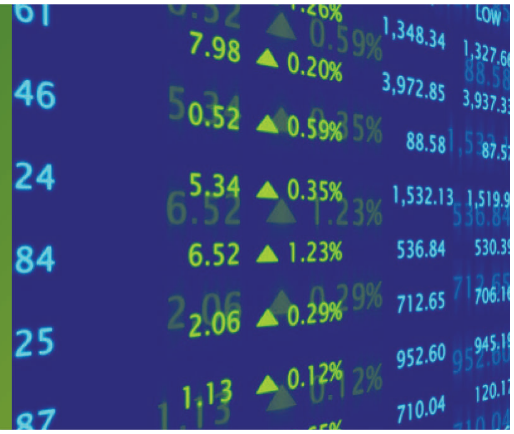
# TAXES & WEALTH MANAGEMENT




PRESERVING WEALTH FOR PEOPLE AND PRIVATE COMPANIES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## EDITOR'S SEASON'S GREETINGS

On behalf of Marty, Rahul, Hellen and the entire behind the scenes editorial team at Thomson Reuters Carswell, we thank you for your continuing readership and support for this Newsletter.

From all of us and our families to all of you and your families, we wish everyone a very healthy, happy holiday season and the best for the coming New Year!

David, on behalf of the Team.

## NEW U.S. TAX CHALLENGES FOR CROSS BORDER REAL ESTATE INVESTMENTS

By David S. Kerzner, Ph.D.[1], Kerzner Law

### INTRODUCTION

Recent changes in the tax laws governing investments in partnerships will impact past, present and future transactions by Canadian investors in partnerships with U.S. assets.

The partnership tax rules in the Internal Revenue Code are without a doubt the most difficult to understand and often are an area where frequent compliance errors can be found on both sides of the border — Canadian reporting of these investments, and U.S. reporting. As well, these same rules often apply to LLC's with more than one member.

This article is adapted from a more comprehensive update and study of the subject to be found in *The Tax Advisor's Guide to the Canada U.S. Tax Treaty* (Thomson-Reuters, 2008-looseleaf and available on TaxNetPro) (see Chapter 6 — Real Property, and Chapter 13 — Capital Gains). The shifting of the proverbial tectonic plates in U.S. tax reform mandate that any practitioner or investor considering the treaty understand the impact of the corporate and international rules. For new investors, coupling a

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## U.S. INTERNATIONAL TAXATION OF THE SALE OR EXCHANGE OF A PARTNERSHIP INTEREST

### Background

A partnership generally is not treated as a taxable entity, but rather, income of the partnership is taken into account on the tax returns of the partners and they are issued K-1s by the general partner. The character (as capital or ordinary) of partnership items passes through to the partners as if the items were realized directly by the partners.

A partner holding a partnership interest includes in income its distributive share (whether or not actually distributed) of partnership items of income and gain, including capital gain eligible for the lower tax rates, and deducts its distributive share of partnership items of deduction and loss. A partner's basis in the partnership interest is increased by any amount of gain and decreased by any amount of losses thus included. These basis adjustments prevent double taxation of partnership income to the partner. Money distributed to the partner by the partnership is taxed to the extent the amount exceeds the partner's basis in the partnership interest.

Gain or loss from the sale or exchange of a partnership interest generally is treated as gain or loss from the sale or exchange of a capital asset. However, the amount of money and the fair market value of property received in the exchange that represent the partner's share of certain ordinary income-producing assets of the partnership give rise to ordinary income rather than capital gain. In general, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless either the partnership has made a one-time election to do so or the partnership has a substantial built-in loss immediately after the transfer. If an election is in effect or the partnership has a substantial built-in loss immediately after the transfer, adjustments are made with respect to the transferee partner. These adjustments are to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee partner's basis in its partnership interest. The effect of the adjustments on the basis of partnership property is to approximate the result of a direct purchase of the property by the transferee partner. These ordinary income-producing assets are unrealized receivables of the partnership or inventory items of the partnership ("751 assets").

A foreign person that is engaged in a trade or business in the United States is taxed on income that is "effectively connected" with the conduct of that trade or business ("effectively connected gain or loss"). Partners in a partnership are treated as engaged in the conduct of a trade or business within the United States if the partnership is so engaged. Any gross income derived by the foreign person that is not effectively connected with the person's U.S. business is not taken into account in determining the rates of U.S. tax applicable to the person's income from the business.

Non-business income received by foreign persons from U.S. sources is generally subject to tax on a gross basis at a rate of 30 percent, and is collected by withholding at the source of the payment. The income of non-resident aliens or foreign corporations that is subject

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to tax at a rate of 30 percent is fixed, determinable, annual or periodical income that is not effectively connected with the conduct of a U.S. trade or business. Among the factors taken into account in determining whether income gain or loss is effectively connected gain or loss are the extent to which the income gain or loss is derived from assets used in or held for use in the conduct of the U.S. trade or business, and whether the activities of the trade or business were a material factor in the realization of the income gain or loss (the "asset use" and "business activities" tests). In determining whether the asset use or business activities tests are met, due regard is given to whether such assets or such income gain or loss were accounted for through such trade or business. Thus, notwithstanding the general rule that source of gain or loss from the sale or exchange of personal property is generally determined by the residence of the seller, a foreign partner may have effectively connected income by reason of the asset use or business activities of the partnership in which he is an investor.

Special rules apply to treat gain or loss from disposition of U.S. real property interests as effectively connected with the conduct of a U.S. trade or business. To the extent that consideration received by the nonresident alien or foreign corporation for all or part of its interest in a partnership is attributable to a U.S. real property interest, that consideration is considered to be received from the sale or exchange in the United States of such property. In certain circumstances, gain attributable to sales of U.S. real property interests may be subject to withholding tax of ten percent of the amount realized on the transfer.

Under a 1991 revenue ruling, in determining the source of gain or loss from the sale or exchange of an interest in a foreign partnership, the IRS applied the asset-use test and business activities test at the partnership level to determine the extent to which income derived from the sale or exchange is effectively connected with that

U.S. business (the so called 'entity approach'). Under the ruling, if there is unrealized gain or loss in partnership assets that would be treated as effectively connected with the conduct of a U.S. trade or business if those assets were sold by the partnership, some or all of the foreign person's gain or loss from the sale or exchange of a partnership interest may be treated as effectively connected with the conduct of a U.S. trade or business.

However, a 2017 Tax Court case rejects the logic of the ruling and instead holds that, generally, gain or loss on sale or exchange by a foreign person of an interest in a partnership that is engaged in a U.S. trade or business is foreign-source.

#### Grecian Magnesite Mining, Industrial & Shipping Co., (2017) 149 TC No 3 [GMM]

The Court in a 2017 decision rejects the IRS ruling Rev. Rul. 91-32, and instead holds that, generally, gain or loss on the sale or exchange by a foreign person of an interest in a partnership that is engaged in a U.S. trade or business is foreign-source.

