitor or an accountant.

4 *Tremblay v. Tremblay*, 2016 ONSC 588 (Ont SCJ).

5 See *Charman v. Charman* and *Kan Lai Kwan v. Poon Lok To Auto* at footnote 6.

6 *Charman v. Charman*, 2005 EWCA Civ. 1606, 2006 1 WLR 1053; *Charman v. Charman* (No. 4), 2007 EWCA Civ. 503, 2007 1 FLR 1246; *Whaley v. Whaley*, 2011 EWCA Civ. 617, 2012 1 FKR 735; *Kan Lai Kwan v. Poon Lok To Auto*, 2014 17 HKCFAR 414; and *Kennon v. Spry*, 2008 HCA 256, 2008 238 CLR 366.

7 *Charman v. Charman (No. 4)* at para. 57.

8 2007 EWCA Civ. 503, 2007 1 FLR 1246.

9 *Charman v. Charman*, 2005 EWCA Civ. 1606, 2006 1 WLR 1053 at paras. 12 and 13.

10 2011 UKPC 17, [2012] 1 WLR 1721 at para. [59].

of the Trust.[11] Further, despite the fact that the FLA grants significant discretionary powers to the court, it does not grant to the court the power to vary Trusts to permit any one or more of the spouses to become a beneficiary of such a Trust.[12]

Tremblay v. Tremblay is the latest in a series of Ontario cases that have considered the inclusion of an interest in a trust property in NFP under the *Family Law Act* ("FLA").

Practitioners have found the ruling troubling and somewhat opaque. The decision is currently under appeal. It is important for estate planning practitioners to understand how trust assets are likely to be treated in matrimonial litigation when advising clients on the settlement of family trusts, including the type of powers to be reserved to an individual, the extent to which Trustee duties are limited and the identity of Co-Trustees. Frequently, clients will wish to retain as much control as is possible, restraining that wish only to avoid income tax rules that restrict benefits if an individual retains rights that would trigger one of the attribution rules. However, the rights retained in *Tremblay v. Tremblay* are not unusual and do not go so far as other more aggressive trust designs. Estate planners will need to examine more carefully the details that will be considered in a determination as to whether or not a specific bundle of rights will qualify as "property" within the meaning of subsection 4(1).

Before reviewing *Tremblay v. Tremblay*, it is helpful to review an Ontario case decided some two years earlier.

MUDRONJA V. MUDRONJA[13]

This case was decided only two years earlier than *Tremblay* but was not cited in that case.

Eddy Mudronja ("Eddy") had an interest as a beneficiary in the Mudronja Family Trust (the "Trust"). The Trust was settled by Eddy's father. Eddy was the sole Trustee. The beneficiaries were Eddy's wife, Marijana, their issue and the Mareddy Corporation ("Mareddy"). This corporation was owned by Eddy as to 60% and by Marijana as to 40%. The Trust subscribed for non-voting common shares of Jitsu, an operating entity. The Trust also provided that Mr. Mudronja, as a protector, acting personally and not as a fiduciary, had the power to declare that any person or class of persons (including himself) should be included as a beneficiary. At the date of trial, no additional beneficiaries had been appointed.

Marijana submitted that the entire value of the Trust should be attributable to Eddy's NFP since he had the power to control the Trust.

Eddy argued that the trust property should be valued as if 35% were owned by the wife (25% plus 10% referable to her 40% share of Mareddy), 25% by Eddy Jr. (a son), 25% by Thomas (another son) and 15% by Eddy Sr. as he owned 60% of Mareddy.

This approach would be consistent with the approach taken in *Sagl v. Sagl*[14] and in *Kushnir v. Lowry,*[15] in which the interests of all beneficiaries of a discretionary Trust were valued at an amount equal to the value of the trust property divided by the number of discretionary beneficiaries. That approach, however, only deals with the interests of the beneficiaries in the Trust *qua* beneficiaries according to the first part of the definition of "property".

RIGHTS RESERVED

In addition to his interest as a beneficiary, Eddy also held a bundle of rights that would also have qualified as "property". In these circumstances, the court found that the value of the power of appointment was properly owned by Eddy, citing authority for the fact that a general power of appointment is tantamount to ownership:

> [91] This conclusion is supported by the following words of Donovan Waters in D. W. M. Waters, M. R. Gillen and L. D. Smith, eds., *Waters' Law of Trusts in Canada* (4th ed. 2012), at p. 97 stating that:
>
> > A general power enables the donee to appoint the property to anyone, including the donee, unless the donee is a fiduciary, and is therefore tantamount to ownership.

The court also noted that the power held by Eddy was held as a protector and was "not as a fiduciary":

> [92] In *Re MacIvor* , [1966] 1. O.R. 307-315 (H.C.) the Ontario High Court described the difference between

11 In *Kennon v. Spry*, 2008 HCA 256, 2008 CLF 366, the court did not accept the position that a husband who held a bare power of appointment among persons that did not include him, should be treated as having owned the property — citing Gibbs J. in *Ascot Investments Pty. Ltd. v. Harper*, (1981) 148 CLR 337 at 354 to 355, at page 46: "It would be unreasonable to impute to the Parliament an intention to give power to the Family Court to extinguish the rights and enlarge the obligations, of third parties, in the absence of clear and unambiguous words…except in the case of shams and companies that are mere puppets of the party to the marriage, the Family Court must take the property of a party to the marriage as it finds it. The Family Court cannot ignore the interests of third parties in the property, nor the existence of conditions or covenants that limit the rights of the party who owns it."

12 Under the New Zealand legislation, the Property (Relationships) Act, 1976, the court has the authority to make a wide variety of orders including orders vesting property and an order varying the terms of any trusts. While the FLA grants to courts the right to vest property, it does not grant the authority under the FLA to vary any trusts.

13 2014 ONSC 6217, 2014 CarswellOnt 15112 (Ont SCJ).

14 1997 CarswellOnt 2144, 31 RFL (4th) 405 (Ont Gen Div); additional reasons 1997 CarswellOnt 4984, 35 RFL (4th) 107 (Ont Gen Div).

15 2004 CarswellOnt 530 (Ont SCJ); affirmed 2004 CarswellOnt 3122 (Ont CA); affirmed 2005 CarswellOnt 2367 (Ont CA).

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a personal/ general power and a fiduciary power by invoking the case of *McCarter and Rusznyak v. M.N.R*, 22 D.L.R. (2d) 109, [1959] Ex. C.R. 316, [1959] C.T.C. 313. In *McCarter* the Court stated at para 8 and 9:

> In determining whether or not a power is exercisable in a fiduciary capacity, I am of the opinion that, if the power is such that the holder can dispose of the property to himself, to be used as his own without any restriction as to the circumstances in which he may so exercise it, and without responsibility to any other person, the fiduciary feature contemplated by the exception is lacking, and I think this is so whether or not the power is incident to or derived from the holding of a position or office which under other circumstances would by itself imply a fiduciary relationship.

The rights reserved were similar to the extensive rights reserved by Mr. Clayton in the recent decision of *Clayton v. Clayton* of the Supreme Court of New Zealand.[16] In that case, Mr. Clayton was the Settlor, sole Trustee, discretionary beneficiary and had powers as a "Principal Family Member" and Trustee that were "both broad and free from the normal obligations imposed on fiduciaries in family trust deeds". The court concluded that that particular bundle of rights amounted to a power of appointment and allocated all the value of the trust property to Mr. Clayton.[17]

INTEREST OF A DISCRETIONARY BENEFICIARY

The court then addressed the issue of whether or not the interest of the object (i.e. a beneficiary) of a discretionary trust is "property" within the meaning of the FLA. It was noted that this had been considered by the Ontario Courts in *Sagl v. Sagl*[18] and in *Kushnir v. Lowry*[19] where the court accepted the position that the interest of each discretionary beneficiary be valued as if the trust assets were to be divided among the discretionary beneficiaries in equal shares. In a later case, *LeVan v. LeVan,*[20] a husband's interest in a discretionary trust was valued at 25% of the trust assets based on his mother's evidence regarding the parent's intentions in estate planning to treat their four children equally.

Had the court accepted this approach to valuation, 50% of the trust property would have been preserved for the Mudronja children and Marijana Mudronja would have been allocated a higher value for her interest in the trust property than the value attributed to Eddy.[21] However, the court did not follow that approach but rather considered a more reasonable and practical approach, taking into consideration Eddy's control of the Trust. The court held as follows:

> [99] The real question therefore is one of value. What is the value of the Respondent's [Marijana's] discretionary interest as an object in the Mudronja Family Trust, in circumstances where she has no status or right to enforce the allocation and distribution of any capital or interest from the assets of the trust? On V-day she had no right or power to either require or prevent the disposition, transfer or encumbrance of the entire trust value, nor does she currently have such a right or power.
>
> [100] In the circumstances of this case the entire discretionary, unfettered power in relation to the distribution and all dealings with the Trust's assets rest with the applicant. He is her adversary now and was also adverse in interest when the parties separated. I find therefore that the V-day value of the Respondent's interest in the Trust is nominal. To allocate otherwise would have the effect of artificially increasing her NFP, thereby unfairly and inequitably diluting her equalization entitlement arising from the applicant's significant business interests. A value of $1.00 is therefore attributed to the Respondent's interest in the Mudronja Family Trust for purposes of the equalization calculation.

Such an approach echos the trend in other common law jurisdictions to balance "worldly realism" with the terms of the Trust.[22]

The court summarized its approach as follows:

> [98] Based on the above-noted authorities, and the need to provide for a fair property settlement following marriage breakdown, I find an interest in a discretionary trust is an interest in property for purposes of equalization pursuant to the FLA... Having regard to the numerous and varied methods spouses choose to arrange their financial affairs during marriage, and the need to ensure an equitable result on marriage breakdown, a beneficial interest in a trust is not automatically excluded from a spouse's net family property merely because it is subject to discretion. The approach needs to be contextual, having regard to the particular circumstances of the

16 [2016] NZSC 29.

17 In the *Clayton v. Clayton* series of cases (and there were many) the New Zealand Courts examined in great detail the powers of the Trustee, the lower standard of care, the extensive indemnities and the exculpatory clauses which went beyond what would be expected where there is a core obligation of a Trustee.

18 (1997), 31 R.F.L. (4th) 405 (Ont Gen Div), Supp. Reasons (1997), 35 R.F.L. (4th) 107 (Ont Gen Div).

19 [2004] O.J. No. 375 (Ont. S.C.J.).

20 (2006), 82 O.R. (3d) 1, 32 RFL (6th) 291 (Ont. S.C.J.), affirmed (2008), 239 O.A.C. 1 (Ont CA).

21 Eddy's interest as a beneficiary in the Trust would have been derivatively through his ownership of Mareddy.

22 See the cases cited at footnote 6.

parties, their financial situation and the terms of the trust in relation to the marital relationship on V-day.

The *Mudronja* decision properly separated the two interests in the Trust, being that of a beneficiary and that of a person entitled to control the Trust. In this instance, Eddy had retained extensive rights that amounted to control. If it were necessary to transfer part of the trust property to Marijana in order to satisfy his equalization payment, it would have been a simple matter to do so by allocating assets to Marijana as a beneficiary or by adding Eddy as a beneficiary, encroaching on capital for his benefit and transferring the property to him in satisfaction of his capital interest which could be used to pay the equalization payment to Marijana.

The *Mudronja* decision is more in keeping with the analysis followed in the U.K. and other Commonwealth jurisdictions.

TREMBLAY v. TREMBLAY[23]

Facts

Catherine and Jeffrey Tremblay met as teenagers in 1991. They married in 1996 and had two children. They separated in 2012.

Both worked hard during their marriage, completed their education and eventually improved their qualifications. Jeff's father, Michael Tremblay, founded a group of companies in which Jeff was employed and served as a senior officer.

In 2009, Jeff's father implemented an estate freeze, the purpose of which was to allow growth of 50% of MH Tremblay Holdings Inc. ("MHTH") to accrue to the benefit of Jeff's family and 50% to Michael's family[24]. Two new holding companies and three new Trusts were created namely, MH Tremblay Family Trust No. 2,[25] the Jeffrey Tremblay Family Trust No. 1 ("Trust #1") and Jeffrey Tremblay Family Trust No. 2 ("Trust #2"). The common shares (growth shares) of MHTH were owned equally by the MH Tremblay Family Trust No. 2 and Trust #1. Despite the fact that various titles were given to Jeff, his father, Michael, retained sole voting control over the corporate entities.

In order to receive dividends from MHTH another company was created, namely Nictor Holdings Inc. ("Nictor"). The dividend income from MHTH would flow through Trust #1 to Nictor, which was a beneficiary of Trust #1. Nictor received the funds tax-free as a related corporation. The only shareholder of Nictor was Trust #2. Jeff was the sole director of Nictor and had the sole power to declare dividends.

23 *Supra* at footnote 4.

24 This presumably included Jeff and his family as beneficiaries but this was not clear from the decision.

25 Suggesting there was already an MH Tremblay Family Trust No 1 in existence.

The beneficiaries of Trust #2 were Jeff, Catherine and their two children. The Trustees were Jeff and his two parents.

At the date of separation, approximately $905,000 was held in Nictor.

The issues in dispute related to, among other things, whether the value of shares in MHTH and Nictor should be included in the husband's NFP.

The Issues

Part of the difficulty with this case was the summary of the questions posed, which were in part as follows:

1. determination of the value of shares in MHTH and Nictor and whether that share value should be included in the Respondent's NFP;
2. a determination of whether the Respondent may exclude the value of the Nictor and MHTH from his NFP as having been received by him via gift.

Since Jeff did not own a direct interest in any of the corporate entities, the questions posed were not as precise as they ought to have been, as the issues related to Jeff's and Catherine's interests in Trust #2 which owned the shares of Nictor.

In determining whether or not the shares of MHTH would be included in Jeff's NFP, Phillips J. noted that if funds were held in MHTH, they were "entirely under the control of Michael Tremblay" and concluded that Jeff did not have a property interest in MHTH as defined by section 4 of the FLA.

We note, however, that 50% of the shares of MH Holdings Inc. were owned by Trust #1 and, presumably, there would have been some growth accruing to the common shareholders since the implementation of the estate freeze in 2009. This issue was not addressed at all. Again, it is unclear if the MH Tremblay Trust No. 2, which held the other 50% of the growth shares of MHTH, included Jeff and his family.

As for Nictor, Phillips J. stated that he accepted the evidence that "Nictor was intended to be a holding company for the Respondent to hold his 50% share of any profits that Michael Tremblay would actually disburse from MH Tremblay Holdings Inc." and noted that once funds are in Nictor, Jeff as director has "unfettered autonomous discretion with respect to the issuance of dividends".

He noted that if Jeff caused dividends to issue from Nictor, the only recipient would be Trust #2, under which Jeff was both a Trustee and a beneficiary. He then addressed the issue of whether Jeff's beneficial interest in Trust #2 constituted "property":

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> [27] Traditional trust law principles are clear that a person who is the object of trustee discretion to pay out capital in his favour does not have an existing property interest. From a pure property law viewpoint, he has only what is termed an "expectancy". He has the right to be considered by the trustees as a recipient under the trust in accordance with its terms and for the trustees to consider this issue acting in good faith in accordance with their fiduciary duty. As such, he has rights which constitute equitable "choses in action".

Curiously, he did not cite any previous decisions which had already concluded that such an interest did.

He then posed the central question as follows:

> [31] In my view, the central question with respect to determining the **proprietary** character of the Respondent's discretionary interest in the Jeff Tremblay Family Trust No.2 **is his ability to control whether distributions of trust property are made to him for his benefit.** His having meaningful control in that regard would undermine the separation as between the entities.
>
> [32] Without trying to set out an exhaustive list, this may involve consideration of the degree to which he **as beneficiary** can directly or indirectly control the actions of the trustees, which may include consideration of such factors as:
>
> (i) any evidence with respect to the founding intent of the trust. Was the trust designed to effectively allow **control by the beneficiary**?;
>
> (ii) the composition of the trustees, including whether **the beneficiary** is a trustee;
>
> (iii) any requirement, including veto powers, that the beneficiary be part of any trustee decisions;
>
> (iv) any history of past trustee actions which demonstrate direct or indirect control by the beneficiary;
>
> (v) any powers of the beneficiary to remove trustees, or to appoint replacement or additional trustees;[26]
>
> (vi) the relationship of the beneficiary to the trustees. Are the trustees independent and at arm's length or are they instead family members or other persons who may not act independently?

Respectfully, these questions seem to confuse the bundle of rights held by Jeff as a Trustee in terms of his ability to control versus his rights as a beneficiary. Specifically, the consideration of "the degree to which he as beneficiary can...control the actions of the trustees" misstates both the facts and the principle of law.

The court noted that Trust #2 was intended to provide for Jeff's family and that Jeff had paid himself from the Trust for "family living expenses".

Power to Remove Trustees

The court noted that while decisions are to be made by majority, "the Respondent has the sole ability to appoint more Trustees" and he concluded that this represents an ability to control the Trust:

> [36] The Respondent and his two parents, Michael and Heather Tremblay, are the trustees. While decisions in the discharge of the trustees' fiduciary obligations to the beneficiaries are made by majority rule, the Respondent has the sole ability to appoint more trustees. I find that his ability to name additional trustees is, in a practical sense, an ability to control the trust, at least insofar as an ability to cause the trust funds to come into his hands should he deem that to be in his and the other beneficiaries' best interests. While I acknowledge that each added trustee would have a personal fiduciary obligation, in my view, practically speaking, the Respondent's ability to select additional trustees' amounts to an ability to ensure his wishes about the best interests of his family will ultimately carry the day.,, It is, after all, the Jeff Tremblay Family Trust. The overwhelming evidence is that the larger Tremblay family is close and has a history of cooperatively sharing their considerable wealth. Even if that close relationship were ever to break down the Respondent has the ability to appoint additional trustees with the result that he could prevail over any dissent.
>
> [38] The degree of control that the Respondent has over the Jeff Tremblay Family Trust No. 2 elevates his expectancy into something more like a certainty. I find that degree of control to amount to the Respondent having a present property interest in the property held in Jeff Tremblay Family Trust No.2. As such, the holdings of the Jeff Tremblay Family Trust No.2 are to be considered property in the context of section 4 of the *Family Law Act.*

Since a majority of the Trustees could make a decision contrary to the wishes of Jeff, the court seems to have concluded that if the Trustees had done so, Jeff could have exercised his power to appoint additional and more compliant Trustees. Regrettably though, he concludes that this power as Trustee changed the

26 The power to remove Trustees appears to have been considered exceptionally relevant to control. See *infra.*

character of his discretionary trust interest *qua* beneficiary from an "expectancy" to a "certainty".

