

Breakfast for Business

Tax Law Update

November 15, 2017

Presenters:

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Introduction

- Each year there are development in case law and amendments to the Income Tax Act and Excise Tax Act
- The purpose of today's seminar is to review a sampling of the key case law developments
- This seminar acts as a complimentary to the issue specific seminars that we hold throughout the year

Agenda

1. Legislative Update
2. Case Law Update
 - i. Audit Powers
 - ii. Penalties and Fake Business Expenses
 - iii. Reorg and Sale
 - iv. Collections
 - v. Litigation and Limitations

1) Legislative Updates

- These past few months have been busy for accountants and tax lawyers with the July tax overhaul proposals and then the dramatic partial reversals in October
- Currently, here is where we stand:
 - TOSI Rules/Income Sprinkling: Restricted income splitting, subject to reasonableness test for a non-arm's length recipient.
 - Passive Investments: Potential limits of the deferral opportunities related to passive investments in excess of \$50,000 per annum. Draft legislation is to come out in the 2018 federal budget.
 - Surplus Stripping: Proposals abandoned.
- In addition to these proposed changes, pursuant to IC00-1R6, effective January 1, there will be an overhaul of the Voluntary Disclosure Program
- Under the new Voluntary Disclosure Program, there will be less generous relief in certain circumstances

2)i) Case Law Updates: Audit Powers

- Under s. 231.1(1) of the Income Tax Act, the CRA has broad audit powers, including inspecting books and records
- In the decision of *BP Energy Company v. Minister of National Revenue*, the taxpayer was a publicly traded company that had an obligation at law to prepare consolidated financial statements
- As part of this effort, tax accrual working papers were prepared and the Minister brought an application in Federal Court to obtain the original working papers
- The Federal Court ruled that the tax accrual working papers were within the CRA's audit powers and declined to exercise discretion to refuse the order
- On appeal, the CPA intervened and explained the chilling effect this would have

2)i) Case Law Updates: Audit Powers

- The Federal Court of Appeal allowed the appeal and held:
“the Minister cannot invoke subsection 231.1(1) for the purpose of obtaining general and unrestricted access to those parts of BP Canada’s Tax Reserve Papers which reveal its uncertain tax positions. In practical terms, this means that the Minister cannot enlist taxpayers who maintain TAWPs to perform the core aspect of audits conducted under the Act.”
- For accountants, it is important to be mindful that, while the CRA may have broad audit powers, these powers do have limits

2)i) Case Law Updates: Audit Powers

- In addition to compelling documents, under section 231.1, the Minister can also compel oral examinations
- In *Minister of National Revenue v. Cameco Corporation*, the Minister applied to the Federal Court for a compliance order to compel 25 people to attend for oral examinations as part of a transfer pricing audit
- Cameco had agreed to provide answer to written questions, but the Minister wanted oral examinations
- The Federal Court held that ss. 231.1 “is not so wide as to compel an indeterminate number of people for oral interviews” and “an unlimited right to conduct oral interviews”

2)i) Case Law Updates: Audit Powers

- In most instance, written questions and answers are preferable, to ensure that there is no misunderstandings or misstatements
- The dispute in *Cameco* is the exception, as in most instances the CRA is agreeable with written questions and answers
- If oral examinations are sought, it is important that the individuals to be examined are limited and specifically addressed

2)ii) Case Law Updates: Penalties

- Over the past year, numerous decisions have been issued by the Tax Court in regards to baseless claimed business losses
- In these decisions, the sole issue was whether the Minister was correct in assessing penalties under section 163(2) of the Income Tax Act
- In the vast majority of the decisions, the Court upheld the penalties
- In those cases, the Court tends to dismiss the appeal on the grounds that the taxpayer ignored the warning signs (e.g. *Wynter*)

2)ii) Case Law Updates: Penalties

- However, in a few decisions, the Court held that, despite claiming a substantial business loss for a business that did not exist, penalties were improperly assessed given the taxpayer's due diligence and trust in the tax preparer
- For example, in the decision of *Bolduc v. The Queen*, the Court held that the Minister had failed to establish gross negligence
- In particular, while the appellant was naïve, the Court found that the conduct was not so reprehensible or unreasonable, and there was no turning of a blind eye in suspicious circumstances

2)ii) Case Law Updates: Penalties

- In our experience, the Minister for the past several years has been imposing penalties almost automatically in regards to every Reassessment
- However, penalties are only appropriate where the Minister has established gross negligence
- Inadvertent errors should not be subject to penalties, just as naïve individuals who (without willful blindness) file false returns should not be subject to penalties