The IRS determined deficiencies in income tax for GMM of $322,056 for 2008 and $1,780,563 for 2009. The statutory notice of deficiency issued to GMM resulted from the IRS determination that GMM must recognize as income within the U.S. the gain it realized on the redemption of its interest in Premier Chemicals, LLC ("Premier"). A portion of the gain that GMM realized from the redemption of its partnership interest in Premier pertained to Premier's U.S. real property interests (see our discussion of FIRPTA in this Chapter) and GMM later conceded this point. However, in dispute was the remainder of the gain not attributable to real property. GMM's principal place of business was Athens, Greece. Its business was extracting, producing and commercializing magnesia and magnesite for global sale. GMM had no office or employees in the U.S.; however, under the Code, the business operations of Premier of extracting, producing, and distributing magnesite extracted or mined in the U.S. are attributable to its foreign partners. Premier is a Delaware LLC though treated as a partnership for U.S federal income tax purposes. Under various agreements, Premier was to redeem GMM's membership interest in Premier.

The IRS after audit determined that GMM should have recognized U.S. source capital gain net income of $1 million for 2008 and $5.2 million for 2009 from the redemption of its interest in Premier. The IRS position arose from its conclusions that as a result of GMM's membership interest in Premier, GMM's capital gain was effectively connected with a trade or business engaged in or within the U.S. The parties agreed that part of the gains for 2008 and for 2009 are attributable to the sale of U.S. real property pursuant to section 897(g) and are thus considered U.S. source income effectively with GMM's U.S. trade or business. The Court found that the redemption gain arose from sale or exchange of the partnership interest and not from the sale or exchange of the partner's portion of individual items of partnership property. The Court also noted that the gain should generally be considered a gain from the sale or exchange of a capital asset (except for assets in 751). The Court regarded GMM's disputed gain as having arose from personal property in the form of an indivisible capital asset. Although the gain from the sale or exchange of a capital asset may be effectively connected with the conduct of a trade or business in the U.S., the test for 'ECI' only applies to gains from sources within the U.S. The Court ultimately held that the disputed gain was a capital gain that was not U.S. source income and that was not effectively connected with a U.S. trade or business and declined to follow Rev. Rul. 91-32.

### NEW LAW

Generally, under the provision, gain or loss from the sale or exchange of a partnership interest is effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. The provision requires that any gain or loss from the hypothetical asset sale by the partnership be allocated to interests in the partnership in the same manner as non-separately-stated income and loss.

The provision also generally requires the transferee of a partnership interest to withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation. If the transferee fails to withhold the correct amount, the partnership is required to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold. These rules dealt with in IRC Section 864(c)(8) and IRS Section 1446(f) as amended by TCJA are effective for sales and exchanges after November 26, 2017 and withholding after December 31, 2017. The new rules are highly complex and the foregoing is intended to bring the tax advisor into awareness of the new changes.

*Critically*, [emphasis added] the application of the new law changes must be considered in context of the intentions regarding TCJA with respect to treaties and IRS guidance reinforced by TCJA history on the taxation of gains where foreign investors have permanent establishments. Other new laws to be considered but not dealt with in this article include the deduction for qualified business income.

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## WHY YOU MIGHT BE ELIGIBLE FOR CAPITAL GAINS TREATMENT ON YOUR STOCK OPTIONS

By Kristy J. Balkwill, Partner, Miller Thomson LLP

### *MONTMINY V. CANADA*, 2017 FCA 156

Typically, Canadian employees have come to expect that a benefit from employment ("Benefit") arising as a result of the exercise of a stock option[1] will be granted capital gains treatment due to the operation of paragraph 110(1)(d) of the *Income Tax Act* (Canada) (the "ITA").[2] Paragraph 110(1)(d) of the ITA typically provides for a

1 Pursuant to subsection 7(1) of the *Income Tax Act*.

2 It should be noted that the 50% deduction afforded by paragraph 110(1)(d.1) of the ITA, relating to the exercise of a stock option to acquire a share of a "Canadian-controlled private corporation", as that term is defined in paragraphs 248(1) and 125(7) of the ITA ("CCPC"), pursuant to subsection 7(1.1) of the ITA, differs from the matters discussed in this article. If a share of a CCPC that has been acquired pursuant to a stock option plan is disposed by the employee within two years from the date of its acquisition (other than as a consequence of the employee's death), the resulting Benefit should not be eligible for the 50% deduction afforded under paragraph 110(1)(d.1) of the ITA. It may still, however, benefit from the 50% deduction afforded

50 percent deduction (the "50% Deduction") on the amount of the Benefit where a share acquired pursuant to the exercise of a stock option (a "Stock Option Share") is, among other things,[3] a "prescribed share" ("Prescribed Share"), for the purposes of regulation 6204 of the ITA (the "Regulations").

It is generally well accepted[4] that the tax policy underlying the requirements of a Prescribed Share is to prevent the turning of stock option benefits (which may be taxed at capital gains rates) into forms of additional remuneration (which should be taxed at full income rates).

Paragraph 6204(1)(b) of the Regulations generally states that, for the purposes of paragraph 110(1)(d) of the ITA, a share is a Prescribed Share if the corporation — or a specified person in relation to the corporation (together, the "Employer Corporation") — cannot reasonably be expected to redeem, acquire, or cancel the Stock Option Share within two years after the time that the Stock Option Share is acquired by the employee. Taken on its own, paragraph 6204(1)(b) of the Regulations seems to state that, if it is reasonable to expect that the employee will dispose of the Stock Option Share to the Employer Corporation within two years of the employee acquiring the Stock Option Share, then the Stock Option Share should not be a Prescribed Share and the Benefit should not be eligible for the 50% Deduction. This was essentially the determination reached by the Tax Court of Canada ("TCC") in *Montminy v. R.*[5] ("*Montminy*").

In *Montminy*, the Employer Corporation, 9178-4488 Québec, Inc. ("Cybectec"), granted stock options to its employees, allowing the employees to purchase shares in Cybectec's capital stock. The terms of the stock option plan provided that a holder of a stock option could not exercise a stock option unless there was an initial public offering of Cybectec's shares, or a sale of all of the shares or assets of Cybectec. Cybectec's assets were purchased; the Cybectec employees exercised their stock options and immediately sold their respective Stock Option Shares to Cybectec's parent company (i.e., an Employer Corporation) for a gain. In order to create a market for the employees' Stock Option Shares, the obligation for Cybectec's parent company to redeem the Stock Option Shares had been negotiated a few days prior to the exercise of the stock options and in anticipation of the purchase of Cybectec's assets.

The TCC interpreted paragraph 6204(1)(b) of the Regulations as providing that the owner of a Prescribed Share cannot "reasonably be expected to, within two years after the time the share is sold or issued [to the employee], as the case may be, redeem, acquire or cancel the share in whole or in part" (the "two-year reasonable expectation test"). Given that the Cybectec employees were aware that the Cybectec Stock Option Shares would be redeemed on the day on which they were acquired, the TCC concluded that the two-year reasonable expectation test was not met.

under paragraph 110(1)(d) of the ITA. While perhaps confusing, the two-year hold period mandated by paragraph 110(1)(d.1) of the ITA is different from the "two-year reasonable expectation test" herein discussed. Please consult your tax advisor should you have any questions or concerns.

3 For example, the exercise price for acquiring the Stock Option Share must be at least equal to the fair market value of the Stock Option Share on the date of grant of the stock option.

4 See, for example, *Montminy v. R.*, 2016 TCC 110 (T.C.C. [General Procedure]) at paras 100 and 101.

5 *Ibid*.

The employees appealed Montminy (the "*Montminy Appeal*")[6] to the Federal Court of Appeal (the "FCA").