Generally, with Canadian trusts, it is not usual to have the same extensive type of control that was seen in the Mudronja Family Trust as it would run afoul of subsection 75(2) of the *Income Tax Act*. However, it is not unusual for an individual to have the power to replace Trustees, even though the reservation of such a right is not recommended. Nevertheless, the trend in family law decisions appears to be that a power to change or add Trustees is often one of the factors considered by the courts in determining whether a person has *de facto* control of the trust such that when combined with the position of such a person as a beneficiary, the interest of that individual is tantamount to the ability to consume the whole of the trust property.

In *Kan Lai Kwan v. Poon Lok To Auto* the court reversed the decision of the lower courts to attribute only two-thirds of the Trust to the "matrimonial pot" on the basis that it would be improper for the Trustees to not reserve one-third of the Trust for the child of the marriage. The court held that the terms of the Trust and the letter of wishes indicated that the husband held a dominant position in relation to the administration of the Trust and, in making himself protector of the Trust, he had reserved important powers, including the power to remove the Trustee which was intended to have only a passive role as a shareholder.

Exclusion as a Gift

The second issue addressed was whether or not Jeff could exclude the value of Nictor as held by Trust #2 as having been received by him by way of gift received after the date of marriage, pursuant to subsection 4(2) of the FLA.

Again, the posing of the question in such a fashion confuses the matter since Jeff did not receive any shares of Nictor by way of gift. Rather, he received an interest in Trust #2 by way of gift.

The court adopted the position taken by the Court of Appeal with respect to the law of gift in *McNamee v. McNamee*[27] which also involved an estate freeze. It was concluded that Michael intended that Jeff receive the benefit of Trust #2 as a gift.[28] Phillips J. concluded that Jeff acquired his interest in Trust #2 when it was settled and that there was no evidence suggesting that he paid any consideration to be included in the class of beneficiaries. Therefore, his beneficial interest in Trust #2 came to him by way of gift.

Inclusion of Trust Interest in Wife's NFP

The court then addressed the issue of Catherine's interest in Trust #2 and concluded that she was "as much of an equitable owner" of Trust #2 as was Jeff.

27 2011 ONCA 533 (Ont CA).
28 At para. 48.

Without addressing whether or not the discretionary interest was to be treated as an equal property interest *per* the *Sagl* decision, there is no further discussion of the beneficial interests in the Trust #2 or the valuation of the beneficial interests. This might have been on the basis that each was entitled to an equal interest in Trust #2 which cancelled one another in terms of value. However this approach is in contradiction to *Mudronja* which considered that it would be unlikely that the spouse be the object of any beneficial entitlement, particularly where the Trustees were the estranged spouse and his parents.[29]

Exclusion of Trust Interest "Owned"

Phillips J. then addressed the issue of whether or not Jeff "owned" the property in question on the valuation date (the date of separation) and concluded that "although this interest amounts to property as contemplated by section 4(1) of the FLA, that finding does not equate to a finding of ownership. The proposition that ownership leads to a property interest does not necessarily work in reverse". He then concludes as follows:

> [55] I conclude that the Respondent has not discharged his onus under section 4(3) of the *Family Law Act* to exclude his interest in the Jeff Tremblay Family Trust No.2 as property owned by him on valuation date acquired by gift.

Subsection 4(3) of the FLA states that the onus of proving a deduction under the definition of NFP or an exclusion under subsection 4(2) is on the person claiming it. "Excluded property" is defined in subsection 4(2) and includes "property, other than a matrimonial home that was acquired by gift or inheritance from a third person after the date of the marriage". Having concluded that the property in question was the interest in Trust #2 and that the trust interest had been received by way of gift, it made no sense to conclude that the onus had not been discharged.

The distinction between owning property and not owning property is ephemeral and there is no guidance given as to why the existence of a property interest does not amount to ownership of a property interest. There was some prior discussion regarding ownership of trust property being split between a Trustee and a beneficiary with a beneficiary having "what could be called equitable ownership". However, the reasoning is unclear and estate planners who are relying on the fact that a trust interest acquired after the date of marriage would be excluded from NFP will need to consider very carefully the significance of this case and the meaning of the finding that although the trust "interest" was property, it was not "owned".

Presumably on the appeal, the Mudronja case will be drawn to the attention of the Court of Appeal and some clarification will

29 *Mudronja v. Mudronja,* 2014 ONSC 6217, 2014 CarswellOnt 15112 (Ont SCJ).

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be made of the distinction between the existence of a property right and its ownership.

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SUMMARY OF QUESTIONS AND ANSWERS FROM THE 2016 STEP CANADA/CRA ROUNDTABLE

By Deven Rath, Student-at-Law, Miller Thomson LLP, edited by Rahul Sharma, Associate, Miller Thomson LLP

The Society of Trust and Estate Practitioners ("STEP") held its eighteenth national conference in Toronto on June 9 and 10, 2016. One of the highlights of the conference was the STEP Canada/Canada Revenue Agency ("CRA") Round Table session on June 10, where senior representatives from the CRA answered 15 questions of interest to estates and trusts practitioners. These questions, and the CRA's general responses to them, are summarized below.

QUESTION 1 — GRADUATED RATE ESTATES AND TRANSFERS TO TESTAMENTARY TRUSTS

Q: The question began by re-stating the view that an individual can only have one estate, even if there are multiple wills and executors, with assets in a number of different countries. It went on to suppose a scenario where a will provided for assets to be broken into three testamentary trusts: a spousal trust, a trust for children, and a third trust for what was called the general estate.

The question itself was divided into four parts:

a) *If the assets were held in the general estate, and not transferred to the two trusts for the spouse or the children for the first two or three years while the estate is under administration, would tax returns be required for all three testamentary trusts?*

A: The CRA noted that it generally views trusts resulting from the residue of an estate as arising on death. However, it will ultimately be a question of fact as to when the trusts were established, which will determine what the filing requirements are for returns under the *Income Tax Act* (the "Act").

b) *If the deceased died in 2014, and in 2015 all the assets had been transferred to the spousal or children trust — would that mean that in 2016, there is no graduated rate estate ("GRE")?*

A: Under the definition of GRE in subsection 248(1), only an estate can be a GRE. If property is transferred from the estate to a trust, that trust will not be classified as a GRE. In this case, there would not be a GRE in 2016.

c) *Could assets be transferred back from the trusts to the GRE?*

A: Any assets transferred to the GRE from the other testamentary trusts would cause the estate to lose its testamentary trust status and consequently its GRE status, because:

- The definition of GRE in subsection 248(1), specifically paragraph (b), requires that the estate be a testamentary trust per subsection 108(1) of the Act.
- Paragraph (b) of the testamentary trust definition, in subsection 108(1), states that where property has been contributed to a trust in any other way than "by an individual on or after the individual's death and as a consequence thereof", it will not be a testamentary trust.

d) *The new rules on donation require that any donations be made by the general estate, and not any other testamentary trusts. Does this mean that the general estate must remain as such until the donations are fully made (up to 60 months)?*

A: A GRE can remain as such for up to 36 months after the death of the individual. New legislative proposals (from January 2016) would allow an estate that would otherwise stop being a GRE 36 months after death to still make a donation within 60 months of death.

QUESTION 2 — GRADUATED RATE ESTATES AND MULTIPLE WILLS

Q: The question asked if a deceased had a second will pertaining to foreign assets, whether the status of an estate as a GRE would be invalidated if only the domestic executors elected for the estate to be a GRE — either because the domestic executors did not know about the second will or could not deal with the foreign executors in a timely manner.

A: The CRA noted that if an individual has multiple wills, they could all be separately administered, but that its view was that an individual's estate encompasses all property owned by the individual at death, wherever it might be located around the world.

Under the definition of a GRE in subsection 248(1), an estate that arose on and as a consequence of the death of an individual will only be considered a GRE if it meets the requirements of paragraphs (a) through (e) of that definition.

Of those, paragraphs (d) and (e) would be of concern in this situation: it will be necessary to ensure that the domestic executors were given the ability to make the GRE designation; and, the domestic executors should ensure that the designation was not already made by the foreign executors.

QUESTION 3 — DISTRIBUTION FROM *INTER VIVOS* TRUST TO GRADUATED RATE ESTATE

Q: The question addressed *inter vivos* trusts that might be created with the estate as a beneficiary. For example, a life insurance policy might be held by the trust, with the trust being the beneficiary of the policy at the individual's death, and the estate being the beneficiary of the trust. The question then asked how that might affect the estate's GRE status.

A: The CRA's answer re-iterated that property contributed to the estate be "by an individual on or after the individual's death and as a consequence thereof." Here, the individual whose life is being insured would not be the policyholder, the *inter vivos* trust would be. So the estate would not meet the requirements of a GRE.

QUESTION 4 — QUALIFIED DISABILITY TRUSTS AND PREFERRED BENEFICIARY ELECTION

Q: The question addressed the conditions that must be met for a trust to be eligible as a Qualified Disability Trust ("QDT") for a particular tax year. Under the preferred beneficiary election, it is possible for the trustee and the preferred beneficiary to jointly elect to have some or all of the taxable income earned by the trust to be included in the income of the beneficiary.

Specifically, the CRA was asked whether the introduction of the QDT provisions restricted the ability to make a preferred beneficiary election, and whether it would be possible for a preferred beneficiary election to be made for each of four testamentary trusts created for the benefit of the same disabled individual.

A: The CRA's response confirmed that the QDT provisions have not restricted the availability of the preferred beneficiary election, nor have there been changes to the method in which a preferred beneficiary election is made. The requisite conditions of making a preferred beneficiary election are mostly different from those required to make a trust a QDT.

It is possible, if the conditions for both are met, for the trust to choose between the preferred beneficiary election and the QDT election. It is also possible for a trust which elects to be a QDT to also make a preferred beneficiary election, jointly with the beneficiary, for a particular tax year.

QUESTION 5 — CAPITAL LOSS CARRY BACK AND LATE FILED SUBSECTION 104(3.2) DESIGNATION

Q: The question was a follow up to a question asked at the 2015 STEP/CRA Roundtable. The original question had been whether a carry back of a capital loss realized in a subsequent year would allow a late subsection 104(13.2) designation to be filed. The CRA noted last year that a late-filed subsection 104(13.2) designation would generally be acceptable, so long as the taxable income for the year was not greater than nil.

The new question noted that for 2016 and subsequent years, where income and capital gains of a trust are actually paid out or made payable, a designation under subsection 104(13.1) or 104(13.2) is not permitted pursuant to subsection 104(13.3), unless the taxable income of the trust is nil.

The question was whether it was permissible for the 104(13.2) designation to include in the income of a trust a capital gain realized for a previous year that had been allocated out to the beneficiary, with the beneficiary's tax return amended to remove the capital gain.

A: The CRA responded that the trust can make a late subsection 104(13.1) or (13.2) designation as long as the application of the loss results in nil taxable income for the trust.

Filings to amend the tax position of the trust and the beneficiary would be as follows:

- The trust would file Form T3A "Request for a Loss Carry back by a Trust" in connection with the loss year to request the loss be carried back to the prior year.
- The trust would file Form T3-ADJ "T3 Adjustment Request" for the prior year to reflect a late subsection 104(13.1) or (13.2) designation so as to amend the trust's T3 Return.
- The trust would issue amended T3 slips to the beneficiary for that prior year.
- The beneficiaries would file a Form T1-ADJ "T1 Adjustment Request" to reflect the revised T3 slip and to amend the T1 Return.

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The CRA will only reassess beneficiaries' returns if the tax years to which they relate and the tax year of the trust to which the loss will be applied are not statute-barred. The trust must file Forms T3A and T3-ADJ together as they must be processed concurrently.

QUESTION 6 — TRUST INSTALMENT REQUIREMENTS AND INTEREST

Q: The CRA was asked to provide an update on its policies from the 2014 STEP Conference, where it stated that, under its then-current administrative practices, penalties and interest would not be assessed where an *inter vivos* trust failed to make sufficient instalment payments.

A: From 2016 onwards all *inter vivos* trusts and testamentary trusts are required to make instalment payments (whereas only *inter vivos* trusts were required to do so before 2016). However, the CRA will continue its current administrative practice of not assessing interest and penalties where a trust does not make sufficient instalment payments.

QUESTION 7 — DEEMED RESIDENT TRUST AND CCPC STATUS

Q: A trust that meets the conditions of section 94 is considered to be a resident for certain purposes under the Act, and is generally referred to as a deemed resident trust. It is not considered to be a resident for all purposes, however, and some rules are different for it. The question was whether the CRA could confirm that where a deemed resident trust controls a Canadian corporation, it would not be considered a Canadian-controlled corporation.

A: The CRA's response first outlined that a non-resident trust that holds the majority voting share of a corporation would mean that the corporation is controlled directly or indirectly by non-resident persons, and so it would not be a Canadian-controlled private corporation (CCPC).

Even though a deemed resident trust is considered to be resident for certain purposes, there is nothing that would allow for the result of a corporation owned by a factually non-resident trust to then be deemed to be Canadian-controlled pursuant to section 94.

QUESTION 8 — CHARACTERIZATION OF LLPS AND LLLPS

Q: The CRA was asked about the status of its review of the characterization for Canadian tax purposes of limited liability partnerships (LLPs) and limited liability limited partnerships (LLLPs) established in Florida and Delaware.

A: The CRA confirmed that it had reached the general conclusion that Florida and Delaware LLPs or LLLPs are corporations for the purposes of Canadian income tax law. It also stated that it is prepared to provide certain administrative concessions for entities that were formed before July 2016, and where (among other conditions) they convert before 2018 to an entity that is generally recognized as a partnership for Canadian tax purposes.

QUESTION 9 — SUPPORT FOR U.S. FOREIGN TAX CREDIT CLAIMS

Q: The CRA was asked about a recent increase in the number of requests it has been issuing to taxpayers regarding transcripts from the Internal Revenue Service in the United States for foreign tax credits claimed in Canada.

A: The CRA's response stated that a decision was made in 2015 to change the requirements for acceptable supporting documents related to claims for foreign tax credits with respect to US source income. This change brought the requirements for the US in line with those for all other countries.

Form T2209, Federal Foreign Tax Credits, notes the documents necessary to support a claim for taxes paid in the U.S., including but not limited to: federal, state, and municipal tax returns, all associated schedules and forms, a copy of the federal account transcript and a similar form for state and/or municipal tax authorities. A breakdown by income type, country, and recipient is also required for taxpayers who filed a joint return with their spouse/common-law partner.

If it is not possible to provide a notice of assessment, transcript, statement or other documents from the applicable tax authority, the CRA will accept proof of the payment that was made or the refund that was received — which may be in the form of bank statements, cancelled cheques, or official receipts. These other documents must show: that the payment was made to, or refund received from, the applicable tax authority; the amount of the payment or refund; the tax year to which the payment/refund applies; and the date the amount was paid/received.

The CRA recommended making the request to the IRS promptly, to avoid missing any deadlines in submitting that documentation to the CRA.

QUESTION 10 – U.S. REVOCABLE LIVING TRUSTS

Q: In U.S. estate planning, it is common for a U.S. person to create a "revocable living trust", where the settlor (or grantor) is the sole trustee, and (so long as he/she is alive) also the sole beneficiary who can access the trust's income or principal, or revoke the trust. The trust provisions often allow for a distribution of trust property to specific named beneficiaries on the death of the settlor.

Even where the trust and the settlor are non-residents of Canada, there may still be situations where Canadian tax law is relevant to this arrangement, particularly with respect to where the trust invests in taxable Canadian property or where the remainder beneficiary is a Canadian resident.

The CRA was asked two questions related to this scenario:

a) *First, whether the CRA could comment on its previous policy that such an arrangement constitutes a trust pursuant to subsection 104(1), particularly in the context of De Mond v R (4 CTC 2007). The court in De Mond found that such a trust was a 'bare' trust, and consequently not a trust for the purposes of s104(1).*

A: The CRA announced its opinion on Canadian income tax consequences of a transfer to a revocable living trust at the 1995 Canadian Tax Foundation's annual conference. At that time it was the CRA's opinion that a revocable living trust should be recognized for income tax purposes at the time that title to the property is transferred to it, and that the transfer is at its full fair market value. This continues to be the CRA view with respect to US revocable living trusts.

The key distinguishing factor between a revocable living trust and a bare trust (such as that in *De Mond*) is that a revocable living trust generally includes beneficiaries that are contingent on the death of the settlor. Therefore, there is a change in beneficial ownership with respect to a transfer to a revocable living trust.

b) *Second, where a Canadian resident is a remainder beneficiary of such a trust, paragraph 70(5)(b) applies to any person who acquires any property that is deemed (by paragraph 70(5)(a)) to have been disposed of by the decedent. Would the beneficiary be considered to have "acquired" the capital interest from the decedent such that 70(5)(b) is applicable?*

A: Pursuant to paragraph 70(5)(a), a deceased taxpayer is deemed to have disposed of any capital property owned immediately before death at fair market value. And, under paragraph 70(5)(b), any person who acquires such property as a consequence of the taxpayer's death is deemed to have acquired the property at the time of death at fair market value.

Under the definition of "as a consequence of death" in subsection 248(8), the acquisition of property as a consequence of the will or testamentary instrument (or of the law governing intestacy) is considered to be an acquisition as a consequence of the death of the taxpayer.

In the scenario above, the remainder beneficiary acquiring an interest in a revocable living trust is acquiring it as a result of the terms of the trust and not as a consequence of the decedent's death, and so paragraph 70(5)(b) is not applicable to determine the adjusted cost base of the beneficiary's interest in the trust.

QUESTION 11 — TAINTING OF A SPOUSAL TRUST

Q: Archived paragraph 8 of IT-305R4 reads as follows:

> Once a trust qualifies as a spouse trust under the terms of subsection 70(6), it remains a spouse trust and is subject to the provisions affecting such trusts (for example, paragraph 104(4)(a)) even if its terms are varied by agreement, legal action or breach of trust. However, these events may cause other provisions of the Act to apply, such as paragraph 104(6)(b) and subsections 106(2) and 107(4).

The CRA was asked to share its comments, previously provided at the 2016 Conference of Advanced Life Underwriting, on this paragraph.

A: The main purposes of paragraph 8 of IT-305R4 is to clarify that in applying paragraph 104(4)(a), one must look to the terms of the trust at the time of its creation, such that any subsequent change in the terms would not invalidate the application of 104(4)(a).

The current wording of subparagraph 104(4)(a)(i) provides for a deemed disposition date that is based on the terms of the trust "at the time it was created". Accordingly, even if the terms are later varied by agreement, legal action, or breach, it is the terms on creation that would determine the application of subsection 104(4).

The previous wording of subsection 104(4) was not as clear, before being amended in 1976, and the explanation in paragraph 5 of IT-305 (from 1976) has been brought forward, most recently into paragraph 8 of archived IT-305R4.