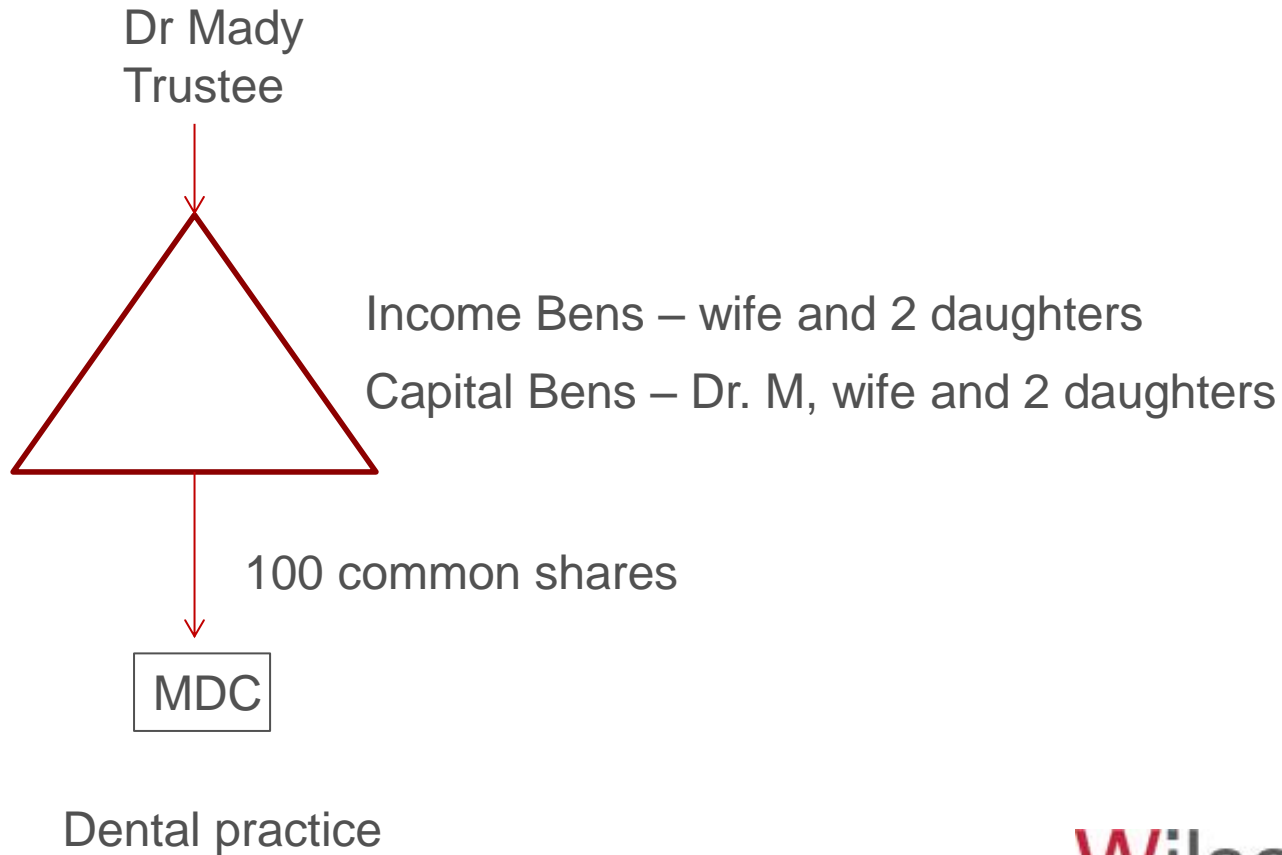
2)iii) Case Law Updates: Reorg and Sale

Mady v. The Queen 2017 TCC 112

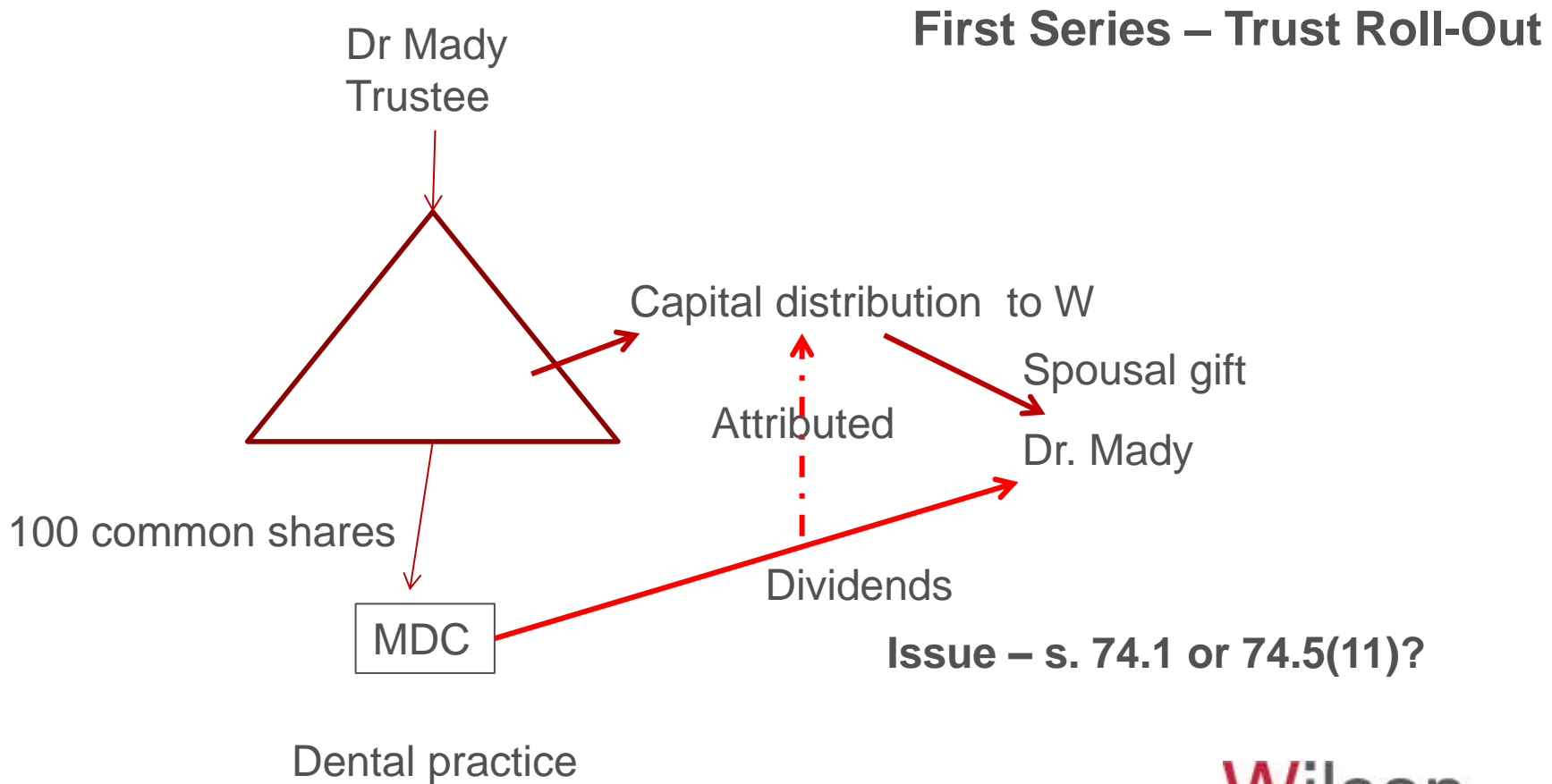
- 3 issues in reorganization and sale of dental practice
- Did “reverse” attribution rules apply so dividend was included in wife’s income?
- Was s. 86 rollover properly denied because wife and daughters realized a benefit through ownership of shares?
- Were gross negligence penalties properly levied?

2)iii) Case Law Updates: Reorg and Sale

Original Structure



2)iii) Case Law Updates: Reorg and Sale



2)iii) Case Law Updates: Reorg and Sale

Capital Reorganization

Dr. Mady

- 100 common shares converted under s. 86 into:
- Redeemable preferred shares - \$2,071,500
- 100 Class A common
- 100 Class B common
- 100 Class C common
- 100 Class D common



MDC

Section 86 satisfied – Dr Mady held all shares after reorganization with aggregate value equal to value of original 100 common shares

2)iii) Case Law Updates: Reorg and Sale

Dr. Mady

Sale to Third Party

- Redeemable preferred shares - \$2,071,500 – sold by Dr, Mady
- 100 Class A common – sold by Dr Mady
- 100 Class B common -15 sold by Dr Mady
 - 85 sold by W
- 100 Class C common – 15 sold by Dr Mady
 - 85 sold by D1
- 100 Class D common – 15 sold by Dr Mady
 - 85 sold by D2

MDC

Sale price of all common shares was **\$8,645 per share**

Capital gain exemption claimed by family members

How did family members get shares to sell?