The FCA determined that (1) the fact that the employees were exposed to a risk from the moment when the stock options were granted (e.g., the stock options could have become underwater); and (2) the shares described under the terms of the plan were in all (other) respects Prescribed Shares, this was sufficient to allow the employees to claim the 50% Deduction.[7]

The FCA determined that the TCC was "necessarily influenced" by the two-year period mentioned in paragraph 6204(1)(b) of the Regulations but found that it was not open to the TCC to rely on paragraph 6204(1)(b) of the Regulations as a basis for denying the 50% Deduction in circumstances where subparagraph 6204(1)(a)(iv) of the Regulations was not avoided.[8]

Subparagraph 6204(1)(a)(iv) of the Regulations prevents the 50% Deduction with respect to a Stock Option Share that carries an obligation for the Employer Corporation to redeem the Stock Option Share. The FCA determined that paragraph 6204(1)(b) of the Regulations is intended to prevent a situation where the employee can have his/her Stock Option Share redeemed at will, in concert with the Employer Corporation, even if no formal or legally enforceable obligation exists.[9]

Given that there are impositions of penalties and interest under the ITA for an Employer Corporation's failure to properly withhold and remit source deductions, and to improperly report income earned on an employee's T4 slip, Employer Corporations may not be (and may not have been) willing to risk penalties and interest based on the black-letter application of paragraph 6204(1)(b) of the Regulations and *Montminy*. Given the TCC's decision in *Montminy*, Employer Corporations may not have been reporting the 50% Deduction on the T4 slips for their employees. However, given the reversal of *Montminy* by the FCA, employees may be eligible for the 50% Deduction that has not otherwise been claimed.

The 50% Deduction is reported in Box 39 of an employee's T4 slip. If you exercised a stock option in the past four years and no amount was reported in Box 39 of your T4 slip for the applicable year, but you believe that your Benefit should have been eligible for the 50% Deduction, you should contact your tax advisor to determine whether you are eligible for a refund.

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## WHAT YOU NEED TO KNOW ABOUT FIRPTA

By Paul Bercovici, LL.B, Principal, Marks Paneth LLP

### BACKGROUND

The *Foreign Investment in Real Property Tax Act of 1980* ("FIRPTA") was enacted to combat perceived abuses whereby foreign investors were able to avoid, with relative ease, otherwise applicable US taxes on the disposition of interests in US real property. FIRPTA imposes

6 *Montminy v. Canada*, 2017 FCA 156 (F.C.A.).

7 *Ibid,* at para 55.

8 *Ibid,* at para 61.

9 *Ibid,* at para 58.

a tax on gains derived by foreign persons from the disposition of US real property interests. Collection of the tax imposed by FIRPTA is ensured by the operation of a tax withholding procedure. The withholding procedure is designed to prevent foreign sellers from removing proceeds derived from the sale of US situs real property without paying, at the very least, a significant portion of the US federal income taxes due in connection with such sale.

### WHAT IS A "US REAL PROPERTY INTEREST"?

As noted above, foreign persons who dispose of a US real property interest are subject to US federal income tax on gains realized on such disposition. A United States Real Property Interest ("USRPI") is defined to include any interest, other than an interest solely as a creditor, in:

- Real property located in the United States or the US Virgin Islands;
- Certain personal property associated with the use of real property (e.g., farm machinery); and
- An interest in a United States Real Property Holding Corporation ("USRPHC").

The remainder of this article considers the FIRPTA implications associated with the sale of a parcel of US situs residential property by a nonresident alien of the US. For federal income tax purposes, the term "nonresident alien" means a natural person who is not a US citizen, is not a "lawful permanent resident" of the US (i.e., an individual who does not hold a "green-card") and does not meet the "substantial presence" test for the year in which the sale of the US situs real property occurs. In general, the principles regarding the application of FIRPTA to the sale of a parcel of residential real property by a nonresident alien of the US also apply in the context of any sale of a USRPI by a foreign person.

### WITHHOLDING ON DISPOSITIONS OF USRPIS

As a general rule, a purchaser of a USRPI from a foreign person must withhold 15 percent of the total amount realized by the foreign person on the sale. There are certain exceptions to the 15 percent FIRPTA withholding requirement, including a reduction in the FIRPTA withholding tax rate from 15 percent to 10 percent for the purchase of a property for use by the purchaser as a residence and where the consideration paid is less than $1 million.

For the purposes of the FIRPTA withholding provisions, the amount realized includes cash, the fair market value of noncash consideration and liabilities assumed by the purchaser to which the USRPI was subject immediately before or after the transfer. It is crucial to note that the amount to be withheld by the transferee is 15 percent of the amount realized by the transferor, not 15 percent of the gain. This concept is illustrated in the following example.

Example:

- Snowbird is a resident of Canada and is a nonresident alien of the US;
- Snowbird owns the 100 percent fee simple interest in a Florida vacation property (the "Florida Property");
- The Florida Property meets the FIRPTA definition of a USRPI;
- The Florida Property is sold to Purchaser for: $2 million in cash, noncash consideration with a fair market value of $1 million and the assumption by Purchaser of $2 million of liabilities to which The Florida Property was subject immediately before the sale; and
- Snowbird's adjusted basis in The Florida Property immediately before the sale was $4 million.

| | |
|---|---|
| Total amount realized by Snowbird on the sale of The Florida Property | $5,000,000 |
| Snowbird's adjusted basis in The Florida Property at the time of sale | 4,000,000 |
| Gain realized by Snowbird on the sale of The Florida Property | $ 1,000,000 |

On the assumption that none of the available exceptions applies, Purchaser would be required to withhold and remit to the IRS $750,000 (i.e., 15% of the $5,000,000 realized by Snowbird on the sale of The Florida Property), not $150,000 (i.e., 15% of Snowbird's gain on the sale of The Florida Property) from the proceeds otherwise payable to Snowbird.

As a general rule, where a USRPI is purchased from a foreign person, the purchaser is required to report and pay US federal income tax withheld under FIRPTA to the US Treasury by the 20th day after the date of sale. It is also crucial to note that the 15 percent withheld on the amount realized by a foreign seller of a USRPI is not the final amount of US tax actually due from the seller in connection with the sale of the USRPI. The 15 percent amount withheld and remitted is merely an advance payment toward the foreign seller's final US tax obligation in connection with the sale of the USRPI. Failure of a purchaser to withhold the required amount on the purchase of a USRPI from a foreign seller can result, in certain circumstances, in the purchaser becoming personally liable for the FIRPTA tax amount that should have been withheld and remitted.

### CHARACTER OF GAIN OR LOSS REALIZED ON THE SALE OF A USRPI

In most cases, the gain or loss realized by a nonresident alien on the sale of US situs real property will be capital in nature. Whether the seller is required to report the gain or loss as a long-term or short-term capital gain depends on how long the seller owned the asset. A capital asset is treated as generating a long-term capital gain if the seller owned the asset for more than one year. Capital assets that are owned for less than one year are treated as generating a short-term capital gain. Net long-term capital gains are taxed at a maximum rate of 20 percent. Short-term capital gains, on the other hand, are taxed at ordinary income tax rates. In those less common cases where the US situs real property that is sold does not qualify as a capital asset, the gain or loss realized on the sale will be treated as ordinary income. The property sold will not be treated as a capital asset if:

- It is an inventory item or it is property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business; or
- It is property used in the taxpayer's trade or business.