QUESTION 12 — AMOUNTS PAYABLE AND PHANTOM INCOME

Q: A trust may realize income for income tax purposes without receiving a payment or even having a transaction. Such income is sometimes called "phantom income".

The question the CRA was asked was whether this phantom income can be taxed in the hands of the beneficiary, and if so, how would the trust meet the requirement that the income be paid or made payable to the beneficiary by the end of the year.

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Assuming the trust meets this requirement, a follow up question was whether the payment be made "in kind" (e.g., by distributing shares).

A: A deemed capital gain, for the purposes of the Act, is not recognized as income or capital in trust law; it is a "nothing" for trust law purposes.

Where a trust elects under section 48.1, the taxable capital gain resulting from the deemed disposition would be taxed in the trust, unless the deemed taxable capital gain is paid or payable to the trust beneficiaries within the meaning of subsection 104(24) and the requirements of subsection 104(6) are met. Subsection 104(24) provides that an amount is deemed not to have become payable to a beneficiary in a taxation year unless it was paid in the year to the beneficiary or the beneficiary was entitled in the year to enforce payment of the amount. The terms of the trust must specifically permit an amount equivalent to the deemed taxable capital gain to be paid or payable, or the trustee must have the discretionary power to pay out amounts that are defined as income under the Act.

With respect to a discretionary trust, an amount equivalent to the deemed taxable capital gain would be payable for income tax purposes only where the trustees have exercised their power to make it payable. The trustees must exercise their discretion before the end of the trust's taxation year and the exercise must be irrevocable with no conditions attached to the beneficiaries' entitlements to enforce payment of the amount in the year. Furthermore, the beneficiaries must be advised before the end of the trust's taxation year. The trustees' exercise of discretion and notification to the beneficiaries should be in writing.

Where a trust is non-discretionary, the trust indenture must provide that the amount equivalent to the deemed taxable capital gain is to be paid or payable to the beneficiaries by the end of the trust's taxation year.

For a deemed taxable capital gain to be distributed by way of a payment in-kind, the trust indenture must permit the assets of the trust to be distributed to the beneficiaries as a payment in-kind. The resolution authorizing the distribution should indicate that the payment is in respect of the amount of the deemed taxable capital gain and not in satisfaction of a beneficiary's capital interest in the trust. Should the fair market value of the property distributed in-kind exceed the amount of the deemed taxable capital gain, the difference would represent a distribution in satisfaction of the beneficiary's capital interest in the trust, assuming the conditions in subsection 107(2) are otherwise met and no other trust income is being distributed.

QUESTION 13 — FILING OBLIGATION FOR 75(2) TRUST HOLDING NON-INCOME PRODUCTION PROPERTY

Q: The "Who Should File" section of the T3 Guide states:

> A T3 return must be filed if the trust is subject to tax, and any one of the following conditions applies. The trust: ... holds property that is subject to subsection 75(2) of the Act.

The CRA was asked to comment on the implication that a reversionary trust that holds non-income-producing property (i.e., no income or profits, or no capital gains) is required to file a T3 Return.

A: The CRA had previously noted that the T3 Trust Income Tax and Information Return is both a return of income and a general information return. A T3 Return serves to report not only information about the reporting trust, but also additional information, such as that affecting the taxation of persons having some connection to the trust.

The requirement for a trust to file a return is provided in paragraph 150(1)(c) of the Act and section 204 of the Income Tax Regulations. Subsection 150(1.1), as it applies to a Canadian resident trust, states that the trust is required to file an income tax return if tax is payable by the trust or the trust disposes of capital property or realizes a capital gain. In addition, subsection 204(1) of the Regulations provides that every person having control of or receiving income, gains or profits in a fiduciary capacity must file a return.

A T3 Return is therefore required for a reversionary trust where the trustee computes nil income for the trust for tax purposes because subsection 75(2) applies to attribute income to the person from whom the trust directly or indirectly received the property.

Where a person in a fiduciary capacity does not control or receive income, gains or profits during the tax year, they would not be required to file a T3 Return for that year.

QUESTION 14 — OFFSHORE TAX INFORMATION PROGRAM

Q: The CRA was asked to provide an update on information for the Offshore Tax Informant Program ("OTIP") since its launch in January, 2014.

A: As of April 30, 2016, the OTIP has received 2,984 calls, 812 of which have been from potential informants, 333 written submissions, and has entered into over a dozen contracts with informants. It should be noted that this is an increase from the previous year.

QUESTION 15 — TRUSTS AND ESTATES ISSUES

Q: The CRA was asked to provide a brief overview on a number of issues it had recently considered relating to trusts and estates.

A: The CRA noted four topics on which it had recently published views:

(a) Form T1135 and jointly held property

At the 2015 Canadian Tax Foundation ("CTF") Annual Conference, CRA was asked how to report specified foreign property on Form T1135 if the property is jointly held by spouses. In document 2015-0610641C6, the CRA stated that it would compare each spouse's share of the property with the $100,000 reporting threshold, and that the respective shares would be based on the amounts contributed by each spouse toward the cost to purchase the property.

(b) Form T1135 and normal reassessment period

In document 2015-0572771I7, the CRA stated that the filing deadline for Form T1135 is the same as for the filing of the Part I return, and that any assessment for failure to file on time pursuant to subsection 162(7) must, subject to subsection 152(4), be made within the normal reassessment period for Part I.

(c) Subsection 159(6.1) election

In document 2015-0594201E5, the CRA was asked whether an election pursuant to subsection 159(6.1) of the *Income Tax Act* can be made where a liability for tax arises from a deemed disposition of resource property. The CRA responded that, since subsection 159(6.1) specifically refers to tax liability arising on the occurrence of a time determined under paragraph 104(4)(a), (a.1), (a.2), (a.3), (a.4), (b) or (c) which is the time when a deemed disposition pursuant to subsection 104(5.2) occurs, an election under subsection 159(6.1) is possible.

(d) Transfer pursuant to subsection 70(6)

At the 2015 APFF Conference, the CRA was asked whether subsection 70(6) of the Act could apply to a situation in which an executor disposed of some of the assets of the estate in order to transfer the proceeds to a spousal trust created by the will of the deceased. In document 2015-0596611C6, the CRA responded that subsection 70(6) would not apply in this situation since the rules in subsection 70(6) apply on a property-by-property basis, and subsection 70(6) requires that the property transferred must be the same property that was deemed to have been disposed of by the deceased.

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TAX COURT OF CANADA UPHOLDS OFFSHORE INSURANCE STRUCTURE

By N. Gregory McNally, N. Gregory McNally & Associates Ltd.

If you were under the impression that the Tax Court of Canada ("TCC") ruled against the use of offshore insurance planning in its recent decision in *Golini v. R.*,[1] you would not be alone. However, nothing could be further from the truth.

The Honourable Justice Campbell Miller upheld every aspect of the offshore insurance planning, including the bridge financing secured to obtain the various policies, in order to find that the taxpayer had received an illegitimate shareholder benefit back home under section 15(1) of the *Income Tax Act* (Canada),[2] ("ITA").

BACKGROUND

Paul Golini, Sr. is the aging patriarch of a multi-million-dollar real estate business in Toronto, referred to as Empire Real Estate. Empire is operated by his son Paul Jr. and nephew, Andrew Guizzetti.

Andrew and Paul Jr. sought advice from their accountants Price Waterhouse Coopers ("PWC") to provide succession planning for Empire from Paul Sr. PWC introduced Andrew and Paul Jr. to a local insurance broker who was familiar with the use of offshore insurance planning for similar objectives.

The broker then approached a tax partner with the national law firm of McMillan Binch Mendelsohn LLP ("MBM") to provide tax advice. MBM advised that not only could the sought after succession planning be secured through the use of offshore insurance, but that it was also possible for Paul Sr. to receive active income deductions within the same plan utilizing a loan to Paul Sr., which would create annual interest deductions.

The gist of the plan was that one of Empire's active operating companies (Ontario Inc.) would enter into a standard domestic reorganization wherein a new Canadian holding company (Holdco) would be created that would issue shares to Paul Sr. in exchange for his shares in Ontario Inc.

Ontario Inc. then secured a bridge loan in the amount of $6M CAD from DGM Bank and Trust Inc. ("DGM Bank") in Barbados and bought back (redeemed) its shares from Holdco using the loan proceeds, thus leaving Holdco with the entire $6M CAD.

Holdco then used the $6M to purchase an annuity from a Nevis insurance company called St. Joseph Assurance Company

1 2013-705(IT)G, 2016 TCC 174, 2016 CCI 174.
2 *Ibid. at para.* 106.

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Ltd. ("St. Joseph's"), which provided for an annual payment of $400,000 to Holdco until the death of Paul Sr., or the expiration of its 15-year term.

Holdco also purchased a $6M life insurance policy from a second insurance company called DGM Insurance Corporation ("DGM Insurance"), which required a $400,000 annual premium payment for 15 years (which matched the annuity stream).

Both St. Joseph's and DGM Insurance reinsured their obligations to a third insurance company called Stellar Insurance ("Stellar"), which was also resident in Barbados. Stellar, therefore, collected the original total amount of $6M that went from DGM Bank, to Ontario Inc., to Holdco.

Next, Stellar (ostensibly in an act to invest the premium proceeds), placed all $6M with a company called Trafalgar Holdings LLC ("Trafalgar"), which was based in St. Vincent and the Grenadines. Trafalgar and Stellar were related companies.

Trafalgar then lent the proceeds to a newly formed Canadian company called Metropac Services Inc. ("Metropac"), which then lent the $6M back to Paul Sr. The loan was guaranteed by Holdco and the annuity and life policy were collaterally assigned first to Metropac and then from Metropac to Trafalgar.

All of the offshore companies were owned and operated by third-party non-residents of Canada whereas Metropac was owned and operated by a Canadian resident lawyer who was known to the local insurance broker's wife.

Paul Sr. then used the loan proceeds to pay for new preferred shares issued by Ontario Inc. and yes, Ontario Inc. paid back DGM Bank its $6M.

All of the insurance and loan transactions were clearly set out for the court to see in an Escrow Agreement signed between the various parties. DGM Bank paid the loan proceeds to MBM in trust, who acted for the Golini's and their companies. MBM, in turn, sent them to K.N. Hyde & Associates ("Hyde"), who acted for the offshore parties. Finally, Hyde sent them back to MBM who repaid DGM Bank.

All of the loans had the same interest rate of 8% per annum. However, Paul Sr. only paid $80,000 of the $480,000 owed each year, as it was set out in the various documents that the offshore insurance companies and the insurance broker were to earn $80,000 per year in fees. Nevertheless, PWC used a deduction of the full $480,000 in its annual tax filing for Paul Sr.

Further, the loan agreement between Metropac and Paul Sr. was limited in recourse only to the annuity and life policy on Paul Sr. issued to Holdco. In other words, if Paul Sr. defaulted, Metropac's only recourse was to Holdco for the annuity payments and proceeds of the life policy.

CANADIAN REVENUE AUTHORITY'S POSITION

CRA's primary argument was that the entire plan was a sham. There was no real substance to the insurance planning or the loan transactions. For starters, was the deficiency in the documentation. There were no standard loan or insurance applications. No medical questionnaire or records were provided, nor exams performed. Some of the actual documents purporting to be in the plan, such as the life insurance contract itself, was not even produced.

Moreover, CRA had an expert witness (a qualified Canadian actuary) testify that none of the benefits created or premiums charged under the annuity and life policy would be used in a commercial context let alone justified using actuarial calculations. The numbers were simply plugged just to make the planning work.

Further, the transactions were all circular in nature such that all obligations offset each other, including the annual annuity payment to be issued by Stellar on behalf of St. Joseph's and collected by Stellar on behalf DGM. There was no risk in relation to the original movement of funds as everything was laid out in the Escrow Agreement. All subsequent payments, if in fact they were even made, offset each other.

Another major discrepancy concerned the specifics of the annuity contract. The annuity contract stated that the premium payment of $6M would be invested in something called the Global Index Fund. But under cross examination, the owner/manager of St. Joseph's confessed that no such investment was truly contemplated. It was agreed at the outset that the $6M would be transferred to Trafalgar, which in turn would be lent to Metropac, which would in turn be lent to Paul Sr.

TAX COURT OF CANADA'S POSITION

Despite the overwhelming evidence, the Tax Court of Canada rejected CRA's argument that the insurance planning and loan transactions were a sham. Justice Miller stated that the insurance contracts and loan agreements were legal and enforceable transactions presented in accordance with their legal reality. At paragraph [106] of the judgment, Justice Miller states:

> The Respondent's sham argument is more far reaching than how I intend to rely upon such a concept. The Respondent's argument is that the transactions in their entirety were just "papering over", and that the funds were simply circled through various entities to achieve a $6,000,000 increase in the paid out capital for the shares held by Paul Sr., along with significant annual interest

> deductions: a shell game according to the Respondent. I do not go that far.[3]

Although Justice Miller found that the testimony by the advisors on behalf of the taxpayer somewhat disingenuous, he would not conclude that the transactions undertaken were meant to be deceitful (a required element of the sham doctrine).

> These transactions abound with smoke and mirrors, but clearing the smoke and looking through the mirrors, as difficult as the Respondent [Canadian Revenue Authority] suggests that is to do, the underlying transactions, I conclude, are for the most part (though not all) legal and enforceable transactions presented in accordance with their legal reality.[4]

The only transaction that Justice Miller alludes to as being a sham is the loan between Paul Sr. and Metropac, and only to the extent of the collateral assignment, which he finds to be an absolute assignment and not collateral. But for the most part, Justice Miller determines that the difference between real and artificial is whether or not legal rights are created.

> The parties argue in terms of what is real or, as the Respondent [CRA] put it, what is artificial. The question of what is real or artificial when dealing with contracts is a question I would suggest of what is legal. Are the legal rights and obligations that are stipulated in the agreements the true legal rights and obligations to which the parties knowingly have bound themselves, understanding they are enforceable as such, with no element of nudging and winking.[5]

Obviously (and most amazingly) Justice Miller must not have found the subject facts to involve any "element of nudging and winking". He further makes the statement that "willful blindness" is not sufficient in the context of sham. He finalizes his argument regarding sham by stating:

> The Respondent claims the increase in PUC [payment by Paul Sr. of the $6M loan proceeds to Ontario Inc. for preferred shares], is artificial and the interest deduction [on the loan from Metropac] is artificial. Clearly, those are consequences of the agreement, consequences the Respondent finds abhorrent, yet consequences the parties expected to flow from the agreements. Consequences that flow from the transactions are not what drive the issue of the real or artificial nature of the transactions.[6]

3 *Ibid*.
4 *Ibid*. at para. 107
5 *Ibid*. at para. 111.
6 *Ibid*. at para. 113.

One last observation about Justice Miller's finding on sham has to do with his disregard of CRA's expert evidence as it applies to the insurance contracts.

> With respect, I do not need actuaries to satisfy me that paying $6,000,000 for an annuity in your late seventies yielding $400,000 a year to the earlier of death or 15 years is "unattractive".[7]

However, despite finding that the reference to the Global Index Fund was a complete misrepresentation on the part of St. Joseph's and the various planners, he concluded that the investment component was not the "essence" of the annuity. Rather, the payment of the $400,000 per year was the real purpose and intent of the parties (despite there being no evidence that Stellar actually made the payments to itself for that purpose).

> I suggest the experts [CRA's expert witnesses], fell into a trap in reviewing the annuity by simply analyzing it in isolation. In doing so they both placed some value on the investment aspect of the annuity. That was not where the parties clearly and openly intended there to be any significance. In that light I am not prepared to strike the annuity down as a sham transaction.[8]

Justice Miller's entire argument focused on the loan from Metropac to Paul Sr. Given that the loan and any outstanding interest were limited in recourse only to the proceeds of the life policy paid for by Holdco, Justice Miller felt that the collateral assignment of the life policy to Metropac was in fact an absolute assignment. As such, Justice Miller reasoned that Paul Sr. received the value of the life policy as a shareholder benefit.

> Mr. Magwood [the owner/managing director of St. Joseph's], confirmed that on Paul Sr.'s death all that would happen, given the structured transactions, is that there would be no insurance proceeds paid but simply the surrender of the insurance certificate by Trafalgar to Stellar, having made its way from Holdco to Metropac to Trafalgar. By this act I understand that all obligations pursuant to the guarantee, the Metropac loan to Paul Sr., the Trafalgar loan to Metropac, the Stellar investment in Trafalgar and under the annuity and life insurance policy are met and consequently terminated.[9]

This evidence, coupled with the fact that Paul Sr. had made only $80,000 worth of the $480,000 interest payment to Metropac, led Justice Miller to conclude that Paul Sr. had received a benefit under section 15(1) of the life policy. He calculated the value of that benefit to be the amount of the premium owed annually

7 *Ibid*. at para. 79.
8 *Ibid*. at para. 119.
9 *Ibid*. at para. 75.

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($400,000), minus a guarantee fee of $40,000 that Paul Sr. was to pay to Holdco annually. The net value of $360,000 annually times 15 years of required payments equals a shareholder benefit of $5,400,000 CAD.

CONCLUSION

Justice Miller's decision was based on a loan paid to a Canadian resident taxpayer, by a Canadian resident lender, guaranteed by a Canadian resident holding company. None of the tax liability related to the offshore nature of the insurance companies or interim lenders.

In today's world of "Panama Papers", the first presumption is that a taxpayer is always liable based on any use of offshore planning. However, nothing could be further from the truth in the Golini case. It is clear that Justice Campbell went out of his way to conclude that all of the insurance contracts and loan agreements were legal and enforceable.

It would have been interesting to know if Justice Miller would have found any tax liability against Paul Sr. had he been making his interest payments to Metropac. Moreover, whether Justice Miller would have found any fault in just the main part of the planning if Ontario Inc. received the loan directly to repay DGM Bank and skipped Paul Sr. altogether, thereby eliminating a pre-requisite for the application of section 15(1).

Certainly, it could be argued that Justice Miller had to go out of his way to find validity in the offshore contracts and transactions, in order to get to the ultimate section 15(1) benefit. If there was no legitimate annuity or life policy, it would have been impossible for Paul Sr. to get the value of same.

Nonetheless, offshore insurance and bridge financing are not found to be the reason for taxation in Golini.

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PROPERTY ASSESSMENT VICTORY FOR CHURCH-OPERATED MONTESSORI SCHOOL

By Peter A. Milligan, Associate Counsel, Miller Thomson LLP, and Jamie G. Walker, Associate, Miller Thomson LLP

On March 9, 2016, the Ontario Superior Court of Justice released its decision in *St. George and St. Rueiss Coptic Orthodox Church et. al. v. Municipal Property Assessment Corporation et. al.*,[1] which dealt with exemptions from property tax for religious organizations and seminaries of learning.