2)iii) Case Law Updates: Reorg and Sale

Gross Negligence Penalties

- CRA imposed penalties on both dividends attributed and on sale proceeds
- TCC concluded Minister did not establish basis for penalties – taxpayer had sought and received expert advice. With respect to dividends, ss. 74.5(11) had not previously been judicially considered
- Reorg – CRA applied wrong section – s. 86 satisfied but taxpayer made a gift to family members which triggered gain to him under s. 69

2)iv) Case Law Updates: Collections

Tjelta v. The Queen 2017 TCC 187

- Directors' liability and CRA collection action
- Corporation owed both general creditors and CRA for deemed trusts
- Corporation had hard assets – general creditor seized assets
- Director notified CRA, which responded promptly to protect its interests
- CRA position was that it relied on receiver to act properly in determining priorities of creditors

2)iv) Case Law Updates: Collections

- Assets disappeared from receiver with no proceeds. No explanation obtained.
- Director objected to collection action on basis CRA had not acted in good faith given information provided to it by director.
- Evidence showed director did not take steps to protect the interests of debtor corporation
- CRA held to have acted reasonably

2)v) Case Law Updates: Litigation and Limitations

- *Biancello v. DMCT LLP* 2017 ONCA 386
 - how broad is a release?
- *Presidential MSH Corporation* 2017 ONCA 3
 - When did limitation period start to run?

2)v) Case Law Updates: Litigation and Limitations

Biancello

- Defendant accounting firm was retained for several special projects, including SRED claim and butterfly reorg
- Appellant client objected to fees and quality of work done
- Fee dispute ultimately settled and parties signed a mutual release in 2008
- Release covered “ all manner of actions ... claims and demands, which against each other they had, now have or hereafter may, can or shall have for or by reason of any cause, manner or thing whatsoever existing to the present time with respect to any and all claims arising from any and all services provided by DMCT to [client] through to and including December 31, 2007...”

2)v) Case Law Updates: Litigation and Limitations

- In late 2011, in the course of a restructuring, client learned that the butterfly transaction, as structured by DMCT, could be subject to a tax liability of approx. \$1.24 million
- Client obtained a court order for rescission of the steps taken in the butterfly reorg on January 23, 2013 – costs exceeded \$250,000
- May 2012 – client filed notice of action against DMCT seeking an order setting aside the 2008 Release and claiming damages of negligence, breach of contract, misrepresentation and breach of fiduciary duty

2)v) Case Law Updates: Litigation and Limitations

Motion for Summary Judgment

- DMCT brought motion for summary judgment, dismissing the claim on the basis it was precluded by the Release
- Motions judge dismissed motion on basis DMCT “admitted negligence” only came to light in 2011 and could not have been contemplated by the parties in 2008
- Appeal to Divisional Court – agreed with motions judge – the negligence claim did not exist when the Release was signed and so was not covered by it

2)v) Case Law Updates: Litigation and Limitations

Court of Appeal

- Overturned decisions below.
- “The Divisional Court held that because the parties were not aware that the accountants had given negligent advice ... the client’s claim for negligence did not exist when the release was signed. . This statement constitutes an error of law. ... Because neither party was apparently aware that the advice was negligent, there would be a discoverability issue for the purpose of determining the relevant limitation period. However, the fact that the claim was not discovered does not mean that it did not exist, nor that it was not discoverable. In fact, it did exist but only came to light upon being discovered by other accountants four years later.”

2)v) Case Law Updates: Litigation and Limitations

Presidential MSH Corporation

- Another summary judgment appeal
- Accountants filed taxpayer's returns after the due date, so CRA refused dividend refunds. Taxpayers suffered damages of approx. \$550,00 in unpaid taxes, interest and penalties
- April 12, 2010 notice of assessment – CRA disallowed the credits that would have been allowed had returns been timely filed. Taxpayer notified accountants.
- April 15, 2010 – taxpayer hired tax lawyer who filed notice of objection – no discussion of possible action against accountants for professional negligence. Accountants assisted tax lawyer in preparing objection until at least November 2011

2)v) Case Law Updates: Litigation and Limitations

- May 16, 2011 – CRA advised it intended to confirm assessments. Confirmation issued July 7, 2011
- Motions judge found that as late as July 2011 there was a reasonable chance that application for discretionary relief would mitigate some or all of taxpayer's loss.
- August 1, 2012 – taxpayer issued statement of claim against accountants. Accountants sought summary judgement dismissing claim on basis the CRA notice of assessment in April 2010 started the limitations clock
- OCA – the claim was not “discovered” until May 2011 when CRA responded to taxpayer's notice of objection

QUESTIONS?

Wilson Vukelich LLP can help with properly addressing and resolving your clients' tax issues and disputes. If you have any questions or require further information, please contact:

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