## COMPLIANCE ISSUES

Purchasers of USRPIs from foreign sellers are required to use IRS Forms 8288 (U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests) and 8288-A (Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests) to report and remit to the IRS any federal income tax withheld on the acquisition of a USRPI. As a general rule, purchasers of USRPIs are required to file Form 8288 and pay over the withheld tax by the 20th day after the date of sale. In addition, purchasers must attach copies A and B of Form 8288-A to Form 8288. The IRS will stamp Copy B of Form 8288-A and send it to the foreign seller. The foreign seller must attach Copy B of Form 8288-A to his or her US income tax return in order to receive credit for the amount of tax withheld. As noted earlier, failure of a purchaser to withhold the required amount on the purchase of a USRPI from a foreign seller can result, in certain circumstances, in the purchaser becoming personally liable for the FIRPTA tax amount that should have been withheld and remitted.

In order for a nonresident alien seller of a USRPI to get credit for amounts withheld and remitted by the purchaser, it is imperative that the seller have some form of US Taxpayer Identification Number ("TIN"). A TIN is either a US Social Security Number ("SSN") or an Individual Taxpayer Identification Number ("ITIN"). In most cases, a nonresident alien seller of a USRPI will not have a SSN.Where a foreign seller of a USRPI does not have a SSN, the seller can apply for an ITIN. FIRPTA documentation and tax amounts remitted by purchasers that do not include a US TIN are likely to disappear into the "black hole" of the IRS bureaucracy. In recent years, the process of obtaining an ITIN has become incredibly time consuming and cumbersome. In addition, applications for ITINs are routinely rejected by the IRS on spurious or questionable grounds. In some cases, foreign sellers of USRPIs are so reluctant to become involved in any way with the US tax system that they refuse to apply for an ITIN, knowing full well that failure to provide a valid ITIN will cause them to forsake a valid claim for excess FIRPTA tax withheld. In many cases, such reluctance is based on a desire to maintain secrecy and a fear of somehow becoming ensnared in the US tax system. Nonresident sellers of USRPIs who do choose to apply for an ITIN are well advised to submit their application as far in advance of the closing of their sale of US situs real property as possible.

## WITHHOLDING CERTIFICATES

The amount that must be withheld in connection with the disposition of a USRPI can be decreased (or entirely eliminated) pursuant to a withholding certificate issued by the IRS. Withholding certificates are generally issued where the 15% amount required to be withheld pursuant to FIRPTA would be more than the foreign seller's maximum federal income tax liability in connection with the disposition of the USRPI or where there is an exemption from US tax of all gain realized by the seller. Applications for withholding certificates are made on IRS Form 8288-B (Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests).

Withholding certificates are most commonly issued where a foreign seller is able to demonstrate to the IRS that the income tax amount due in connection with the sale of a USRPI will be less than the amount required to be withheld under FIRPTA. A withholding certificate authorizes the purchaser to withhold (and remit) an amount less than the 15 percent FIRPTA withholding tax otherwise required to be withheld and remitted.

In order to enable the IRS to determine whether reduced withholding is appropriate, the seller is required to provide the IRS with certain information, including:

1. Evidence of the amount to be realized by the seller, such as a copy of the signed contract of sale;
2. Evidence of the adjusted basis of the property, such as closing statements, invoices for improvements, and depreciation schedules, or if no depreciation schedules are submitted, a statement of the nature of the use of the property and why depreciation was not allowed;
3. Amounts to be recaptured for depreciation, investment credit, or other items subject to recapture;
4. The maximum capital gain and/or ordinary income tax rates applicable to the sale;
5. The tentative tax owed; and
6. Evidence showing the amount of any increase or reduction of tax to which the seller is subject, including any reduction to which the seller is entitled under a US income tax treaty.

According to the instructions for Form 8288-B, the IRS will normally act on an application for reduced withholding within 90 days of receipt of all information necessary to make a proper determination. As a result, applicants for withholding certificates are well advised to submit their application as far in advance of the scheduled closing date as possible.

## FILING FOR REFUNDS OF FIRPTA TAX ALREADY PAID

In a perfect world, attorneys for purchasers who are provided with a valid withholding certificate will withhold the amount of tax as authorized by the IRS. However, in far too many cases, attorneys for purchasers who are buying US situs real property from a foreign person either do not understand the significance of a withholding certificate or refuse to withhold as directed by the withholding certificate. In many cases, attorneys for purchasers advise their clients not to honor the terms of a valid withholding certificate because they are concerned about the purchaser somehow being held personally liable for failure to withhold and remit the correct tax in the event the withholding certificate is somehow determined to be invalid. In such cases, the attorney adopts a "better safe than sorry" approach, advises their client to withhold at 15 percent and leaves it to the seller to seek a refund of the excess FIRPTA tax withheld.

In such cases, and in other cases where the amount of tax withheld and remitted under FIRPTA exceeds the seller's ultimate US federal tax liability, the seller can apply for a refund of the excess FIRPTA tax withheld. There are generally two ways that the seller can seek a refund in such cases:

1. Apply for an "early refund"; or
2. File a US federal income tax return to claim a refund.

As noted above, in many cases the attorneys for the purchaser of US situs real property from a foreign person will not base the amount withheld and remitted on a valid withholding certificate and will withhold and remit at the 15 percent rate. Nonetheless, a valid withholding certificate can be used to apply for an early refund. In general, a seller will avail himself or herself of the "early refund" procedure where they are anxious to receive the refund of excess FIRPTA tax withheld and where the time for filing an income tax return to claim the refund amount is too far in the future. For example, a nonresident alien who sells a USRPI in January of 2019 and who is entitled to a refund of excess FIRPTA tax withheld cannot make a claim for refund by filing a 2019 income tax return until, at the earliest, February 2020. This is because the IRS will not start to process 2019 income tax returns until, at the earliest, February 2020. In the alternative, the nonresident seller could make a claim for "early refund" immediately after the January 2019 closing is completed and significantly expedite the issuance of the refund by many months.

A nonresident alien seller of a USRPI makes an application for early refund by providing the information required under certain Treasury regulations and submitting certain required documentation. The information required to be provided pursuant to the above-noted Treasury regulations is:

(1) The name, address, and identifying number of the transferor seeking the refund;

(2) The amount required to be withheld pursuant to the withholding certificate issued by the IRS;

(3) The amount withheld by the transferee; and

(4) The amount to be refunded to the transferor.

The applicant is also required to include Copy B of Form 8288-A as stamped by the IRS and should submit a withholding certificate where one has been issued prior to the application for early refund being submitted. Where a withholding certificate has not been issued prior to the application for early refund being submitted, the applicant must submit an application for withholding certificate with his or her application for early refund.

Whether a foreign person applies for a refund of excess FIRPTA tax by making an application for early refund or by filing an income tax return, the IRS will not pay interest on the excess tax amount withheld.

### EFFECTIVE ADVANCE PLANNING IS CRUCIAL

The FIRPTA withholding provisions can be quite complex. Failure to rigorously adhere to the FIRPTA provisions could, for example, result in foreign sellers failing to apply for refunds of FIRPTA tax to which they are entitled, to significant delays in the receipt of tax refunds to which foreign sellers are entitled and to the possible imposition of penalties on purchasers of US situs real property from foreign sellers for failure to timely remit FIRPTA taxes withheld and/or to timely submit required documentation to the IRS in connection with such sale.