The Superior Court's decision provides valuable guidance to charitable organizations and non-profit corporations seeking exemptions from property tax under the *Assessment Act*, R.S.O. 1990, c.A.31, as amended (the "Act"). It also offers the latest insight into how two separate legal entities may be treated the same for tax purposes by virtue of the concept of patrimony.

BACKGROUND — "PATRIMONY"

The term "patrimony" is a concept that originates from the French civil law (*la patrimoine*) and essentially refers to a person's total assets and liabilities.[2] In the context of property assessment, the notion of a shared patrimony emerged from two 1994 decisions of the Supreme Court of Canada: (i) *Montréal Métropolitain (Conseil de la santé & des services sociaux) v. Montréal (Ville)* ("*Buanderie*")[3] and (ii), *Québec (Communauté urbaine) v. Partagec Inc.*[4] In both cases, the Supreme Court held that two separate legal entities shared a common patrimony such that one should not be treated differently than the other for tax purposes. This determination would have significant property tax implications, especially in terms of the exemption provisions under section 3 of the Act.

FACTS

St. George involved assessment appeals by two registered charitable and non-profit corporations: (i) St. George and St. Rueiss Coptic Orthodox Church (the "Church"); and (ii) St. George Montessori School Inc. ("SGMS"). At issue was a single building complex in North York built and owned by the Church which housed its church facilities as well as a non-denominational Christian Montessori school operated by SGMS (the "Subject Property").

In order to operate the school, the Church incorporated SGMS and enlisted the expertise of Dr. Stephanie Ling and Mr. Winston Ling to assist with the daily operations. The parties agreed by way of a Memorandum of Agreement ("MOA") that a nine-member Board of Directors would operate SGMS, with five members being appointed by the Church and four members being appointed by the Lings (the "SGMS Board"). Additionally, the Chair of the Board of the Church (the "Church Board") would always be the Chair of the SGMS Board.

1 St. *George and Rueiss Orthodox Coptic Church v. Municipal Property Assessment Corp.* 2016 ONSC 1723 (Ont SCJ).

2 Nik Diksic & Terry McDowell, "Foreign Exchange Gains and Losses" (2007) 15:12 Can Tax Highlights 6.

3 *Conseil de la Santé & des Services Sociaux (Montréal) v. City of Montréal* [1995] 1 CTC 223 (SCC).

4 *Partagec Inc. v. Québec (Communauté urbaine)* [1994] 3 SCR 57 (SCC).

Under the MOA, the Lings agreed to license the name "Cornerstone Montessori Prep School – Don Mills Campus".[5] In exchange, the Church would provide a fully functional and furnished school facility, pay all utility expenses, and significantly subsidize the tuition and transportation fees for qualifying students.

In 2014, the Municipal Property Assessment Corporation ("MPAC") issued an Omitted Property Assessment Notice classifying the classroom areas, school administrative areas, and gymnasium portions of the Subject Property under the Residential Tax Class. In response, the Church and SGMS brought an Application arguing that the entire Subject Property was exempt either as land used in connection with a place of worship or as a seminary of learning.

THE DECISION

After reviewing the evidence, Justice Dunphy rejected the notion that exemptions under the Act should be interpreted narrowly. Rather, the goal of statutory interpretation involved discerning the intent of the legislature having regard to all of the policies advanced by an enactment, not merely some of them. In the present case, this required balancing the raising of revenue through taxation with the social goal of supporting activities that have a larger social purpose.[6]

With this in mind, Justice Dunphy held that all of the portions of the Subject Property used by SGMS, with the exception of the school administrative areas and Church bookstore, were exempt as a place of worship and land used in connection with it pursuant to section 3(1)3.i.[7] The SGMS portions of the Subject Property were integral to the Church's place of worship, notwithstanding that the Church's use of these areas was incidental and off-hour.[8]

With respect to the second exemption under section 3(1)5., Justice Dunphy held that all of the school areas were exempt as an educational seminary of learning on the basis that the Church and SGMS shared a common patrimony.[9] Unlike in the *Buanderie* case cited by MPAC, the Church controlled SGMS by virtue of its control of the SGMS Board. Given that the Church had previously operated a school at its former facility[10] and now had full control of SGMS, Justice Dunphy concluded that:

> [23] ...the change in legal structure did not alter the fact that the same activities took place before and after and there is no reason why the formerly tax exempt activities should be found to be altered by the change in legal structure since they form part of a common patrimony. The land and building are owned by the Church who formerly operated a properly tax-exempt school. The new legal structure continues to serve the same tax-exempt objects of the same institution — the Church.[11]

IMPACT FOR CHARITABLE ORGANIZATIONS AND NON-PROFIT CORPORATIONS

Charitable organizations and non-profit corporations should take note of the Court's decision in *St. George* when structuring their operations in order to take full advantage of the exemptions available under the Act. The authors of this article acted as counsel for the Church in *St. George* and are available to answer questions and assist with exemption applications for the 2016 General Reassessment (2017-2020 taxation years).

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5 The "Cornerstone" name refers to a private Christian Montessori school operated at 177 Beverley St. in Toronto: http://www.cornerstoneprep.ca/toronto-montessori-school-location.
6 *Supra* Note 1, at para. 17.
7 *Ibid*. at para. 21.
8 *Ibid*. at para. 19.
9 *Ibid*. at para. 22.
10 Before moving to its current location at the Subject Property, the Church operated out of 141 Bond Avenue in Toronto for approximately 10 years.
11 *Ibid*. at para. 23.

THE TAXATION OF MARIHUANA IN CANADA

By Graham E. Purse, Associate, Miller Thomson LLP, and David W. Chodikoff, Editor of *Taxes & Wealth Management,* Tax Partner, Miller Thomson LLP

INTRODUCTION

Presently, the future legal regime concerning the future of taxation of marihuana in Canada remains uncertain. Therefore, we are speculating on the nature of the legal framework for marihuana taxation. In this article, we deal with three probable aspects of marihuana taxation: income taxes, excise taxes (GST), and pigouvian (or market-correcting) taxes. Next, we briefly discuss the marihuana and the medical expense tax credit. Finally, we discuss the taxation of marihuana at the Tax Court of Canada, given its current status.

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INCOME TAXES (THE BUSINESS CONTEXT)[1]

It is expected that marihuana business will be taxed like any other business; thus, in accordance with the various provisions of the *Income Tax Act* (Canada) (the "ITA").

Business income is computed in accordance with section 9 of the ITA. It is based on the "profit from that business or property for the year". Perhaps the most useful explanation from the Supreme Court of Canada of the computation of profit is as follows: where profit in a year was taken to consist of "the difference between the receipts from the trade or business during such year ... and the expenditure laid out to earn those receipts."[2] In other words, a marihuana business should be taxed normally for income tax purposes, in accordance with general commercial principles.

Under a legal recreational marihuana regime, it is expected that businesses will be able to incorporate and/or operate as partnerships. Also germane to the discussion below, marihuana horticultural practices likely meet the definition of farming set out in section 248 of the ITA provided they are done on a for-profit basis.[3] This suggests that certain tax preferences available to farmers may also be available to marihuana growers.

If incorporated, the possibility exists of carrying on business as a Canadian-controlled Private Corporation, which may entitle the company to a better tax rate via the small business deduction ("SBD"),[4] which applies in respect of the first $500,000 of active business income earned in Canada.[5] The SBD is designed to lower corporate taxes for small business — it makes reinvesting in the business less expensive from a tax perspective, but it also allows for tax deferral for profitable businesses. It is unclear whether the SBD will continue to exist in the future.[6] Further, separate real property corporations owned by grow-ops may also be able to enjoy the SBD.[7]

If a marihuana farming operation is incorporated, it is expected that income taxes can be deferred when the farm is transferred to children, either on a testamentary or *inter vivos* basis, just the same as if the farm were owned personally.[8] A family marihuana farming operation of the future may also benefit from an enhanced capital gains exemption on the sale of "qualified farm or fishing property".[9] There is no court decision as to the status of marihuana farming in respect of the various tax preferences afforded to farms, so any advice in this area will necessarily expose the taxpayer to risk.

For most closely-held marihuana shops, the capital gains exemption will likely be front and centre in tax elimination planning on the sale of the business.[10] As of 2016, this deduction provides for an offset of $824,176 against capital gains where an individual disposes of qualified small business corporation shares ("QSBC shares").[11] Depending upon the province in which the business is operated, the lifetime capital gains exemption can mean over $200,000 in tax elimination per individual.

Any profits of the corporation can be paid out to shareholders using various forms of owner-manager remuneration, which are beyond the scope of this paper. Two benefits of incorporation that should not be overlooked, however, are the ability to defer tax by leaving retained earnings in the corporation and dividend sprinkling. In the case of the latter, dividends may be paid to shareholders who are at lower marginal rates than the owner-manager, such as a spouse, parent, or adult child. The Supreme Court of Canada implicitly endorsed dividend sprinkling in *Neuman v M.N.R.*[12]

From an employment law perspective, upon legalization, where a marihuana dispensary hires employees, the employer will be expected to remit EI[13] and CPP,[14] and make applicable employee withholdings.[15] Further, as can be noted, directors can be held personally liable for failing to make such remittances.[16] A similar rule applies in respect of GST remittances.[17]

Capital gains tax will also be relevant to the marihuana producer and vendor. Where a sale is made to a consumer, it is on account of inventory and is fully included in income by the vendor.[18] Where the actual plants are sold from one business to another for the purposes of production, this will be on account of capital, triggering a potential capital gain or loss.[19] Dispositions of sativa or indica plants (or hybrid strains) as capital assets, if sold by a corporation for a net gain should therefore create a balance in the corporation's capital dividend account, which can be paid out tax free to Canadian resident shareholders.[20]

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1 This portion of the paper appropriates much of an earlier paper Graham Purse wrote with Crystal Taylor, TEP: "The Decision to Incorporate," *Taxes & Wealth Management*, Thomson Reuters (November 2015). To the extent the work product is worse here than in the former paper, Graham Purse takes full credit.

2 *Irwin v. Minister of National Revenue*, [1964] (SCR) 662 (SCC) , at p. 664.

3 2011-0392741E5.

4 ITA, ss. 125(1).

5 ITA, ss. 125(2).

6 See: K. Moody, "The end of the Small Business Deduction?" (16 June 2016): (http://bit.ly/1Q8PYdd).

7 ITA, ss. 129(6).

8 See, *inter alia*: *inter vivos*: ss. 73(3), (3.1), (4), (4.1) and *mortis causa*: ss. 70(9), (9.01), (9.2), (9.21).

9 ITA, s. 110.6.

10 ITA, s. 110.6.

11 ITA, ss. 110.6(1).

12 *Neuman v. Minister of National Revenue* [1998] 1 SCR 770 (SCC).

13 Paragraph 5(1)(a) of the *Employment Insurance Act*.

14 Paragraph 6(1)(a) of the *Canada Pension Plan*.

15 ITA, para. 153(1)(a).

16 ITA, ss. 227.1(1).

17 ETA, ss. 323(1).

18 ITA, ss. 9(1).

19 ITA, ss. 39(1).

20 ITA, ss. 83(2).

Presently, for contrast, business income includes income from criminal activity. In *Canada (Minister of Finance) v. Smith,*[21] the taxpayer appealed from a determination that income tax was owed on profits earned on liquor sales, which were illegal by virtue the *Ontario Temperance Act*. The Privy Council held such profits were taxable. This has been a long standing principle: taxes must be paid on criminal enterprises, although this is often administratively impractical for persons engaged in such enterprises.

EXCISE TAXES (GST/HST) AND PROVINCIAL SALES TAX

It is fully expected that marihuana for recreational purposes will be subject to sales tax. The *Excise Tax Act* ("ETA") imposes a 5% tax on most goods and services sold in Canada.[22] In jurisdictions with HST, the prevailing rate will likely apply. In provinces with their own sales tax legislation, it is expected that that sales tax will also apply. For example, in Saskatchewan every consumer of tangible personal property purchased at retail in Saskatchewan must pay a tax of 5% on property being purchased.[23]

Provincial regimes may possibly exempt medical marihuana. In the case of Saskatchewan, for example, drugs and medicines for use by humans that can only be obtained by prescription from a duly qualified medical practitioner are PST exempt.[24]

Medical marihuana sold by prescription should be zero-rated in accordance with ETA VI-I-3, which applies to prescription drugs dispensed by a medical practitioner. Although outside of the ambit of this article, marihuana has been shown to have numerous uses as a medicament.[25] It is reasonable to expect that marihuana will come to receive similar excise tax treatment to other drugs.

There is presently some prevailing uncertainty in this area because of the decision in *Hedges*,[26] wherein the Federal Court of Appeal did not enunciate a doctrine in respect of the application of GST to medical marihuana.

In *Hedges*, the taxpayer sold medical marihuana without collecting and remitting GST. He was assessed by the CRA for failing to do so. The main holding was that sales of marihuana for medical purposes, without a prescription, were taxable. This means that an Authorization to Possess is not sufficient to trigger zero-rating.[27] This can be contrasted with traditional prescription drugs, which are zero-rated.[28]

If, as a general principle, the Federal government has passed legislation zero-rating prescription drugs, then one would have thought that the Court should have found non-prescription medical marihuana was also zero-rated. We find ourselves in complete agreement with Noah Sarna's observation that the "result may be technically correct, but it is potentially at odds with current social, economic, and political realities."[29] Further, at least one tax expert has argued that the correct legal position is that "no GST or HST applies to sales of medical marijuana that are 'lawful' under the [Marihuana for Medical Purposes Regulations]."[30]

PIGOUVIAN TAXES

If a government really does not like an activity, it can be criminalized. Conversely, if a government is willing to tolerate an activity, but feels that the activity generates social costs, it will commonly either tax it (e.g., tobacco) or impose a cap and trade system (e.g., carbon emissions). Where such a tax is imposed, it is referred to in the literature as a "pigouvian tax".

A pigouvian tax "is used to control an externality-generating activity".[31] That is, where there is a view that an activity has a harmful effect on society, a tax can be imposed in an effort to decrease that activity. Proponents of such taxes will typically assert that an activity imposes a social cost (e.g., cannabis poisoning or impaired driving causing death[32]) and, therefore, a tax should be levied to help pay for those costs.

An interesting analytical issue arises here: what effect would such a tax have on the choice of intoxicants? For example, it is to be expected that, if marihuana taxes are higher than alcohol taxes, then persons will choose to consume proportionately more alcohol. This analysis assumes that consumers will treat them as substitutes to an extent. As scientific research advances, it may be that the relative rates of taxation are adjusted to incentivize the consumption of one as compared to another.

A related tax policy issue relates to maximum effective revenue generation. If rates are considered too high by the consumer, there may be a tendency by some consumers to purchase through the black market. Ultimately, this would hurt the ability of government to maximize revenue. All of this depends, in turn, on the price elasticity of demand for marihuana.

Although largely beyond the scope of this paper, we can note from the Colorado experience that a number of boutique taxes

21 [1917-27] CTC 251 (Jud Com of Privy Coun).
22 ETA, ss. 165(1).
23 *PST Act*, ss. 5(2).
24 *PST Act*, ss. 8(1).
25 Medical marijuana: Medical necessity versus political agenda Peter A. Clark, Kevin Capuzzi, Cameron Fick Med Sci Monit 2011; 17(12): RA249-261.
26 2016 FCA 19
27 ETA, Schedule VI-I-2(d).
28 ETA, Schedule VI-I-3.
29 GST/HST on Medical Marijuana–Noah Sarna, Canadian Tax Highlights, March 2016.
30 David Sherman, "Does GST or HST apply to Medical Marijuana?", p. 6.
31 A. Polinsky, "Pigouvian Taxation With Administrative Costs"; A. Mitchell Polinsky and Steven Shavell, Journal of Public Economics 19 (1982) 385-394. North-Holland Publishing Company, p. 385.
32 *Criminal Code*, para. 253(1)(a).

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were enacted that had the effect of increasing the price of marihuana. Specifically, a 15% excise tax was introduced on wholesale marihuana, a 10% marihuana retail sales tax, the regular state sales tax of 2.9% applied, and finally certain cities like Denver imposed additional municipal taxes.[33]

THE MEDICAL EXPENSE TAX CREDIT

A medical expense credit is available to individuals. Where a person's medical expenses exceed 3% of net income, then 15% of those expenses are available as a credit, to a maximum of $2,208 as of 2015.[34] The amount is indexed for inflation.[35] The CRA opined that for persons who grow their own medical marihuana, only the cost of seeds purchased from Health Canada are a valid medical expense.[36] The CRA has taken the position that vaping systems would not qualify.[37]

More recently, the CRA has expressed the view that the CRA will not disallow eligible medical expenses claimed for the purchase of medical marihuana allowable under the Marihuana Medical Access Regulations.[38] Generally, the authors are of the view that, where there is a *bona fide* expenditure relating to medical marihuana, it should qualify for the credit. CRA's interpretations are, to date, generally unsatisfactory and fail to properly protect medical users.

MARIHUANA IN FRONT OF THE TAX COURT OF CANADA

Recreational marihuana use and distribution is prohibited by virtue of, *inter alia*, the *Controlled Drugs and Substances Act*.[39] As discussed, *supra*, criminal proceeds are taxable. Obviously, like many waiters, taxi drivers, and tradespeople, most persons engaged in criminal enterprises do not report their income for tax purposes. A few cases, however, have gone before the Tax Court of Canada with respect to marihuana taxation under the current criminal regime. These kinds of situations — where a person is expected to report income from a criminal enterprise — are among the least reasonable circumstances in which a person can find his or herself.

The case of *Pirart v. R.*[40] dealt with gross negligence penalties assessed under the ITA.[41] In that case, the taxpayer operated an automobile salvage business. It was discovered that he also ran a grow-op, which produced approximately $32,000 per annum in revenue. The taxpayer did not report that income. He was reassessed as to the unreported income and gross negligence penalties were assessed on account of the taxpayer's indifference and wilful blindness. This case suggests that failing to report income from a marihuana-related business can have significant negative tax effects.

In *Neeb v. R.*,[42] the issue was again unreported income. The *Income Tax Act* contains a specific rule that allows the CRA to assess on the basis of net worth.[43] The net worth rules often arise where a taxpayer's lifestyle is different than her or his reported income. Net worth assessments are also used where business records are incomplete and a proper accounting is impossible at audit. In *Neeb*, the assessment was upheld for the taxpayer's importation and distribution business, because records were insufficient to support the various deductions and expenses that the taxpayer claimed in respect of the business.

CONCLUSION

It is expected that marihuana will be legalized. Generally, it is expected that recreation marihuana will be taxed like tobacco or alcohol. Medical marihuana will likely receive preferential tax treatment, such as zero-rating for GST purposes and, in time, the general availability of the medical expense tax credit for **medicinal users**.