Nonetheless, effective advance planning can yield one or more of the following positive results:

1) Reduction or complete elimination of the withholding tax imposed by FIRPTA through the use, where appropriate, of withholding certificates and/or other tax planning techniques;

2) Entitling a foreign seller of a USRPI to expeditiously receive a refund of tax paid where his or her ultimate tax liability in connection with the sale of the USRPI is less than the amount withheld under FIRPTA; and

3) Ensuring that all compliance and reporting requirements imposed by FIRPTA are met in a timely fashion.

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## SUPREME COURT OF CANADA UPHOLDS COMMON INTEREST PRIVILEGE RULE

By John Grant, Partner, Miller Thomson LLP, Toronto

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The Supreme Court recently rejected the Canada Revenue Agency's leave application,[1] meaning the much heralded decision in *Iggillis Holdings v. Canada*,[2] is good law. This confirms that sharing legal advice with other transacting parties, or working together with other parties' lawyers to develop the legal advice, will not waive solicitor-client privilege where the collaboration is done in pursuit of a common interest.

### PRIVILEGE AND THE COMMON INTEREST RULE

Solicitor-client privilege protects communications between a lawyer and a client, made for the purpose of seeking or giving legal advice, that are intended to be confidential. Common interest privilege is misnamed. It is not a stand-alone privilege. It is a rule that permits the sharing of privileged information without loss of solicitor-client privilege.

### IMPACT ON CLIENTS AND COUNSEL

The reality of legal discourse in Canada means that clients and their counsel will often have a practical interest in sharing privileged advice, or directly collaborating with, another party's counsel when there is a common interest.

With leave to the Supreme Court being denied, the Federal Court of Appeal decision confirms that the common interest rule is firmly established in Canadian law. The Court of Appeal in *Iggillis* remarked that,

> [S]olicitor-client privilege is not waived when an opinion provided by a lawyer to one party is disclosed, on a confidential basis, to other parties with sufficient common interest in the same transactions. This principle applies whether the opinion is first disclosed to the client of the particular lawyer and then to the other parties or simultaneously to the client and the other parties. In each case, the solicitor-client privilege that applies to the communication by the lawyer to his or her client of a legal opinion is not waived when that

1 *Canada v. Iggillis Holdings Inc.*, et al., 2018 CanLII 99657 (SCC).
2 2018 FCA 51.

opinion is disclosed, on a confidential basis, to other parties with sufficient common interest in the same transactions.[3]

Accordingly, aside from the litigation context, parties to a transaction can have a "common interest" in completing the deal or in sharing legal advice. They can generally share privileged documents, like tax memos and other legal opinions, without mistakenly losing privilege over those documents. Refreshingly undisturbed is the Federal Court of Appeal's pronouncement that the interests of respective clients are better served if the lawyers collaborate regarding an opinion in respect of the application of a statute to the series of transactions to be completed by the parties.[4]

As a practical takeaway, best practices would dictate that parties consider signing a common interest privilege agreement to crystalize the common interest and intentions. In approaching such agreements, among the many pitfalls, parties should be mindful that:

- they must share a sufficiently common interest;
- they will need to clearly demonstrate that they intended for the sharing of privileged communications and materials (e.g., an opinion) to remain confidential as regards the rest of the world and that the exchange of privileged communications was made in furtherance of that common interest; and
- they should limit the circumstances, if any, in which such materials may be disclosed to third parties (e.g., only on consent of all parties, only after sufficient notification is given to other parties, or only where required by law).

Broadly, as a means of protecting their communications and materials, taxpayers should take all reasonable steps to develop, to claim, and to maintain solicitor-client privilege.

For more information on solicitor-client privilege and the common interest privilege rule, or for assistance with drafting common interest privilege agreements, please contact us.

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## *AKANDA INNOVATION INC. V. HER MAJESTY THE QUEEN*: NEW FCA DECISION CLARIFIES TEST FOR MOTION REQUESTING AN EXTENSION OF TIME

By Hayley Ossip, Ossip Professional Corporation

In the recent Federal Court of Appeal decision *Akanda Innovation Inc. v. R.*,[1] Justice Webb clarified when a motion for an extension of time to make an application should be allowed. While the decision sets forth the four-factor test and explains that the underlying consideration is the "interests of justice", the decision applies the test specifically to the facts at issue, without providing much-needed guidance for future cases: the "interests of justice", "the merits of the application" and "prejudice" are not clearly defined.

### THE FACTS AT ISSUE

The motion related to Akanda Innovation Inc.'s ("Akanda Innovation") appeal of reassessments by the Canada Revenue Agency. The appeal was delayed several times. The notices of appeal for the taxation years of 2007-2009 were filed on November 18, 2015; the notice of appeal for 2016 was filed following an Order of the Tax Court dated March 18, 2016 that granted Akanda Innovation an extension of time to file. Delays to the appeal further occurred as Akanda Innovation missed deadlines to file its list of documents. An application for an extension of time was made on January 12, 2017. On January 6, 2017, counsel to Akanda Innovation submitted a letter to the Tax Court stating that it was to be removed as counsel of record for Akanda Innovation. By letter dated January 10, 2017, the Tax Court notified Akanda Innovation that ". . .where a party to a proceeding is not an individual, that party shall be represented by counsel except with leave of the Court and on any conditions that it may determine" (para 6). On January 19, 2017, the Tax Court issued an Order granting Akanda Innovation's request for an extension of time to file and serve its list of documents to May 31, 2017, and to extend the date for examinations to September 29, 2017. The Order also provided, among other requirements, that Akanda Innovation was to appear at a show cause hearing on March 7, 2017 if it had not brought a motion regarding its counsel, otherwise default judgments would be issued. Akanda Innovation did not appear, and default judgments were issued on April 9, 2017 dismissing the appeals. After these Orders were given, Akanda Innovation retained new counsel. On July 25, 2017, it filed a motion requesting an extension of time to bring an application to set aside the default judgments and also to set aside the default judgments that had been issued.

This case was presented to the Federal Court of Appeal, on appeal from the Tax Court of Canada. The standard of review for a motion for an extension of time is correctness for questions of law, and palpable and overriding error for questions of mixed law and fact.

### TAX COURT DECISION

Initially, the Tax Court dismissed the motion upon consideration of the correct four factors but analyzed them in an incorrect manner (as found by the Federal Court of Appeal). The factors are: (1) continuing intention to pursue the underlying application; (2) merit of the appeal; (3) prejudice to the Crown arising from the delay; and (4) reasonable explanation for the delay. The Tax Court found that Akanda Innovation satisfied the first two factors, but not the third or fourth.

### FEDERAL COURT OF APPEAL DECISION

On appeal, the Federal Court of Appeal stated that the Tax Court was incorrect on questions of law. First, the wrong standard for prejudice was applied: the "delay" attributed was the delay of the entire proceeding, rather than the delay of filing the motion from the last possible date of appealing the default judgment; second, the court did not consider the relevant facts in relation to the application; third, the Tax Court did not address case law in which it was decided that not all four factors would need to be satisfied; finally, Tax Court did not examine the underlying consideration of

3 *Iggillis Holdings Inc. v. Canada*, 2018 FCA 51 at para 41.
4 *Iggillis Holdings Inc. v. Canada*, 2018 FCA 51 at para 42.
1 2018 FCA 200 (F.C.A.).

the "interests of justice". Upon review of the corrected factors, the Federal Court of Appeal found that Akanda Innovation satisfied the third criteria of the test: the delay became one of three and half months rather than one of more than a year. Although the fourth criterion — a reasonable explanation for the delay — remained unmet, the other three criteria were met, and the "interests of justice" prevailed.

While the explanation of the test is somewhat helpful, certain significant factors remain undefined so it is unclear how the test for allowing a motion to extend time will be applied in the future.

## THE INTERESTS OF JUSTICE

The "interests of justice" are described as being fundamental to the determination of whether a motion to extend time to file an application should be granted, but the Federal Court of Appeal does not provide much guidance as to what the "interests" are. This is somewhat odd because the Federal Court of Appeal overturned the Tax Court's judgment as it did not consider the "interests of justice".

In one instance, the decision examines the "interests of justice" with respect to whether there is merit in the application, stating: "the central question is whether the interests of justice are better served by setting aside the default judgment or dismissing the application to do so" (para 32). In another instance, the "interests of justice" are deemed to be found "since the findings with respect to three of the four factors favour Akanda Innovation and since the amounts involved are significant". The factor is not explained further.

One may expect that the considerable delay throughout the course of the proceeding at issue would be measured when examining the "interests of justice." However, the Federal Court of Appeal explicitly stated that the Tax Court erred by considering this delay when looking at whether the length of the delay prejudiced the Crown (para. 24). Another consideration that one may expect to sway the "interests of justice" would be the fact that the delay was partially due to the fact that Akanda Innovation was unrepresented for a time. This factor was brought up in the context of demonstrating the company's continuing intention to pursue the application (para. 30). It may be possible that this factor was implicitly considered with respect to the "interests of justice", but such thinking is only conjecture.

## MERIT IN THE APPLICATION

The question of "merit in the application" is entirely dependent on the definition of whether the "interests of justice" are better served by either setting aside the default judgment or dismissing the application to do so (para. 32). Accordingly, some clarity of the term "interests of justice" is needed in order to establish whether such merit exists.

## PREJUDICE CAUSED BY THE DELAY

The Federal Court of Appeal overturned the Tax Court's finding that prejudice to the Crown occurred due to the general delays of the proceeding by stating that the Tax Court did not identify any specific prejudice that would be suffered by the Crown as a result of the delay from April 9, 2017 to July 25, 2017 (at para. 36). After the Federal Court of Appeal decided that such a delay was not prejudicial, it did not provide details about what factors should be considered in making such a determination.

## CONCLUSIONS

Overall, the decision provides some clarity regarding when a motion for an extension of time to file an application will be allowed but raises questions about what surrounding facts are relevant. It will take further decisions to better establish when such motions will be allowed.

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## TAXATION OF CRYPTOCURRENCIES & TOKENS (PART III) – A DIRECT, PRE-SALE, A SAFT & AN ITO: AN "IMMEDIATE TAX OBLIGATION"

By Marc Richardson Arnould, Partner, Miller Thomson LLP and Brad Kirby, Managing Partner, DLT Advisory Group

At some point during its life cycle, almost every business will seek third-party capital injections for purposes of financing growth projects. Investment through either debt or equity (or a combination thereof) has traditionally been the keystone of finance.[1] The advent of blockchain technology companies has, however, disrupted the traditional model of finance. Over a relatively short period of time, initial coin or token offerings (each, an "Offering") have become a viable source of capital for companies involved in the development of conceptual distributed ledger technology projects (each, a "DLT Project").[2] In the aggregate, Offerings have raised $13.7 billion over the course of the first five months of 2018,[3] which certainly evidences mass-market appeal for Offerings as viable means of raising capital.[4]

The following article is the third of a series of four articles,[5] each examining particular transactions involving tokens[6] and consider-

1 Traditional forms of financing include bootstrapping (i.e., use of founder funds or credit card indebtedness), friends and family, angel investors, private equity groups (including venture capital interests) and financial institutions. In addition, there are a number of auxiliary sources of capital such as, *inter alia*, government grants and subsidies, business incubators, factoring (e.g., consisting in the sale of receivables upfront at a discount) and tax credit financing.

2 Increasingly, token issuers include businesses that already have working products and funding.

3 See PWC Report, "Initial Coin Offerings: A strategic perspective" (June 2018): https://cryptovalley.swiss/wp-content/uploads/20180628_PwC-S-CVA-ICO-Report_EN.pdf. As of the date of publication of this article, 905 ITOs account for raising USD$21,465,463,082: https://www.coinschedule.com/stats.html?year=2018.

4 It is important to note that an Offering may not be appropriate for all businesses. Prior to entertaining the notion of an Offering to raising capital, consideration should be given to the practicability of token integration in the company's core business.

5 Part I is referenced as follows: Marc Richardson Arnould & Brad Kirby, "Taxation of Cryptocurrency & Tokens: Simple, Yet Not So Simple, Taxation (Part 1)", Taxes & Wealth Management, Thomson Reuters, Issue 11-2, June 2018. Part II is referenced as follows: Marc Richardson Arnould & Brad Kirby, "Taxation of Cryptocurrency & Tokens (Part II) — Forking-Up Taxes On Forks?", Thomson Reuters, Issue 11-3, October 2018. The final article will address the tax treatment of losses arising from fraud, theft or the embezzlement of cryptocurrencies & certain other off-market transactions.

6 The terms "cryptocurrency", "coin(s)" and "token(s)" are used interchange-

ing the tax treatment applicable thereto under the *Income Tax Act* (Canada)[7] and, where applicable, the *Excise Tax Act* (Canada).[8] We here introduce the concepts of an initial token offering ("ITO") and a Simple Agreement for Future Tokens ("SAFT") and consider certain Canadian tax considerations applicable to either an issuer of tokens or a holder thereof. The following discussion is not exhaustive of all Canadian federal income or sales tax considerations which may be applicable in the context of an ITO and a SAFT.

## INITIAL TOKEN OFFERING (ITO)

An ITO can be viewed as a form of crowdfunding undertaken for the purpose of financing particular business projects through the sale of tokens — and usually without the exchange of equity. In particular, ITO undertakings are generally associated with a DLT development group and their technology project. Presently, a great majority of tokens are created as "ERC-20" tokens, which are designed and used solely on the Ethereum platform — a decentralized network of computers that generates an (immutable)[9] record of transactions and features an operating system (*a.k.a.* virtual machine) that can produce smart contracts.

An ITO will involve the sale of (functional) ERC-20 tokens in consideration for either fiat currency or convertible coin tokens (cryptocurrency), such as Bitcoin and Ether. Offers generally set a minimum goal and timeframe for the capital raise. The supply of tokens is usually fixed with either a predetermined or variable price, the latter being dependent on the amount of funds invested in the offering (i.e., the token price will increase in proportion to the amount of capital raised). In addition, as part of an ITO, the founders/development team, as well as any advisors or consultants, will usually, either directly or indirectly, be allocated a percentage of tokens.[10]

Initially, the majority of businesses entertaining an ITO shared the view that offerings were not subject to the various Canadian securities restrictions, registration and reporting requirements associated with a traditional initial public offering and, more generally, the ongoing disclosure requirements applicable to public companies. Canadian Securities Regulators have since adopted the position that most ITOs involve the issuance of securities and are, therefore, subject to Canadian securities regulations.[11] Notwithstanding the foregoing, the issuance of a functional "utility token"[12] on an operational platform should generally not be treated as a security.[13]

Executing an ITO can be a costly undertaking. Typically, businesses will first engage in an initial capital raise to cover costs related to the eventual Offering.[14] Two options are currently available: (i) a direct token pre-sale; or (ii) a SAFT.[15] For securities law purposes, engaging in a direct token pre-sale may be unappealing. A company conducting a pre-sale would likely be construed as selling securities for Canadian securities law purposes. However, a functional "utility token" distributed as part of an ITO should not be treated as a security. While a SAFT itself constitutes a security for Canadian (and US) securities law purposes (as described in more detail below), provided the funds raised pursuant to a SAFT are sufficient to develop a functional token which can be distributed at the time of the ITO, then such token will generally not be treated as a security.