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33 N. Goltz and E. Bogdanov, "Lessons from Washington and Colorado: The Potential Financial Gains of Recreational Marijuana to Canada," Osgoode Legal Studies Research Paper No. 4/2016, pp. 8-9.
34 ss. 118(2).
35 ss. 117.1.
36 2006-0209581E5.
37 2012-0432791E5.
38 2015-0588751E5.
39 *Controlled Drugs and Substances Act* (S.C. 1996, c. 19).
40 2016 TCC 160 (TCC [General Procedure]).
41 ITA, ss. 163(2).
42 97 DTC 895, [1997] TCJ No. 13.
43 ITA, ss. 152(4).

GST AND REQUIREMENTS TO PAY: A CASE REVIEW OF *DAN MASON v. CANADA*

By Lesley Akst, Associate, Miller Thomson LLP

INTRODUCTION

A "regular" garnishment order issued under subsection 317(1) of the *Excise Tax Act*[1] (the "ETA") or s. 224(1) of the *Income Tax Act*[2] (the "ITA") is often referred to as a Requirement to Pay ("RTP") and is issued to a third party or garnishee who will be making a payment to a tax debtor, or a person who is liable to pay amounts to Canada Revenue Agency ("CRA").

Section 317 of the ETA provides, in part, as follows:

> (1) If the Minister has knowledge or suspects that a particular person is, or will be within one year, liable to make a payment to another person who is liable to pay or remit an amount under this Part (in this subsection and subsections (2), (3), (6) and (11) referred to as the "tax debtor"), the Minister may, by notice in writing, require the particular person to pay without delay, if the moneys are payable immediately, and in any other case as and when the moneys become payable, the moneys otherwise payable to the tax debtor in whole or in part to the Receiver General on account of the tax debtor's liability under this Part.
>
> ...
>
> (7) Every person who fails to comply with a requirement under subsection (1), (3) or (6) is liable to pay to Her Majesty in right of Canada an amount equal to the amount that the person was required under subsection (1), (3) or (6), as the case may be, to pay to the Receiver General.

The above legislation allows the Minister of National Revenue (the "Minister") to garnishee a person, who for whatever reason, will be paying money to the tax debtor. The garnishee may include an employer, a financial institution, or a person who owes an account to the tax debtor.[3]

Unlike most garnishments, an RTP issued by CRA is valid without court involvement. The garnishee may become liable if it does not pay CRA the monies requested.[4] This powerful collection tool has, not surprisingly, been referred to as "confiscatory" and having "draconian effect".[5]

In terms of recent case law, the Tax Court of Canada ("TCC") tackled the question of whether garnishees failed to comply with RTPs, as illustrated in case of *Gordon Feil, C.G.A. Ltd. v. R. ("Gordon Feil"),*[6] where the TCC dismissed the appeals as it found the recipients of the RTPs, members of an accounting firm joint venture were, in fact, liable to pay the tax debtor, Mr. Gordon Feil. The TCC held so because the payments were made to a Nevada "Corporation Sole", which was in effect, a vehicle or conduit of Mr. Feil. As well, the Federal Court ("FC") commented in *Canada v. Callidus Capital Corporation,*[7] that if CRA issued an enhanced RTP[8] to Callidus, CRA would have obtained priority to GST deemed trust funds at issue, despite the bankruptcy of the tax debtor, CFRH Inc. In that case, CFRH Inc. owed GST and amounts to Callidus. Given that an RTP was not served in that case, the FC's comments are hypothetical. Notwithstanding this, such comments have been questioned, because an RTP directs a person liable to pay the tax debtor (CFRH Inc.) which was not applicable as it relates to Callidus. Callidus did not owe amounts to CFRH Inc.[9] In the case of *Dan Mason v. Canada*, ("*Mason FC*")[10] the issues of jurisdiction and Ministerial discretion concerning RTPs were explored. Specifically, the FC considered the interplay between a taxpayer's right to: 1) dispute underlying GST assessments; and 2) review and question the Minister's collection actions in relation to, and specifically, within the framework of RTPs. A dissection of the *Mason FC* case, and its winding journey follows. It is important to note that this decision is under appeal to the Federal Court of Appeal ("FCA").

DAN MASON v. CANADA

Background Facts and Previous Court Proceedings

In *Mason FC* an application for judicial review was brought by Mr. Mason as to whether CRA reasonably or properly issued RTPs to Mr. Mason's clients. In the application for judicial review, Justice Strickland of the FC recounted the history of the matter, and its impact to the application before the Court.

1 *Excise Tax Act*, R.S.C. 1985, c. E-15, as amended.
2 *Income Tax Act*, R.S.C. 1985, c.1 (5th Supp.).
3 ETA, ss. 317(2).
4 *Ibid*. at ss. 317(7).
5 *Montreal Trust Co. v. Powell Lane Investments Ltd.,* 1994 CarswellBC 370 (BC Master) at paras. 7-8.
6 *Gordon Feil, C.G.A., Ltd. v. R.,* 2015 TCC 140 (TCC [Informal Procedure]). In this case, the RTPs were issued pursuant to ITA ss. 224(1).
7 *Canada v. Callidus Capital Corporation*, 2015 FC 977 (FC); under appeal to FCA.
8 Subsection 317(3) of the ETA provides for an enhanced garnishment, often referred to as a "super-priority" which applies to GST and under subsection 224(1.2) of the ITA to income tax source deductions.
9 Analysis/Commentary – David Sherman, "David Sherman's Analysis, 317 – Garnishment" *Taxnet Pro* 2016 Thomson Reuters Canada Limited. (2015-12-31) 17 online.
10 *Mason v. Canada (Attorney General)*, 2015 FC 926 (FC) ["*Mason FC*"].

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Mr. Mason is an accountant.[11] The Minister assessed Mr. Mason GST amounts for the January 2003 to December 2011 reporting periods, pursuant to section 299[12] the ETA. The Minister asserted that the applicant did not file GST returns as required by section 238 of the ETA.[13] On October 5, 2011, Mr. Mason filed an appeal to the TCC for the assessments relating to the 2003-2007 reporting periods, raising among other arguments, that GST was incorrectly attributed to him.[14] On October 3, 2014, Justice Miller of the TCC issued a decision, followed by an amended judgment on November 6, 2014, in which the TCC reduced Mr. Mason's debt.[15] On October 28, 2014, Mr. Mason filed a notice of appeal of Justice Miller's decision to the FCA.

On November 19, 2014, the Minister issued Mr. Mason reassessments for the 2003-2007 reporting periods, reducing the amount of the GST owed, as per the TCC's decision.[16] On March 25 and August 5, 2014, as Mr. Mason's appeal to the TCC progressed, the Minister issued RTPs, pursuant to section 317 of the ETA*,* for the 2003-2011 reporting periods, to persons the Minister knew, or suspected were or would become liable to make a payment to Mr. Mason. The RTPs referred to "DAN MASON (sometimes carrying on business as Mason and Associates Certified General Accountant)".[17]

On March 28, 2014, Mr. Mason wrote the TCC advising that he received telephone calls from clients in receipt of the RTPs and the alleged GST debt of $119,080.29. Mr. Mason requested the TCC issue an order quashing the Minister's collection action. According to Mr. Mason, the TCC indicated it was unable to hear the request as it did not have jurisdiction.[18] On September 2, 2014, Mr. Mason requested in writing that the Minister stay collection action as the matter was before the TCC and would likely be before the FCA. In the request, Mr. Mason stated that the amounts before the court did not resemble anything close to the amount stated in the RTPs, the RTPs were based on arbitrary and notional assessments, and subsequent years cannot be dealt with until the court ruled on the years at bar.[19] A follow-up request for a stay was submitted to CRA on October 6, 2014, noting the absence of a response from the Minister.[20]

As of October 28, 2014, no response was received from the Minister. As a result, Mr. Mason brought an application for judicial review before the FC. The application coincided with the filing of an appeal of the TCC decision to the FCA. In the application for judicial review, Mr. Mason sought an injunction requiring the Minister to cease collection activity until the matters before the FCA were finalized, along with an injunction requiring the Minister to withdraw all RTPs and to notify all parties receiving the demands of their withdrawal.[21] On the same date, Mr. Mason brought a motion in the FC for the same injunctions sought in the judicial review application. The Minister brought a cross-motion for an order striking Mr. Mason's application for judicial review. The Minister contended that Mr. Mason's application for judicial review was premature, given that the Minister had not yet decided on Mr. Mason's request for a stay, and thus there was no decision to review.[22]

Justice Gleason of the FC dismissed both the motion and the cross-motion by order dated November 12, 2014.[23] Specifically, Justice Gleason held that it was not plain and obvious that an application for judicial review could not be brought with respect to RTPs, as there may have been a decision made by the Minister in this matter.[24] With respect to Mr. Mason's motion, Justice Gleason found that none of the three elements required to satisfy injunctive relief were demonstrated, and specifically:[25] 1) the application did not raise a serious issue, as the ETA allowed the Minister to enforce GST assessments while appeals were pending; 2) Mr. Mason did not demonstrate that he would suffer irreparable harm, through clear non-speculative evidence; and 3) the balance of convenience favoured the Minister, as the TCC found Mr. Mason owed GST and failed to remit same.[26] Through a letter dated January 12, 2015, the Minister informed Mr. Mason that there are no collection restrictions on GST accounts, even if a registrant has filed an objection or appeal, and thus collection action would continue. The Minister further stated in her letter that the actions of CRA aligned with CRA collection policies.[27]

In written submissions in support of the application for judicial review, Mr. Mason argued that in conducting his business as an accountant, clients employed services once a year, and thus no accounts receivable were owing to him. Mr. Mason further argued that the RTPs would effect a loss of clientele and irreversible harm to his ability to generate income, and hence pay amounts owing. The FC noted that Mr. Mason emphasized such arguments at the hearing, however it commented that such facts did not appear in an affidavit.[28]

11 *Ibid.* at para. 3.
12 Assessments issued pursuant to ETA s. 299 are sometimes referred to as "notional" assessments.
13 *Mason FC* at paras. 4-5.
14 *Mason v. R.*, 2014 TCC 297 (TCC [General Procedure]).
15 *Ibid*. at paras. 55-58.
16 *Mason FC* at para. 7.
17 *Ibid.* at para. 8.
18 *Ibid.* at para. 9.
19 *Ibid.* at para. 10.
20 *Ibid.*
21 *Ibid.* at para. 11.
22 *Ibid.*
23 As reported in *Mason FC* at paras. 12, 21-23.
24 *Ibid*. at para. 12.
25 As outlined in *RJR- MacDonald Inc. v. Canada (Attorney General),* [1994] 1 SCR 311.
26 *Mason FC* at para. 12.
27 *Ibid*. at para. 13.
28 *Ibid*. at para. 14.

ISSUES BEFORE THE COURT

The issues before the FC in the judicial review were whether:

1) The court should grant an injunction staying the Minister's collection action regarding GST amounts assessed until the disposition of the appeal of the TCC decision to the FCA; and

2) The court should quash the RTPs issued to third parties regarding the GST amounts assessed against the applicant.

ANALYSIS AND CONCLUSIONS

In dismissing the application, Justice Strickland emphasized that Mr. Mason sought identical relief as sought in the previous motion before Justice Gleason, i.e., an injunction requiring the Minister to cease collection activity pending the appeal to the FCA and an injunction requiring the Minister to withdraw all RTPs and notify parties that have received RTPs of the withdrawal. The FC highlighted that Mr. Mason provided no new evidence on the application for judicial review, other than the letter from the Minister.[29] As a result, Justice Strickland held that she adopted the prior findings of Justice Gleason, which denied the injunctive relief sought. There was no basis to depart therefrom.[30]

In arriving at this conclusion, Justice Strickland confirmed the longstanding principle that the TCC has exclusive original jurisdiction to hear and determine references and appeals on matters arising under Part IX of the ETA and the ITA. Notwithstanding this, the FC has jurisdiction to deal with certain matters concerning the ETA and ITA, including discretionary decisions of CRA to issue RTPs, and challenges to collection measures conducted by the Minister.[31] Justice Strickland commented that if an application is, in fact, challenging the correctness of the assessment, under the cloak of a judicial review, judicial review is not available.[32] The Court elaborated that the FC is without jurisdiction to award damages or grant other relief sought on the basis of an invalid reassessment, unless the TCC overturns the reassessment, as this would, in effect, enable a collateral attack on the correctness of the assessment. In its analysis, the Court noted that judicial review remedies are remedies of last resort, and hence the aperture for judicial review regarding decisions of the Minister is narrow.[33]

Justice Strickland emphasized that the essential nature of Mr. Mason's claim was that the Minister incorrectly assessed GST liability, and therefore the RTPs should not have been issued and collection action should not be pursued while this matter remained in dispute before the FCA. Because these were matters that concerned the correctness of the Minister's GST assessments, which was to be heard by the FCA, the FC held that it had no jurisdiction pursuant to section 18.5 of the *Federal Court Rules*.[34]

The court acknowledged that it had jurisdiction to consider whether the Minister's decision to issue the RTPs was reasonable, but because GST assessments are deemed valid and binding until varied or vacated on objection or appeal, unlike the ITA, there is no statutory stay on collection activity under the ETA while an objection or appeal is outstanding.[35] The court therefore concluded that the decision to issue the RTPs was reasonable as collection action was conducted in relation to valid assessments and was thus lawful. The court accordingly held that there was no legal basis to grant a stay of collection action.[36]

COMMENTARY

Given the parameters of ETA legislation, and the narrow relief available on judicial review, Mr. Mason faced a difficult argument before the FC. That said, the conclusions of the court in *Mason FC* appear well-reasoned. As stated above, this matter is under appeal to the FCA, and thus whether the collection actions of CRA were reasonable will be reviewed by that court. It should be noted that the FCA dismissed Mr. Mason's TCC appeal in early 2016.[37] As well, leave to the Supreme Court of Canada of the FCA's decision was recently dismissed,[38] thus culminating Mr. Mason's challenge to the correctness of the GST assessments.

While the absence of a stay on collection action under the ETA may seem asymmetrical in comparison to the ITA, Parliament clearly stated its intent, and thus considered the implications of allowing the Minister enhanced collection powers in this regard.[39] That said, subsection 315(3) of the ETA provides that the Minister may postpone collection action regarding all or any part of the amount assessed that is subject of the dispute. Justice Strickland noted the discretionary element of this provision in *Mason FC*.[40] Exactly when or under what circumstances CRA will exercise such discretion for GST amounts owing is very fact specific. However factors such as the type of assessments issued, the tax debtor's compliance history, availability of realizable security, and the attitude of the debtor may impact CRA's

29 *Ibid*. at paras. 20-21.
30 *Ibid*. at para. 24.
31 *Ibid*. at paras. 33-34.
32 *Ibid*. at para. 35.
33 *Ibid*. at paras. 36-37.
34 *Ibid*. at para. 40.
35 *Ibid*. at para. 41.
36 *Ibid*. at para. 42.
37 *Mason v. R.*, 2016 FCA 15 (FSA).
38 *Mason v. R.* (2016), 2016 CarswellNat 2621, 2016 CarswellNat 2622 (SCC).
39 ITA s. 225.1 provides that most collection action is stayed pending the filing of a notice of objection or appeal. This restriction does not apply to ITA source deductions.
40 *Mason FC* at para. 43.

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decision in this regard.[41] The *Mason FC* case suggests that the Minister may employ powerful collection tools such as an RTP, and decline to exercise a discretionary stay as it relates to GST amounts owing, when ETA section 299 assessments are issued (despite reassessment) and the debtor operates a business.

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41 Excise/GST News No. 22 (Fall 1996) and 1993 Institute of Chartered Accountants of Alberta GST Roundtable (Q. 1(c)) as cited in Analysis/Commentary – David Sherman, "David Sherman's Analysis, 315 – No Collection Before Assessment" *Taxnet Pro* 2016 Thomson Reuters Canada Limited. (2012-03-15) 2-3 online.

OUTPERFORMING THE MARKETS — A MYTH DISPELLED

By Cenk Albayrak, CIM, Senior Investment Advisor, National Bank Financial Ltd.

There's a perception amongst investors that in order to out-perform the markets, one has to take on greater risk. Conventional wisdom states that higher risk equities produce higher returns. However, conventional wisdom is not always backed up by the facts.

There is an index for everything these days, but one that proves my point is the S&P/TSX Low Volatility Total Return Index. This index measures the least volatile stocks in the Canadian listed universe. Over the past 10 years this index has returned 64.14% greater returns than the S&P/TSX Total Return Index. This equates to an annual return of 8.39% per year for the lower volatile companies versus a 4.79% return for the average Canadian equity portfolio. This same analysis also holds true in the U.S. stock market. Take a look at the chart below.

Returns Over 10 Years of S&P/TSX Low Volatility Index versus S&P/TSX Composite Total Return Index

Source: Bloomberg, June 2016

So why is this the case? It's based on a simple mathematical truth — companies that produce steady, compounding returns don't attract investors looking for rapid growth. But the steady returns that rack up over the long-term often compound more rapidly than companies with volatile returns from one year to the next. Volatility versus the market is called Beta, and the Beta of the market is always 1. Beta is something I monitor closely. I always strive to construct investment portfolios that are less volatile than the market (Beta <1) with growth rates in excess of the market. Then I let the compounding effect take over.

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AVOIDING LITIGATION: TIPS FROM AN ESTATE LITIGATOR

By Lisa Filgiano, Partner, Miller Thomson LLP

It is no secret that the largest intergenerational transfer of wealth is set to occur over the next decade. Unfortunately and inevitably, this will likely result in a corresponding increase in estate litigation. Although some issues that arise in estate litigation are inevitable, many others are avoidable with proper estate planning, communication and forethought. Below is a list of tips to avoid landing your estate and loved ones in costly litigation which could result in a significant or total depletion of your hard-earned assets.

1. REVIEW YOUR WILL REGULARLY

The importance of reviewing your Will regularly cannot be over-emphasized. Much litigation arises as a result of outdated Wills or intestacies. Significant milestones such as marriage, divorce, the birth of a child or the death of a spouse or a child should be used as reminders to review and update a Will.

These milestones may also have significant implications on an overall estate plan. For example, in Ontario, according to section 15(a) of the *Succession Law Reform Act,* marriage revokes a Will. If a new Will is not prepared, an estate will be divided on intestacy, rather than according to a testator's prior expressed wishes.

It is always recommended to seek the advice of a lawyer when making a Will. Some people, often in an effort to save money, choose to prepare a holograph Will (a handwritten Will). Although holograph Wills are valid Wills in Ontario (so long as they are wholly in the testator's own handwriting and signed by the testator), they are easily and often contested by disappointed

beneficiaries. Litigation may involve a dispute over whether the document was made in the testator's own handwriting, whether the testator was unduly influenced or whether the testator lacked testamentary capacity. Any costs which may have been saved at the outset are immediately lost once litigation is initiated.