## SIMPLE AGREEMENT FOR FUTURE TOKENS (SAFT)

A SAFT is a promise made by a prospective issuer to an accredited investor for the future delivery of functional tokens at a fixed (discounted)[16] price (payable in either fiat or with another token) once

ably and refer generally to all digital currencies/assets, including a coin token, utility token and security (or asset-backed) token. This article does not address in detail the distinguishing features of each type of token.

7 R.S.C., 1985 c.1 (5th Supp.), herein referred to as the "ITA".

8 R.S.C., 1985, c. E-15, herein referred to as the "ETA".

9 Ethereum Classic stands out as an exception to the immutable nature of a blockchain. The 2016 fork of Ethereum involved a "retroactive" fork of the Ethereum blockchain protocol prior to the initial coin offering of the Decentralized Autonomous Organization (DAO) resulting in the generation of Ether and maintenance of Ethereum as Ethereum Classic.

10 Financing opportunities in the form of either debt or equity tends to increase over the course of a business' life cycle; from nominal seed financing to more important capital raises in view of a sale or public offering. In the case of an ITO, the converse is generally true. A business can gain access to significant amounts of capital at a very early stage in its life cycle. One explanation for this phenomenon is the so-called "Fat Protocol" thesis, pursuant to which blockchain technology/DLT turns on its head the traditional relationship between protocol value and application value such that the protocol layer will now accrue exponentially more value than the application layer (i.e., protocol value increases in proportion to application use). For additional information, see for e.g., Avi Felman, "Exploring the Fat Protocol Thesis", *Medium* (June 26, 2018): https://medium.com/ledger-capital/the-fat-protocol-thesis-debated-65ad56285fd5.

11 Canada, Canadian Securities Administrators, "Cryptocurrency Offerings", CSA Staff Notice 46-307 (Ontario: 40 OSCB 7231, 2017). This staff notice was published in all Canadian jurisdictions with the exception of Saskatchewan and raises concerns with price volatility, a lack of transparency related to an offering entity's actual business activities, and the risk of exposure to illegal schemes or unethical practices. Securities regulators rely essentially on the broad, catch-all concept of an "investment contract", which has the potential to bring many of the (coin and security) tokens being offered within the purview of Canadian securities laws. The test is as follows: "Does the scheme involve an investment of money in a common enterprise with profits to come solely from the efforts of others?": *Securities Act*, RSO 1990 c S 5, s. 1(1)(n), "security". See the Supreme Court of Canada's decision in *Pacific Coast Coin Exchange of Canada v. Ontario (Securities Commission),* [1978] 2 SCR 112 citing with approval the Supreme Court of the United States in *SEC v. WJ Howey Co*, 328 US 293 (1946) and the Hawaii Supreme Court in *State of Hawaii v. Hawaii Marker Center Inc*, 485 P 2d 105 (1971).

12 A utility token does not constitute an actual investment but allows the buyer direct access to the product or service of the ITO. It should be noted, however, that the term "utility token" is not a legal distinction, but simply an organizational one. There is currently no distinction between different types of tokens for purposes of the ITA or ETA. This article does not address the risk that the functional utility tokens generated at the time of their offering will fall under the definition of a security for Canadian securities law purposes — including whether the risk of such a characterization increases by virtue of the fact that a corresponding SAFT is viewed as a derivative for such purposes.

13 The initial coin offerings of CryptoKitties (https://www.cryptokitties.co/) and EOS (https://eos.io/) stand as further exceptions to the extension of securities laws to tokens.

14 These costs can include strategic recruitment, smart contract audit, advertising, and public relations as well as travel expenses to attend conferences and meet with potential investors.

15 A DLT Project may entail more than one direct token pre-sale or SAFT; a number of such capital raises can take place.

16 As a forward sale agreement, the legal substance of a SAFT is that of a purchase and sale agreement. The fact that there may exist a discount, however, might suggest the incidence of an interest payment. One of the important aspects of potentially characterizing the SAFT payment as a loan is the possibility of treating some amount as interest. The fact that the price of tokens under a SAFT includes a discount should not change the legal substance of the contract. In that regard, a SAFT may be analogous to a "securitization" transaction pursuant to which accounts receivable are disposed of at a discount. In that case, the discount is not characterized as interest. Generally, interest must be calculated on a day-to-day basis in reference to a principal sum or a right to a principal sum and must represent

the compatible platform is developed and becomes operational.[17] Developers will generally provide for a discount structure to incentivize early investment in the ITO as part of a direct token presale or SAFT.[18] Upon a successful ITO, the initial investors in a presale or SAFT will be distributed their allocable share of tokens, including any additional tokens attributable to a discount.[19]

More specifically, a SAFT transaction consists of an initial sale of a SAFT by the issuer (i.e., developers) to accredited investors — usually at a discount. Consideration for the SAFT will be prepaid by the investors immediately upon entering into the agreement. The SAFT proceeds will then be used by the issuer to develop a functional "utility" token. Once the network/platform is operational, the issuer will deliver to the investors the functional tokens taking into account any discount. The investor will then be able to either use the tokens to gain access to the platform's product(s) or service(s) or dispose of such tokens — usually at a profit. A SAFT is, essentially, a prepaid forward contract, the legal substance of which is a purchase and sale agreement.[20] As such, a SAFT is a security for Canadian securities law purposes and requires the issuer's compliance with the relevant Canadian securities laws and regulations.

compensation paid for the use of such principal sum or right to use same (see e.g., *Reference as to the Validity of Section 6 of the Farm Security Act, 1944, of the Province of Saskatchewan*, [1947] S.C.R. 394 at 412). A SAFT does not evidence the foregoing requirements, particularly since there is no obligation to repay any sum of money. In addition, the payment of tokens by the developer will constitute the delivery of a commodity for Canadian tax purposes, which would create a practical impediment with respect to Canadian non-resident withholding tax on cross-border interest payments, where applicable. If that were the case, the developer could conceivably sell a portion of the tokens otherwise attributable to such investor's discount at the time of the ITO such that the liability to withhold and remit Part XIII tax is satisfied with the proceeds of disposition of such tokens converted into Canadian dollars, where applicable.

17 A SAFT should contain details of the applicable terms and include distribution date (maturity), discount or bonus computations, minimum/maximum fundraising targets, and in some cases, provisions for a *pro rata* return of residual funds in the event that, for example, the project is abandoned, or sufficient funds have not been raised. There is, however, no obligation to repay the advance or interest thereon. An Investor shall have no recourse against the issuer should the project fail for any reason whatsoever, which is admittedly a distinct possibility. The essence of a loan is that the advance shall be repaid. Ergo, the absence of a covenant to repay supports the view that a SAFT shall not be characterized as a loan. The issuer's only obligation is to deliver, if possible, an agreed number of functional tokens.