2. CONSIDER YOUR DEPENDANTS IN YOUR ESTATE PLAN

When preparing an estate plan, a testator must adequately provide for his or her dependants. Some dependants are easily identified and considered in an estate plan. Minor children, for example, are often the reason a testator makes a first appointment with an estates planner. Although minor children are obvious dependants, it is important that a testator consider whether there are other dependants that must be adequately provided for in the Will or estate plan.

In Ontario, section 57 of the *Succession Law Reform Act* defines dependants as a spouse, parent, child or sibling that the deceased was providing support to or was under a legal obligation to provide support to immediately before his or her death. Each of those categories of dependants are broadly defined. For example, a spouse may include a married spouse or a common law spouse and a child may include a grandchild or a person the deceased demonstrated a settled intention to treat like a child.

Dependant support claims are perhaps most commonly made by common law spouses. Other dependants however, such as adult children enrolled in post-secondary education, immediate family members with a disability, or aging parents who rely on their children for their day to day needs, may also have valid claims as dependants.

Failing to adequately provide for these persons on death may put an executor in a position of responding to a dependant support claim, and related litigation. If all dependants are properly considered in the estate plan, a testator will save his or her executor the grief of managing such litigation and the attendant (and perhaps significant) costs.

3. CHOOSE YOUR EXECUTOR CAREFULLY

The choice of an appropriate executor may be one of the most effective ways of shielding your estate from litigation. While a testator or testatrix may think that their children will rally together after his or her death, unfortunately that rarely appears to be the case. Similarly, if your children are unable to be in the same room as your new spouse, it is unlikely that they will respect his or her decisions as executor of your estate. When choosing an executor, it is important to look for a relatively neutral family member, friend or professional who is more likely to mediate and resolve disputes rather than escalate them. It is equally important to choose a suitable alternate executor, in case your primary executor is unable or unwilling to take on the role.

In some circumstances, none of your family or friends may be appropriate executors. You may then want to consider appointing an institutional trustee as executor. Trust companies are in the business of acting as professional executors. Although it may seem like a higher upfront cost, it is worth every penny if it protects your estate from litigation.

4. COMMUNICATE YOUR ESTATE PLAN TO YOUR BENEFICIARIES

"The single biggest problem in communication is the illusion that it has taken place" (George Bernard Shaw). Transparency and communication with your beneficiaries is often the most effective way of reducing the risk of estate litigation. When a beneficiary is caught off-guard, especially during a time of grief, they may react by escalating their disappointment to litigation. If, however, a beneficiary is forewarned that a testator intends to prefer one beneficiary over another and the testator is able to explain the reason for the unequal treatment, the disappointed beneficiary is less likely to resort to litigation.

Many useful estate planning tools may, when used, leave beneficiaries confused about a testator's or testatrix's intentions. For example, while placing a bank account into joint ownership may be an effective way of avoiding probate fees, it may result in the transfer of an account to the joint holder by right of survivorship. It is not always clear what was intended. If the testator does not communicate whether the intention was for the account to transfer by right of survivorship or to fall in the estate, a dispute may arise between the joint account holder and the beneficiaries of the estate.

SUMMARY

Avoiding estate planning and/or keeping your loved ones in the dark of your plan increases the risk of involving your estate in litigation. If you have any doubts about your estate plan or you have been putting off preparing a Will, do not delay any longer: speak to your estate planner today. If not, your loved ones may end up on opposite sides of expensive litigation that could not only drag on for months or years, but could also result in complete deterioration of their relationship.

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PENSION PLAN TAXATION IN CANADA: EASING THE TAX BURDEN

By Hennadiy Kutsenko, J.D., Tax Counsel, Barrett Tax Law

Over the course of the next 20 years, approximately 7 million Canadians will retire.[1] A considerable portion will be retiring with the (now rare) benefit of a pension plan; some with defined benefit plans, others with annuities purchased with the funds they receive from a defined contribution plan. Many will be spending much more time in retirement than anticipated by those designing the pension plans.[2] The sustainability of those plans, however, faces an uncertain future, as exemplified by the bankruptcy or insolvency proceedings concerning Indalex, Nortel and most recently, and for the second time, U.S. Steel Canada (Previously Stelco).

Numerous measures have been considered for the purposes of promoting a stable and sustainable future for pension plans, with concern for both the retirees as well as the sponsors. These have included considering a shift to target benefit plans that provide for the reduction of benefits or the increase in contributions should the Plan underperform,[3] mandatory provincial plans to supplement retirement income[4] or expanding the Canada Pension Plan.

However, less consideration has been given to the impact on pension plan sustainability by the framework for taxation of pension plans and their respective beneficiaries. This lack of attention is particularly pronounced in exploring the tax burdens upon retirees and plan sponsors.[5] As such, this article considers a specific means of lowering the tax burden, thereby promoting plan sustainability through lower tax incidence.

CURRENT SYSTEM OF TAXING PENSIONS IN CANADA

The current system for taxing pension plans is referred to as an "EET" system: exempt, exempt, taxable. This is the system generally used across most jurisdictions for taxing pension plans and retirement savings vehicles, whereas a "TEE" (taxable, exempt, exempt) system is often used to tax other savings vehicles, such as Tax Free Savings Accounts ("TFSAs").[6]

The respective digits in "EET" refer to the three stages of a pension plan: contribution, accumulation and withdrawal. At the contribution phase, consistent with the tax policy objectives of deducting savings from the tax base in order to encourage saving for retirement,[7] a deduction is provided for the amount contributed to a registered pension plan ("RPP").

The employee is not considered to receive a taxable benefit[8] and receives a deduction for the amount they may have contributed as well,[9] as in the case of a Jointly-Sponsored Pension Plan ("JSPP"). The employer also receives a deduction for the amounts that are contributed.[10]

The funds are then generally placed in trust for the benefit of the plan members. The pension fund invests and accumulates income from various sources; trading in securities, investment in infrastructure and real estate, interest income and numerous other means.

Generally, a pension fund acts as any large scale investment vehicle, albeit with a crucial added caveat; the added fiduciary duties owed to its membership. The general investment mandate of a pension plan, then, is a much more risk averse approach; government bonds with a low rate of return but stability over time, rather than risky securities and speculative joint ventures.

The income the pension fund earns at this time is also not taxable, as pension funds generally rely on tax-exempt vehicles under Division H of Part I of the *Income Tax Act*[11] ("ITA"). This is most often a pension trust,[12] pension investment corporation[13] or a Master Trust[14] in some instances. The amounts earned by a pension plan are often quite sizeable, especially when one considers large scale public multi-employer plans, such as Teachers, OMERS or HOOPP.[15] This growth stage is the second "E" in the EET system.

Thus, pension plans have a considerable tax advantage; tax is not paid on sizeable amounts of investment income for a substantial

1 Jim Leech & Jacqui McNish, *The Third Rail: Confronting Our Pension Failures* (Toronto: McLelland & Stewart, 2013).
2 *Ibid.*
3 National Pension and Benefits Law Section, Canadian Bar Association. "Pension Innovation in Canada: The Target Benefit Plan". Ottawa, June 2014.
4 The now-defunct Ontario Registered Pension Plan, as an example
5 Alexandre Laurin and Finn Poschmann, "Who Loses Most? The Impact of Taxes and Transfers on Retirement Incomes". C.D. Howe Institute, November 13, 2014.
6 Katarzyna Romaniuk, "Pension Fund Taxation and Risk Taking: Should We Switch from the EET to the TEE Regime?". Annals of Finance, Vol. 9, Issue 4, pp. 573–588, November 2013.
7 John A. Turner, "Tax Treatment of Pensions". *NTA Encyclopedia of Taxation and Tax Policy, Second Ed.*, Washington, Urban Institute Press, 2005.
8 Subsection 6(1)(i) of the ITA.
9 Subsection 8(1)(m) of the ITA.
10 Paragraphs 20(1)(q) and 147.2(2) of the ITA.
11 R.S.C., 1985, c. 1 (5th Supp.).
12 Paragraph 149(1)(o) of the ITA.
13 Clause 149(1)(o.2)(iii) of the ITA.
14 Paragraph 149(1)(o.4) of the ITA, Regulation 4802(1.1) of the *Income Tax Regulations* (C.R.C., c. 945).
15 Ontario Teachers' Pension Fund, Ontario Municipal Employees Retirement System and Healthcare of Ontario Pension Plan.

length of time. The factor of 9, as is used to determine the upper limit of pension plan contributions under the ITA,[16] further promotes horizontal equity between those who have pension plans that wish to contribute to individual retirement savings vehicles, such as RRSPs and those without a pension plan. This is the basis for the Pension Adjustment limit ("PA"), whereby a taxpayer's room to contribute to RRSPs is lessened by pension plan contributions.

Finally, the last stage is withdrawal; when the beneficiaries actually retire and begin to collect their pension. This is the "Taxable" part of the EET formula explained above. The retirees benefit from the income smoothing inherent in a pension plan: income that otherwise would have been taxed at higher rates is deferred and later included in the tax base at a time when income is presumably lower, thus bearing a lower marginal tax rate. Aside from that, and generally receiving a non-refundable tax credit,[17] the retirees are taxed on the pension income as if such was regular income; at 100% inclusion, based on their marginal tax rate.[18]

THE ISSUE

While the above system of taxing pension plans and their beneficiaries provides a significant advantage in terms of tax deferral, it also results in a peculiar detriment to the beneficiaries. This occurs because the pension plans accumulation stage, being tax-free, has no need for certain deductions, credits and other advantageous tools provided in the ITA. It thus cannot use these "tools" to offset taxable income, as it has none.

To name a few examples, a pension fund has little need for deducting interest under paragraph 20(1)(a) of the ITA, there is no dividend gross up and credit system[19] for a pension fund receiving dividends, and neither does the fund derive any value from loss utilization through carrying non-capital and net capital losses forward or back in order to offset income or capital gains.[20]

Similarly, a pension fund has no use whatsoever for the lifetime capital gains exemption on QSBC shares,[21] and, on that note, dispositions on capital account have no need, and thus no ability, to take advantage of the 50% inclusion rate for capital gains.[22]

All of these things have little use for a pension fund because, quite simply, the fund does not face income taxes on its' growth. Rather, it is the beneficiaries that ultimately pay taxes on the amounts invested in the pension fund, in the withdrawal or payout phase.

16 Subsection 147 of the ITA, James Pierlot, "A Pension in Every Pot: Better Pensions for More Canadians". *The Pension Papers*, C.D. Howe Institute, No. 275, Toronto, November 2008.
17 Subsection 118(3) of the ITA.
18 Paragraph 56(1)(a)(i) of the ITA.
19 Subsections 82(1) and 121 of the ITA.
20 Paragraphs 111(1)(a) and (b), respectively.
21 Qualified Small Business Corporation shares, ss. 110.6(2.1).
22 Subsection 38(a).

And, while they do so with some credit and attention paid to their retiree status (such as the above mentioned credit in subsection 118(3) of the ITA), they generally pay income tax on the entire amount, at an inclusion rate of 100%.

Thus, the potential issue arises as illustrated in the following hypothetical example; a pension plan makes considerable dispositions on capital account. Suppose even that 50% of its growth arises from the gains made in these dispositions. The remaining 50% is earned in interest from regular investment income.

The pension fund does not face capital gains taxation, using a tax exempt entity, and thus the 50% inclusion rate for capital gains has little meaning or use. If the pension fund were taxable however, it would pay tax on only 75% of its income: 50% of the plan income being fully included by virtue of being regular investment income, and only 25% of the remaining half, by virtue of the 50% inclusion capital gains.[23]

However, when a retired plan member receives their monthly pension, the tax they pay would be calculated on roughly 100% of their income; the 50% capital gains rate does not flow-through. There is no means through which to account for the various deductions and credits an investment vehicle would otherwise have access to.

Thus, where a taxable investment vehicle would, ideally speaking, be able to pass on the economic benefits that result from the tax deductions and credits available to it, a pension fund has no such ability. And so retirees could well be argued to have received the benefit of long-term tax deferral, in exchange for a potentially lower tax rate by virtue of receiving the flow-through benefit of the various deductions and credits that were spoken of.

MAKING USE OF THE TAX BENEFITS

One may then reason from the above point that, perhaps, if one could account for the lack of the ability for retirees to get access to the various deductions and provide a benefit in lieu or a flow-through of the deductions, the tax burden on retirees would be eased.

This could be done in numerous ways. For example, a plan could keep an annual account of capital dispositions, noting the amount of income that would be subject to the 50% inclusion rate, perhaps with regard to the percentage that that income is of all income. Active members that make contributions in that year could then receive a deferred deduction, on a pro-rata basis, that they could then make use of in retirement.

Alternatively, either active members or employers could receive a portion of the annual deductions or credits that the pension plan may have been entitled to (if it were a taxable entity), such that they may shelter or offset some of their current income or gains.

23 *Ibid.*

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Finally, the amounts of the benefit that would have been received from the deductions or credits could be treated as a refundable tax credit, whereby either the employer or the plan member could potentially receive a tax refund, thereby offsetting their inability to make use of the deductions, credits and capital gains inclusion rate during the pay-out phase.

In any case, whichever way this would be implemented, both plan members and sponsors could take advantage of this benefit. Plan members could lower their taxes during retirement or during their active income stage. A lower tax burden upon payout could also result in an easier fulfillment of the pension promise for plan sponsors, whereby through proper tax planning in the investment stage employers could lower the promised amount with the retirees nevertheless getting the same benefit. This would be because the after tax dollars paid out to the retirees would constitute a higher percentage of their pension earnings. Alternatively, sponsors (and employees in a JSPP) could also reduce contribution levels, knowing that a higher amount will be available upon payout due to the presumably lower tax rates.

PROS AND CONS

The above point, of course, is simply stated and entails a slew of considerations, pitfalls and counter arguments based on both practical considerations and the policy side of things.

First and foremost, pension plan members are already considered to receive a considerable benefit in the deferral of tax. Not only so, but they can also be generally considered to be fairly privileged in a time when pension plans, especially defined benefit, are becoming increasingly rare outside of the public sector.[24]

Thus, one may wonder whether this extra added benefit would be equitable in a system that already favours this cohort. Considering the aforementioned measures in using a PA limit to level the field between those with and without pension plans, this would certainly go against that policy by again favouring those with a pension plan over those without.

Second, this would be incredibly difficult to implement. Pension plan membership is not static and is subject to transfers, service buy-backs, plan conversions, terminations, early retirement and plan wind-up. To account for deductions and credits for each and every plan member, throughout what is already a difficult and highly complex system may just be an administrative nightmare, if not nearly impossible.

Finally, the actual cost vs. benefit approach may not work out to be economically beneficial; the added costs of extra tax planning in what is already a heavily regulated industry simply might not work out to provide a monetary benefit. In other words, it may just cost more to implement this policy than the actual monetary benefit received through the reduction of tax.

24 *Supra* note 15.

CONCLUSION

Pension plan members can be said to be subject to inequitable treatment through paying taxes on a full income inclusion basis, without the flow-through economic benefit of various deductions and credits that would normally be encountered had the funds been invested in another vehicle.

However, to actually implement a means to provide that flow-through may not be practical or even economically beneficial. The task would be immensely complex and require substantial changes to both the pension taxation scheme and the administration of pension plans in Canada.

Nevertheless, with pension plans, their members and the sponsoring employers facing an uncertain future, less and less of the population saving for retirement and more members living longer than plan design had initially anticipated,[25] this is a subject worth discussion and debate.

After all, if effective and properly implemented, this measure could assist in promoting sustainability of pension plans and their respective members through providing a higher amount of after-tax dollars to both.

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25 *Ibid.,* see note 1.

MAXIMIZE CHARITABLE GIVING BY USING A HOLDING COMPANY

By Tina Tehranchian, MA, CFP, CLU, CHFC, Branch Manager and Senior Financial Planner at Assante Capital Management Ltd.

A small business can be a powerful engine for creating wealth. Small businesses are also the biggest creator of jobs in Canada. According to Statistics Canada's Key Small Business Statistics Survey, "Small businesses account for more than 98 percent of all firms in Canada and proportionally play a large role in net job creation, creating 77.7 percent of all private jobs from 2002 to 2012".[1]

1 Statistics Canada Key Small Business Statistics – August 2013, https://www.ic.gc.ca/eic/site/061.nsf/eng/02806.html.

According to the Canadian Federation of Independent Business (CFIB), close to 50% of business owners plan on exiting their business in the next five years with more than 75% planning to exit within the next 10 years.[2] This provides a great opportunity for effective tax planning and charitable gift planning strategies for business owners.

Our tax rules provide a favourable tax rate for Canadian Controlled Private Corporations (CCPC). The first $500,000 of income of a Canadian-controlled Private Corporation (CCPC) enjoys a very low federal small business tax of 10.5%. The small business rate is available on active business income up to the amount of the Business Limit. The federal business limit of $500,000 begins to be reduced when a CCPC's taxable capital reaches $10 million, and is eliminated when taxable capital reaches $15 million.

In 2016, CCPCs that are eligible for the small business deduction pay the following combined federal and provincial (Ontario) tax rates on different types of income:[3]

General Rate	26.50%
Small Business (to $500,000)	15.00%
Investment	50.17%

When money is withdrawn from the corporation, it will be taxed at the top marginal tax bracket of the owner, depending on the amount of income he or she declares in that year. If the owner's net income is over $220,000 in Ontario, and the amount that is withdrawn from the corporation is in the form of salary, the income would be taxed at 53.53%. If it is withdrawn in the form of non-eligible dividends then it would be taxed at 45.3%.

LOCKED-UP CAPITAL IN HOLDING COMPANIES

The cash inside an operating company can be transferred to a holding company using inter-corporate dividends, on a tax free basis. Business owners set up holding companies mainly either to protect themselves from claims of creditors or as a retirement strategy to set up an investment portfolio inside the corporation without having to withdraw any funds and then to withdraw the funds as dividends during retirement.

While the low tax rate for small businesses helps spur growth in the business sector and helps the business owners accumulate wealth, this wealth creates complexity.

The biggest dilemma for most business owners is how to extract the funds in their corporations and holding companies without paying personal taxes at very high rates, due to those funds being taxed as personal income upon extraction from the company. There can be substantial reduction in the value of a company upon withdrawal of the funds. For example, assuming a 45% tax rate, a holding company with a value of $3,000,000 is actually only worth $1,650,000 after tax.

Therefore, it is understandable that business owners are always looking for tax effective methods of extracting their locked up capital from their corporations.

CHARITABLE GIVING CONSIDERATIONS FOR BUSINESS OWNERS

When a corporation makes a charitable gift, the corporation receives a tax deduction, which reduces its income and will therefore reduce the taxes it has to pay. When a charitable gift is made personally, it results in a charitable donation tax credit which will reduce tax that was otherwise payable. Both on a personal level and corporate level, the limit on the amount of the charitable donation that may be claimed in a given year is 75% of net income; if the credit or deduction is not used, it can be carried forward for five years. Also, capital gains are eliminated for both personal and corporate gifts of public securities when the gift is made in kind.

A big difference between personal and corporate donations is that in the year of death, for an individual, the limit is 100% of net income and any excess can be carried back one year.

THE KEY ADVANTAGE OF GIVING THROUGH A PRIVATE CORPORATION

Private corporations have a notional account called the capital dividend account (CDA). The CDA creates a unique financial planning opportunity for business owners when it comes to philanthropic tax planning and makes charitable giving through a corporation extremely attractive.

The CDA does not appear on the corporation's balance sheet and is a notional account that keeps track of the amounts that are eligible to be flowed to a shareholder on a tax free basis, and is a cumulative total that is often recorded in the notes to the financial statements. The CDA is a very important notional account as it allows a shareholder to withdraw funds on a tax free basis from the corporation.

When a publicly traded security is sold by a corporation, 50% of the capital gain is taxable as income. The remaining 50% is not taxable and is credited to the CDA account.

When publicly traded securities with accrued gains are donated to a charity in kind, the CDA is credited with the non-taxable portion of the capital gain. Since donation of securities in kind to a charity eliminates 100% of the capital gain, 100% of the capital

2 CFIB's study on business succession planning that was released in November 2012. The study was conducted over the period from March 9 to May 4, 2011. Over 8,300 Canadian business owners responded to the study.

3 http://www.sslgroup.ca/?section=tax-rates.

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gain will be credited to the CDA account in this case. Therefore, by donating securities in kind to a charity, the entire capital gain can be withdrawn on a tax free basis from the CDA account.

While the decision with regards to making a charitable gift is a personal decision and is based on the philanthropic intentions of the donor, the decision as to whether to make a gift personally or through a corporation often hinges on the tax benefits. Therefore, the ability to extract money on a tax free basis from a corporation through the CDA, is a major consideration for shareholders as to where the source of the charitable gift should be.

The proceeds of a corporately owned life insurance policy also flow through the CDA account and can be paid to the shareholders on a tax free basis after deduction of the adjusted cost base of the policy.

The use of life insurance together with donation of securities in kind can allow business owners to multiply the results of their giving and minimize their estate tax liability. The upcoming changes to insurance rules in 2017 will reduce the maximum premiums and/or deposits permitted in an exempt policy and therefore will reduce the possibility of accumulating funds on a tax sheltered basis in a corporately owned policy. Therefore, now is a good time for business owners to review and update their retirement and charitable giving strategies.

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MACKAY ESTATE v. MACKAY: JOINT ACCOUNT HOLDERS AS FIDUCIARIES

By Alison Minard, Partner, Miller Thomson LLP

In a recent decision, the Ontario Superior Court of Justice ruled on whether a non-contributing joint bank account holder owed a fiduciary duty to the contributing joint bank account holder, and whether she was in breach of that duty by paying herself compensation out of the joint bank account.

The facts in *MacKay Estate v. MacKay*[1] reflect the common family scenario in which an elderly parent transfers a bank account into joint names with a child. This is often done for convenience or for probate planning purposes, rather than as a gift of an undivided one-half interest in the account, and the funds are therefore presumed to be held on resulting trust for the parent's estate.

In this case, the elderly Annie MacKay moved in with her son, Tom and her daughter-in-law, Dawn. Annie subsequently named Tom as her attorney for property and added Dawn as a joint account holder to her bank account. At trial, Dawn asserted that Annie had asked Dawn to provide her with companionship and assist her with her banking and personal care in exchange for compensation.

In late 1999, Annie relocated to a retirement residence close to Dawn and Tom's house. The court accepted that Dawn visited Annie at the retirement residence five days per week, on average, and took Annie on frequent outings.

In early 2003, Dawn transferred $1,000 out of the joint account. Her stated reason for this transfer was that it was in respect of weekly compensation of $250 for her banking assistance and companionship. From early 2003 to mid-2008, Dawn periodically transferred additional funds out of the joint account for her own benefit, again purportedly as compensation for her banking assistance and companionship.

Dawn and Tom separated in 2008, at which point Tom commenced an action on Annie's behalf seeking an accounting with respect to all transactions on the account.

The first issue raised in this case was whether Dawn owed a fiduciary duty to Annie in the management and operation of the joint bank account. The court cited the following indicia set out in the decision of the Supreme Court of Canada in *Frame v. Smith*,[2] to assist with the determination of whether a fiduciary relationship exists:

- The fiduciary has scope for the exercise of some discretion or power;
- The fiduciary can unilaterally exercise that power or discretion so as to affect the beneficiary's legal or practical interests; and
- The beneficiary is vulnerable to or at the mercy of the fiduciary holding the discretion or powers.

The court found that Annie relied upon Dawn to exercise her discretion, performing duties generally recognized as being fiduciary in nature. The court also found that the evidence established vulnerability on Annie's part and a recognition of that vulnerability by Dawn. As a result, the Court concluded that

1 2015 ONSC 7429 (Ont SCJ).

2 [1987] 2 S.C.R. 99 (SCC).

Dawn acted as a *trustee de son tort* and owed a fiduciary duty to Annie regarding the operation of the joint bank account.

The court then considered whether Dawn breached her fiduciary duty by making payments to herself from the joint account. Justice Woodley acknowledged that, at common law and in equity, the general rule is that fiduciaries are not entitled to benefit from their appointment. However, the rule of equity states that once the court has established a conflict between personal interest and duty the question then becomes whether there was consent to the activity. In this case, the question was whether Annie or her attorney consented to Dawn's compensation for personal services. The court examined the evidence and concluded that Annie had consented to the arrangement verbally and that this agreement was a "family agreement" for personal service. The court also found that Tom's actions inferred his consent to the family agreement.

Finally, the court considered whether Dawn was liable to repay any or all of the withdrawn funds. Based on her journal records, Dawn provided detailed evidence relating to the personal services she provided to Annie. Dawn stated that she and Annie had agreed to weekly compensation of $250. However, the total amount withdrawn by Dawn from the joint account for the weeks' services Dawn provided was less than half that amount. The court also accepted that the sporadic nature of the payments reflected Dawn's concern that Annie be cared for and her expenses met before Dawn compensated herself.

This case confirms that joint accounts held on resulting trust may give rise to a fiduciary relationship between account holders where the contributing account holder is incapable. The question still remains as to whether a non-contributing account holder owes a fiduciary duty to a capable contributing account holder. Accordingly, non-contributing account holders would be well advised to handle account assets with care.

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IT'S NOT TOO LATE! THE NEW TAX CHANGES AND WHAT YOU CAN DO

By Ana Simões, Associate, Miller Thomson LLP

Your life insurance policy will be significantly affected by changes coming into effect on January 1, 2017, considerably impacting your estate planning.

In 2014, the government introduced changes to the tax rules to help sort out inconsistencies in tax treatments. These changes come into force on January 1, 2017. This means policyholders will lose some preferential tax treatments available today through life insurance policies and annuity products. Policies issued prior to January 1, 2017, will be grandfathered in.

HOW THE CHANGES WILL AFFECT YOU

- It will take longer to prepay a permanent insurance policy; currently you may be able to prepay an insurance policy in four years or less, after January 1 some products will take at least eight years;
- The permitted exempt insurance policy cash value accumulation will initially increase but then will be reduced until your early 90s;
- The cost of insurance rates will likely increase for level cost products; and
- More income will be taxable, if you purchase a prescribed annuity, reducing its net yield.

This means

Your policy's annual net cost of pure insurance will be lower for standard mortality policies. This will affect how the adjusted cost basis of the policy is calculated which will mean lower capital dividend accounts, and lower tax-free distributable amounts in corporate owned life insurance policies. This will also affect the collateral value of the policy for investment purposes, and due to the changes, increase your life insurance premiums.

However, in very limited situations, deferring your life insurance planning until after the new changes come into effect might benefit you. If you are subject to substandard health ratings on your policy, the net cost of pure insurance may actually be higher under the new rules, which will lead to increased deductions from immediate finance strategies and earlier capital dividend account benefits.

THE GOOD NEWS

If your heart is racing now, don't panic; there are ways to retain your current life insurance tax benefits:

- don't purchase additional coverage requiring medical underwriting for an existing policy; and
- don't convert existing term insurance policies into permanent coverage policies.

There are some changes you can make which will not affect your tax benefits status:

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- changing the ownership of the policy;
- changing the smoking status of the policyholder;
- adding non-life insurance waivers and benefits;
- exercising a guaranteed insurability option, if it was purchased and medically underwritten before 2017;
- reinstating lapsed policies without changes to the coverage;
- switching dividend options; and,
- reducing the death benefit.

What to do, NOW

If you have been thinking about estate planning, or making changes to your life insurance policy, this is the time.

Make sure that any medically underwritten changes are completed *before January 1, 2017, to avoid the loss of grandfathering* and to retain your current tax status.

IF YOU ALREADY HOLD AN INSURANCE POLICY

- if it makes financial sense, convert any term policies to permanent coverage; it will take longer to prepay a permanent insurance policy; currently you may be able to prepay an insurance policy in four years or less, after January 1 some products will take at least eight years;
- add or increase coverages or lives to permanent policies;
- increase your coverage by adding term benefits for yourself; your spouse or another insured;
- add a plus premium benefit to your whole life policy; and/or
- if you have a young family, add a child term benefit.

IF YOU DON'T HOLD AN INSURANCE POLICY

- if you want to take advantage of maximum funding, purchase a permanent life insurance policy before 2017; and/or
- if you want to maximize your capital dividend account credit, purchase your policy before 2017.

Don't get caught off guard by the imminent changes. There are various ways to manage these changes; be sure to contact your estate planning professionals, review your portfolio and put yourself in the best possible financial situation.

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CRA INTERPRETATION: TAX IMPLICATIONS OF A CONTRACTUAL RIGHT TO "SPLIT" A MULTIPLE LIFE POLICY

By Rahul Sharma, Associate, Miller Thomson LLP

INTRODUCTION

The Canada Revenue Agency (the "CRA") recently released an interesting interpretation (2015-0608261E5, the "Interpretation") regarding the "splitting" of a universal life insurance policy between the two lives insured under the policy. More particularly, the CRA was asked whether there is a disposition under subsection 148(1) of the *Income Tax Act* (Canada) (the "Act") when the holder of a universal life insurance policy exercises his or her contractual right (under the policy) to split the policy between the two lives insured, and whether paragraph 148(10)(d) of the Act would otherwise apply to exempt such a disposition. Additionally, the CRA was asked how the exemption test policy, accumulating fund and adjusted cost basis of the two policies would be determined if the policies were to be "split".

THE MULTIPLE LIFE POLICY

Based on the information provided in the Interpretation, the universal life policy in question provides life insurance coverage on the lives of the taxpayer who requested the Interpretation and the taxpayer's child. Cost of insurance charges under both of these coverages apply for a 10-year period and provide coverage for as long as the life insured is alive. The CRA notes that the cost of insurance charges for each coverage, as well as guaranteed cash values, are based on the age, gender and smoking status of each life insured at the time of the policy's issuance. The policy provides the taxpayer with the contractual right to "split" the coverage on the child and to set up the same policy for the child with the same death benefit, cost of insurance charges and guaranteed cash values which would have been provided in the original policy covering both lives. If the taxpayer exercises his right to "split" the policy in this manner, the taxpayer could choose to be the owner of the separate policy on the life of the child; otherwise the child would become the owner of the policy on his or her own life.

THE CRA'S RESPONSE

In responding to the taxpayer's questions, the CRA notes that subsection 148(1) of the Act generally provides that, when the holder of a life insurance policy has disposed of his interest in

the policy during the year, he or she is to include the difference between the proceeds of disposition of the policy and its adjusted cost basis in his or her income for the year. A disposition, in the context of a life insurance policy, is defined in subsection 148(9) to include, *inter alia*, a surrender or maturity of an interest in a life insurance policy or a disposition of the interest by operation of law.

Subsection 148(10) of the Act generally deals with life annuity contracts and is composed of five conjunctive paragraphs (a) through (e). Paragraph (d) provides as follows:

> (d) except as otherwise provided, a policyholder shall be deemed not to have disposed of or acquired an interest in a life insurance policy (other than an annuity contract) as a result only of the exercise of any provision (other than a conversion into an annuity contract) of the policy; and

In considering the language of paragraph 148(10)(d), in the Interpretation, the CRA takes the view that, to give meaning to the word "only", "it is necessary to determine whether the changes that are made to the terms of the policy, including but not limited to the premium structure, are so fundamental as to go to the root of the policy." If the changes went to the "root of the policy", then the CRA states that there would be a disposition of the policy and the acquisition of a new policy.

In the circumstances of the Interpretation, the CRA notes that the Act does not contemplate the "splitting" of a life insurance policy into multiple policies. Although the CRA does point out that the legislative amendments affecting life insurance policies (in Bill C-43) specifically provide for life insurance policies with multiple coverages, the amendments do not provide for specific rules regarding the "splitting" of life insurance policies. In the case presented in the Interpretation, the CRA takes the position that the legislative purpose behind paragraph 148(10)(d) of the Act was not to provide for the non-disposition of a life insurance policy in cases where the policy is "split" into two separate policies under the contractual terms of the policy.

In the Interpretation, the CRA declines to provide a definitive response as to whether the taxpayer would be deemed to have disposed of his or her interest in the life insurance policy in question if he or she was to exercise the contractual right to "split" the policy between the two lives insured. Rather, the CRA states that this is a determination of fact and law which would require a review of the specific policies. This would require a case-by-case review and, in this regard, the CRA invited the taxpayer to request an advance income tax ruling in respect of any actually contemplated transaction.

Although the CRA takes the position that the "splitting" of a life insurance policy is not contemplated by the Act, only limited guidance is provided on how to deal with the sorts of policies that appear to be contemplated in the Interpretation. In this regard, although the CRA refers to "changes" to the terms of a life insurance policy, including "fundamental changes" which go to the root of a policy, it does not appear to respond to the circumstances of a thorough and well drafted policy that clearly contemplates the "splitting" of the policy between the lives insured and the implications of such an action. It is in no way clear from the Interpretation that the exercise of a contractual right to "split" such a policy would impose a fundamental change to the terms of the policy or go to the "root of the policy" so as to result in a disposition of the holder's interest under subsection 148(1). Additional guidance and clarification appears to be required on this point.

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OTTE & ASSOCIATES CONTRACTORS INC. v. R.: BLURRED LINES BETWEEN THE BUSINESS AND ITS SHAREHOLDER

By John Forman, Student-at-Law, Miller Thomson LLP

In *Otte & Associates Contractors Inc. v. R.*,[1] the Tax Court of Canada ruled on reassessments issued to a corporation, highlighting the difficulty the court faces in distinguishing a corporation when it is closely held and operated by a shareholder. The case involved Patrick Otte, the operator and shareholder of Otte & Associates Contractors Inc. ("OAC"), who purchased a tract of land in order to build his personal home. His company, OAC, was in the business of renovating and constructing homes and the reassessment was issued on the basis that OAC had purchased the property, constructed the house, and had subsequently transferred it to Mr. Otte. As a result, the Canadian Revenue Agency ("CRA") reassessed OAC pursuant to subsection 173(1) of the *Excise Tax Act*.[2]

FACTS

In 2007, Mr. Otte and his wife decided to build a new home and purchased a 4.90 acre parcel of vacant land in White City, Saskatchewan for $124,900.00 plus GST. On December 27 of that year the Ottes entered into an Option to Purchase Agreement with Stone Pointe Estates Ltd ("SPE", the developer

1 2016 TCC 162, 2016 CarswellNat 2578 (TCC [Informal Procedure]) [*Otte*].
2 *Excise Tax Act*, R.S.C. 1985, c E-15, ss.173 (1)(d) [ETA].

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selling the property) for a total price of $131,145, and soon after Mr. Otto paid a $16,237 deposit to SPE, and subsequently paid the remainder of the purchase price with two further payments in 2008 ($60,000) and 2009 ($59,000). The total of these amounts actually exceeded the agreed upon purchase price by approximately $4,000, but no explanation for this discrepancy was provided, nor is it material to the case in general. After the land was fully paid for in 2009, the Saskatchewan Land Titles Registry issued title for the land which listed Mr. and Mrs. Otte as the registered owners.

Mr. Otte, a journeyman carpenter, had practiced in the construction industry for over four decades, and in the 1990s began building custom homes for clients. In 2008, he arranged for OAC to be incorporated and for his renovation business to continue under this company with him as its shareholder. This is the point where the lines between Mr. Otte's actions as an individual and his actions as an agent of OAC blurred. OAC's financial statements for the fiscal year ending November 2010 showed that they had inventories consisting of four lots on Stone Pointe Estates, one of which was the land purchased by Mr. Otte. The same documents also indicated that payments for the land in the amounts of $16,237, $60,000, and $59,000, corresponded to the amounts paid by Mr. Otte for the property.

Adding to this confusion was the actual house that was built on the parcel of land. In building his own custom house, Mr. Otte tried to do the majority of the project himself, including pouring the concrete foundation, framing the house and installing the windows and doors. But, there were also some jobs where OAC was used to procure supplies and perform work, such as the electrical work, exterior stonework, and installation of the plumbing. For the most part, all the work that Mr. Otte performed on the house himself was done on the weekends or after business hours, with only two exceptions which were unavoidable. Once the house was complete Mr. Otte estimated the total value of his labour to be approximately $144,000, which OAC did not pay for. But, OAC did issue an invoice to Mr. Otte for the work that the company performed on the house in the amount of $459,198.24.

ISSUES

The primary issue in this case appears to be that of ownership. The CRA was of the view that OAC purchased the land, constructed the house in its entirety, and then only transferred the house and land to Mr. and Mrs. Otte after the construction was complete. Because of this, the CRA reassessed OAC pursuant to subsection 173(1) of the ETA, holding that the fair market value of the property (the land and house) was $1,200,000 and that accordingly there was a benefit amount of $762,668.34, on which OAC had an obligation to collect $38,133.42 of GST. "Benefit amount" is defined in subsection 173(1)(a) of the ETA, which states:

> 173(1) Where a registrant makes a supply (other than an exempt or zero-rated supply) of property or a service to an individual or a person related to the individual and
>
> (a) an amount (in this subsection referred to as the "benefit amount") in respect of the supply is required under paragraph 6(1)(a), (e), (k) or (l) or subsection 15(1) of the Income Tax Act to be included in computing the individual's income for a taxation year of the individual

In challenging the reassessment, OAC took the position that Mr. and Mrs. Otte were the ones who constructed the house, and that any acts performed by OAC on the home were done so at the request of and for the Ottes. OAC felt that it did not transfer or supply anything to the Ottes that would trigger the application of section 173 of the ETA.

ANALYSIS

i) Agency

Judge Sommerfeldt's first task was to determine who was the agent of whom. OAC had argued that they acted as an agent for Mr. and Mrs. Otte whereas the CRA had claimed that the exact opposite was true (that Mr. Otte had at all times been acting as an agent of OAC). There were no written agency agreements. However, in accordance with applicable case law, agency can be express or implied. The court cited the leading textbook on the matter which stated that:

> As with other contracts, the agency relationship may be impliedly created by the conduct of the parties, without anything having been expressly agreed as to terms of employment, remuneration, etc.... The assent of the agent may be implied from the fact that he has acted intentionally on another's behalf. In general, however, it will be the assent of the principal which is more likely to be implied.... Such assent may be implied where the circumstances clearly indicate that the principal has given authority to another to act on his behalf. This may be so even if the principal did not know the true state of affairs. Mere silence will be insufficient. There must be some course of conduct to indicate the acceptance of the agency relationship.[3]

The court concluded that on the whole Mr. Otte acted as the agent of OAC in procuring certain materials for the building of his home. Prior to this reassessment, the CRA had previously challenged OAC's claim for input tax credits in respect of purchases made by OAC from suppliers used by Mr. Otte before OAC was incorporated. In defending its actions, OAC had produced documentation to show that Mr. Otte was acting as the

3 G. H. L. Fridman, *Canadian Agency Law*, 2nd ed (Markham: LexisNexis Canada Inc., 2012) at 40-41.

company's agent. The court highlighted these previous claims in the present context to point out that OAC and Mr. Otte could not have it both ways. In those previous claims by OAC, the CRA had agreed that Mr. Otte was acting as an agent for OAC, and the input tax credits were allowed. Based on this information, the court could not hold that OAC was now the agent of Mr. Otte. Due to this finding the court further held that any items provided by OAC to the building of the house were supplied in OAC's capacity as principal in the agency relationship.

ii) Ownership of Land

In determining which party in fact owned the land, the court held that accounting documents and entries only ever reflect reality and do not create it, echoing the Supreme Court of Canada's sentiments: "[t]he law is well established that accounting documents or accounting entries serve only to reflect transactions and that it is the reality of the facts that determines the true nature and substance of transactions...".[4] Therefore, after reviewing all the legal documentation the court felt that the Ottes were, at all material times, the owners of the property. The court felt that even though some of OAC's financial documents may have showed the property as being owned by the company, the documentation associated with the legal title must prevail. Accordingly, the court held the Ottes were the registered, legal and beneficial owners of the land.

iii) Labour

Turning to the cost of Mr. Otte's labour, the CRA took the position that it was not their job to determine what the supply of labour was, a position which the court disagreed with. The court highlighted the fact that Mr. Otte primarily worked on the home (bar two exceptions) on weekends and after regular working hours. Accordingly, the court found that the labour Mr. Otte put into the building of his home was not supplied by OAC and was solely from Mr. Otte himself.

VALUATION

During the course of the trial, the CRA called a real estate appraiser as an expert witness. The CRA appraiser concluded that the property was worth $1,200,000. However, Judge Sommerfeldt disagreed with the CRA appraiser's valuation method and after his own recalculation found the property to be worth $1,170,000, with the land value compromising $170,000 of that.

APPLICATION

Applying the above determinations, the court found that the disagreement between the CRA and OAC could be resolved by simply recalculating the benefit amount based on the court's findings regarding the value of the house, land ownership, labour amounts, and the cost of supplies. Accordingly, the court allowed the appeal and the reassessment was referred back to the Minister for reconsideration and reassessment on the basis of the court's calculations.

The *Otte* case serves to highlight the importance of clearly defining the differences between one's business and one's external activities. When one is a primary shareholder of a business, the lines can become blurred for tax purposes if he or she has conducted similar work to his or her business, while using that same business's resources. This type of situation results in a detail oriented analysis by the court to determine precisely what the business and shareholder have individually done in every transaction to rule on who is responsible for any applicable tax implications.

In this instance, Mr. Otte was found to generally have ownership and responsibility for the project, but he was also found to be an agent of OAC due to past claims. As a result, OAC will be liable to collect some portion of GST based on any recalculated benefit amount. This was certainly not a home-run for the CRA as the court heavily modified their calculations, but the reassessment was still held to be valid. Mr. Otte was most likely looking for tax benefits when he initially incorporated OAC, but this situation was not one that he foresaw. Ensuring that there is a clear distinction between one's business and one's own actions is key to adequate tax planning.

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4 *Hickman Motors Ltd v. R.*, [1997] 2 SCR 336, 1 CTC 213 (SCC).

MARIANO v. R.:[1] TAX SHELTER CASES COME WITH THE RISK OF HEAVY COSTS!

By Marco Maduri, Student-at-Law, Miller Thomson LLP

INTRODUCTION

The Canada Revenue Agency ("CRA") was completely successful after a lengthy trial on charitable tax credits claimed by the Appellants after participating in a tax shelter scheme created by GLGI (the "Promoter"). The parties, and several appellants who had agreed to be bound by the decision in this case (the "Bound Appellants"), made submissions on costs. The Tax Court of Canada awarded $491,136.95 in costs to the Respondent, on a joint and several liability bases, to be allocated among the Appellants (including the Bound Appellants) and the Promoter.

1 2016 TCC 161 TCC [General Procedure].

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FACTS

The CRA was completely successful after a trial that spanned 25 days of hearings and a week of oral arguments (in three cities). The issues at trial included donative intent, trust validity and trust property, program sham and valuation of in kind software donations. The court noted the high level of complexity and volume of work involved. The CRA submitted a bill of costs totaling $491,136.95, including expert witness fees in the amount of $422,286.20.

The Respondent made reference to all the factors in Rule 147(3) concerning its cost submissions, whereas the focus of the Appellants' arguments was on Rule 147(3)(j) of the Tax Court of Canada Rules (General Procedure), SOR/90-688a, which allows the Court to consider "any other matter relevant to the question of costs". The Appellants argued that:

1. As a "test case", each party should bear its own costs;
2. The Promoter should be liable for the costs;
3. That the costs should be allocated amongst thousands of taxpayers who were similarly assessed under the charitable tax credit scheme or affected by the decisions; including alternatively taxpayers at the objection stage or those at the appeals stage or those who agreed to be bound by this decision under the Tax Court of Canada Rules or by agreement with the Respondent at the objection stage;
4. That the fees and disbursements were beyond what was reasonably expected by the Appellants as a cost liability; and
5. That the quantum of expert fees should be reduced.

REASONS

In rejecting each of the Appellants' arguments, the judge gave the following notable reasons in his decision.

A lead case is not always a test case

The Appellants noted that their cases were selected as lead cases from among many thousands of taxpayers who participated in the GLGI program in 2004 and 2005. Only a few of the participants were at the actual appeals stage. The Appellants argued that it would be reasonable for a Lead Appellant (whose case would be used to dispose of potentially thousands of cases) to expect that he/she would not be forced to pay more than a pro-rata share of the costs. Otherwise, hefty costs could serve as a deterrent to Appellants acting as Lead Appellants.

With regard to their status as a "lead case", the Appellants tried to analogize their situation to a "test case". The Judge conceded, at paragraph 37, that lead cases may be test cases in circumstances where the parties agree to be bound. However, the Judge noted that there were thousands of taxpayers at the "objection" stage that were not bound by the decision of the case. These taxpayers had a right to appeal that would not be extinguished by the decision in the case at bar.

The Judge recognized that there is a general interest in ensuring that laws are complied with and taxes are paid. However, this general interest is not sufficient to elevate a tax case to the level of a test case. In searching for something more, the Judge found that the law surrounding trust, sham, and donative intent had already been well established.

While the Judge also acknowledged that the precedential value of a lead case may practically determine the results in subsequent cases, he cited the decision in *Brown v. R.*,[2] at paragraph 20, namely:

> ...that the decision of a Court in a tax appeal may help settle other assessments and reduce the Crown's expenses are not reasons for the Crown to absorb costs of the appeal.

The Judge reiterated that the issues before the court must transcend the interest of the litigants and be of public interest or there must be misconduct by the successful party to deviate from the practice of costs following the result.

Non-parties may be liable for costs

The Judge reviewed authority from Alberta and Federal Courts that confirmed a court's jurisdiction to assess costs against non-parties to an action.[3] In the case at bar, the court found that the non-party promoter funded the action and "conducted it from the sidelines". In particular, the court noted the direction executed by Mariano and several others that stated:

> Global Learning Group Inc. ("Promoter") will establish a legal fund equal to 3% of the amount of cash raised for the Foundation (to a maximum of $750,000) to pay legal fees in the event of a reassessment by the Canada Revenue Agency. To avail itself of the defense fund, the undersigned must consent to carriage of its appeal by the Promoter on behalf of the undersigned, with legal counsel of the Promoter's choice, by way of binding test case, at Promoter's option.

Based on this language, and the Promoter's conduct, the court found a strong *prima facie* case that the Promoter would cover the costs associated with the defence.

2 [2002] TCJ No. 204, 2002 DTC 1925 TCC [General Procedure].

3 *155569 Canada Ltd. v. 248524 Alberta Ltd.*, [1999] AJ No. 623 (Alta QB) at paragraph 48. *Richards v. Minister of National Revenue* [2005] FCJ No. 21, 2005 DTC 5155 (FC).

No evidence tendered on costs of the Appellant and Bound Appellant

The court found that, based on the issues at trial, expert evidence was required from the Respondent to rebut the evidence of two expert reports and expert witnesses of the Appellant. It was also needed to assist the court in understanding the concept of software valuation. The issues were factually complex and made more complex by the structure of the Promoter's donative program.

The Appellants' failure to provide evidence as to amounts expended by them for expert witnesses made a comparison of expert fees impossible. As a result, their submissions as to the Respondent's expenditures were somewhat meaningless. In *Hague v. Liberty Mutual Insurance Co.*,[4] the court cited *The Law of Costs*:[5]

> One might fairly ask how the expectation of the parties is to be found out as part of the costs process. In my view, it is not to be obtained directly from the parties through, say, affidavits being filed. Any such affidavit evidence would inevitably be completely self-serving and of no assistance to the court. Rather, it would appear that the expectation of the parties will fall to be determined in one of two ways. It may be determined by the unsuccessful party revealing what his/her/its costs were on the same matter as some measure of what was to be expected. The unsuccessful party is, of course, not required to reveal that information but, if they choose not to do so, they may impair their ability to make any meaningful submissions on this aspect of the process....

The Judge also found it incredulous the Appellants were not aware or were not told this would be expensive and time consuming litigation when it was initially set down for eight weeks over two cities (Vancouver and Toronto — with Halifax added at Appellants' own request). The Judge agreed with the Respondent that if the Appellants were not made aware of the risk of significant costs, then it was a matter between the Appellants and their counsel.

Additionally, the Judge found the existence of the aforementioned $750,000 legal defense fund to be clear evidence that the parties knew that the costs of litigating the tax scheme would be very high.

Therefore, with the exception of some minor charges for the redundant attendance of experts at a few hearings, the court found that the quantum of the Respondent's expert fees were reasonable.

4 [2005] OJ No. 1660 (Ont SCJ).

5 Mark M. Orkin , *The Law of Costs,* Second Edition, Volume 1, at pages 2-37 and 2-38.

Allocation of costs

The Appellants, Bound Appellants, and Promoter were all found to be responsible for costs. While the Promoter was directly responsible for the sham, the court found that the Appellants and Bound Appellants blindly or willingly participated in the program with the expectation of receiving a net tax advantage far greater than the amount of their cash donations.

In allocating costs, the court found that a simple award on the basis of joint and several liability would offend the principle that costs "should be compensatory and contributory" and "not punitive nor extravagant". Therefore, the court awarded costs on a joint and several basis with the liability of each Appellant and Bound Appellants capped such that

> ...each of their liability for costs shall be limited to the proportion that their total Charitable Tax Credits claimed in respect of the Program for all years under appeal herein is to total of all Charitable Tax Credits claimed by all of them combined with respect to the Program for such years under appeal.

It should be noted, however, that there was no limit to the Promoter's liability for costs. Essentially, the award would avoid treating the Appellants and Bound Appellants unfairly amongst themselves while also treating them as a group that, along with the Promoter, would be liable for the full amount.

CONCLUSION

Taxpayers should not assume that their status as a Lead Case necessarily confers any special consideration against a cost award. Unless there are also special circumstances, public interests, or Constitutional issues that transcend the taxpayers' own private interest in the litigation, or barring misconduct by the successful party, taxpayers should not expect similar discretionary relief from costs as might otherwise be expected in the context of a test case. Taxpayers who are not parties to the litigation, but nonetheless agree to be bound under Rule 146.1 of the *Tax Court of Canada Rules*, will be bound in whole by the decision and subject to any costs awarded.

Complex tax schemes that require specialized and costly expert evidence to assist the court in understanding the facts may carry risks of high cost awards against unsuccessful litigants. Amounts will not be found to be unreasonable or excessive only because they are significant. The court may also look to the unsuccessful litigants' own expenditures on expert witnesses and reports in determining whether amounts claimed by the successful party are reasonable. There is also an expectation that counsel has a role to play in managing parties' expectations regarding costs in the event that their clients are unsuccessful.

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Promoters should be aware that they may be subject to a cost order in litigation involving their tax shelter schemes, even if they are not parties to such litigation. In addition, any steps taken in the creation of the tax scheme to finance anticipated tax litigation may be viewed as evidence of the reasonable expectation of costs and their quantum by promoters and, where disclosed, by participants in such schemes.

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UPDATE ON TAX EVASION

By David W. Chodikoff, Editor of *Taxes & Wealth Management,* Tax Partner, Miller Thomson LLP

Do you remember SCTV? The Great White North? with Bob and Doug McKenzie? The brothers (David Thomas and Rick Moranis, the actors that played the brothers in real life), would commence their "show" by asking: "How's it goin, eh?" And that is the precise question I attempt to answer in relation to the current status of Canada's efforts to halt tax evasion.

In early September 2016, the Minister of National Revenue, Diane Lebouthillier, outlined the various steps that have been taken by the Canada Revenue Agency to crack down on tax cheats. Apparently, when it comes to audits of offshore tax havens, the Canada Revenue Agency is presently conducting audits on over 750 taxpayers and investigating 20 other cases of tax evasion. The rest of the press release was pretty much old news. In the press release, there was also the reference to international cooperation by Canada's participation in the Joint International Taskforce on Shared Intelligence and Collaboration (JITSIC) network, the continuing Isle of Man saga, the reference to the government's 2016 budget commitment of $444 million to provide the Canada Revenue Agency with more resources, the commencement of hiring more auditors this Fall and the effectiveness of the Offshore Informant Program (OTIP). By July 2016, the OTIP had received 868 calls from potential informants and 361 separate written submissions. The press release indicated that as a result of this program over 180 taxpayers are presently under audit.

While all of this information suggests that the government is heading in the right direction, the actual outcome of these measures has yet to be determined. Put simply, the question is whether the government will achieve its targeted goal of collecting an estimated additional $500 million in revenue over the next five years. I doubt it and for a number of reasons — beginning with the concept of due process. Whether it is a civil or criminal audit, every taxpayer has the right to raise challenges and defend themselves. This process in either the criminal or civil circumstance can take many, many years. It is not only the length of the process itself, but it is the substance of how investigations are conducted and if the Canada Revenue Agency has correctly audited and ultimately assessed or reassessed the taxpayer.

We should remain positive about the government's objectives but all Canadians have a duty to ensure that the government carries out these audits as quickly and efficiently as possible. The end result should be a fair and speedy application of the law.

David W. Chodikoff is an Editor of Taxes & Wealth Management. David is also a Tax Partner specializing in Tax Litigation (Civil and Criminal) at Miller Thomson LLP.

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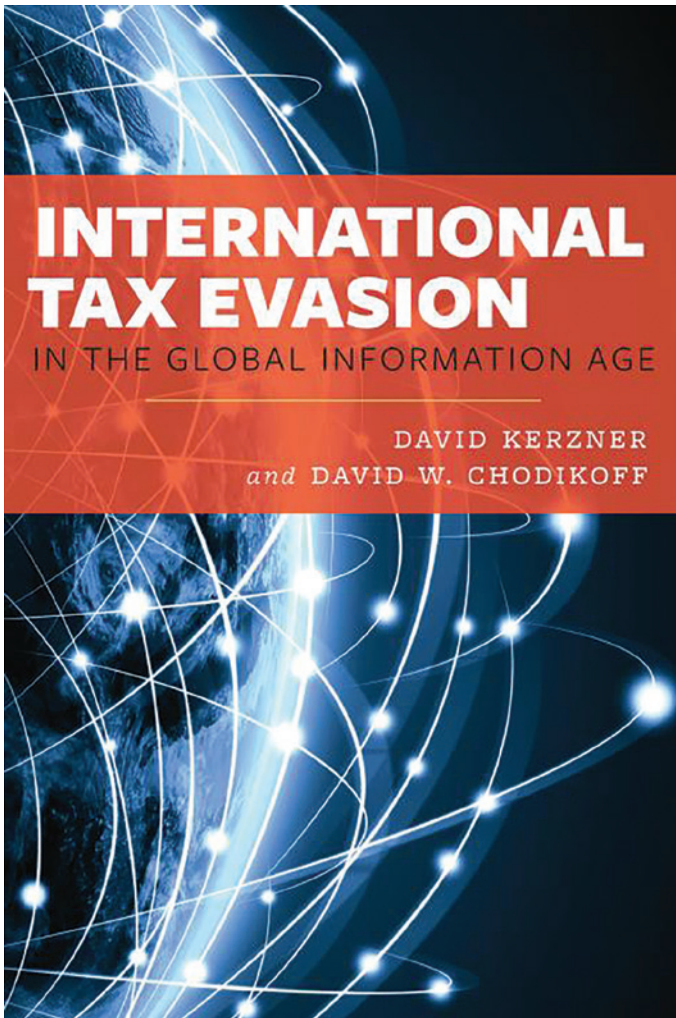

We are pleased to share with our readership that two of our Thomson Reuters authors and editors have recently published two new books in the field of tax law. Dr. David Kerzner and David W. Chodikoff have co-authored *International Tax Evasion in the Global Information Age*. And David Chodikoff has also served as the General Editor of *Tax Litigation* the second edition. We congratulate both Davids!

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