18 Generally, a pre-sale/SAFT discount shall not exceed 30 percent. A more aggressive discount may have the opposite effect of deterring investment. In addition, discounts should be associated with token holding periods (i.e., transfer restrictions) in order to limit the abusive dispositions of tokens by initial investors at the time of the ITO (i.e., pump-and-dump transactions). It should be noted that there exist a variety of discount models, including: (i) fixed; (ii) tiered; (iii) quantity; (iv) time; and (v) engagement bonuses. A single project may combine several discount formulas depending on the financing phase of the project (i.e., private, pre-sale or public sale). See: https://medium.com/etherflair/most-popular-bonus-discount-types-in-icos-1250ad7ef2f1.

19 The number of tokens to be allotted to the investor will be computed by applying the relevant discount to the price of the tokens at the time of the ITO.

20 A SAFT should not constitute a "derivative forward agreement" as defined in subsection 248(1) of the ITA for purposes of the character conversion rules.

## CANADIAN FEDERAL INCOME TAX CONSIDERATIONS

Tokens are treated as a commodity, and not a currency, for Canadian federal income tax purposes. Any gains realized (or losses incurred) as a result of the sale of tokens should be subject to tax in the same manner as any other commodity.[21] Accordingly, proceeds derived either from an ITO or a direct token pre-sale should be taxable as income to the developer (i.e., issuer) in the taxation year of receipt.[22] A purchaser's cost basis in the purchased tokens should be determined at the time of purchase and should be equal to either the amount of fiat currency or the fair market value of any cryptocurrency exchanged in consideration for such tokens.[23]

In dealing with a SAFT, more specifically, there seems to have developed a view pursuant to which a developer may benefit from a deferral in respect of SAFT proceeds until the taxation year in which tokens are delivered to investors.[24] While having gone curiously unchallenged until now, this position is untenable for Canadian tax purposes.

Generally, a prepaid amount in respect of goods to be delivered in a subsequent taxation year should be included in income in the taxation year in which such amount is received.[25] Depending on the circumstances, a taxpayer may be able to defer the recognition of such income until the time at which the goods are delivered by claiming a reserve.[26] The ability to claim such a reserve, however, is subject to a number of conditions, including the following limitation:

> [a] taxpayer could not claim a reserve if under an agreement with its client, the taxpayer was allowed to retain the prepayment made by the client in any event, regardless of whether or not the services or goods will in fact ever be provided. In other words, under this type of clause, the taxpayer would be allowed to retain the prepayment

21 CRA document no. 2013-0514701I7 (December 23, 2013).

22 In the case of proceeds derived either from an ITO or from a direct token pre-sale, proceeds will be taxable to the issuer pursuant to sections 3 and 9 of the ITA.

23 In the event that an investor purchases more of the same tokens at a future time, subsection 47(1) of the ITA may require the cost of the newly-acquired tokens to be averaged with the adjusted cost base of any previously-acquired tokens. Subsection 47(1) of the ITA will apply solely where tokens are held on capital account. It should be noted that an investor in tokens will not be able to make an election under subsection 39(4) of the ITA so as to treat proceeds of disposition in respect of tokens as a capital gain (or loss). Such an election can only be made in respect of "Canadian securities" as defined in subsection 39(6) of the ITA. Where the tokens are held by the investor as inventory, consideration should be given to averaging the cost of the tokens given their fungibility. See CRA document no. 9517667 (August 8, 1995). See also IT-473R, Inventory Valuation (December 21, 1998 - archived). It may be worth considering holding tokens indirectly through a "Canadian-controlled private corporation" as defined in the ITA so as to benefit from the small business deduction on the first CAD$500,000 of income, where applicable. Depending on the business of the corporation additional tax benefits restricted to corporations that qualify as a CCPC may be available.

24 Most popular among US practitioners. See for e.g., Lisa Zarlenga and John Cobb, "What ICO Issuers and Investors Need to Know About Taxes" (April 16, 2018): https://www.coindesk.com/ico-issuers-investors-need-know-taxes/.

25 CRA document no. 2000-0062337, "Prepaid forward sales contract - bifurcation" (May 31, 2001).

26 Paragraph 20(1)(m) of the ITA. Under certain circumstances, a reasonable reserve can be claimed in each taxation year for the portion of the revenue related to the commodity that is not delivered prior to the end of that particular taxation year.

even if the taxpayer did not fulfill its obligations under the contract and was in default.[27]

In the case of SAFT proceeds, it is unlikely that an issuer will be able to claim a reserve. Once the capital has been received, the SAFT proceeds will be under the complete control of the developer.[28] The terms of a SAFT generally do not impose an obligation to repay the prepayment on the developer. In fact, that would remain the case even if the issuer does not develop a functional token. Accordingly, for federal income tax purposes, the issuer will realize income equal to the SAFT proceeds in the year of receipt. Current operating losses incurred in, prior to, or subsequent to, the year of receipt, as applicable, may serve to offset such income inclusion.[29]

There should be no gain realized (or loss incurred) for the investor on the settlement of a SAFT (i.e., distribution of functional tokens).[30] The purchase price of the SAFT will constitute the purchaser's cost in the tokens — including those received under an entitlement to a discount. Any gain or loss will only be recognized on a subsequent disposition of the tokens.[31]

## CANADIAN SALES TAX CONSIDERATIONS[32]

A supply of goods or services made in Canada in the course of a commercial activity will be subject to GST/HST unless such supply is specifically exempted from GST/HST under the ETA.[33] Indeed, only supplies of goods or services which are specifically deemed by the ETA to be "tax exempt"[34] or "zero rated"[35] can be supplied in Canada in the course of a commercial activity free of GST/HST. The ETA does not specifically address the supply of tokens. The CRA has adopted the position that tokens are to be treated as a commodity for purposes of the ETA.[36] The normal rules in that ETA apply to a supply of tokens; tokens are to be treated the same way as any other commodity supplied by a GST/HST registered person. Accordingly, the sale of tokens by a developer, as part of either a direct token presale or an ITO, will constitute the delivery of a commodity, and will be subject to GST/HST for purposes of the ETA.[37]

As noted above, a SAFT is a derivative.[38] The Canadian sales tax treatment of a payment made pursuant to a derivative will depend on whether or not the derivative contract is a "financial instrument" for purposes of the ETA.[39] The definition of "financial instrument" set out in the ETA includes, *inter alia*, an option or a contract for the future supply of a commodity, where such option or contract is traded on a recognized commodity exchange.[40] Such an option or futures contract will qualify as an exempt financial instrument for purposes of the ETA. A SAFT is a prepaid forward contract and, as such, does not constitute a financial instrument for purposes of the ETA. While futures contracts are traded on exchanges, forward contracts are private agreements. Where the commodity option or contract is cash settled and not traded on a recognized commodity exchange (i.e.,"over-the-counter" or "OTC"), the purchase or sale could be exempt if it meets the definition of a "financial service" set out in the ETA. This definition will be met if such an option or contract constitutes the issue, granting, allotment, acceptance, endorsement, renewal, processing, variation, transfer of ownership or repayment of a financial instrument. A SAFT would not be within the definition of a financial service. Given that a SAFT is not specifically exempted in Schedule V of the ETA, it would constitute a taxable supply if made in Canada in the course of a commercial activity.

The general rule is that GST/HST is payable for a taxable supply on the earlier of either the day that the consideration is paid or be-

27 CRA document no. 2005-0141171C6F (October 7, 2005).

28 *Ellis Vision Inc. v. R.*, 2004 D.T.C. 2024: "Amounts become taxable as income in the taxation year that the amounts received exhibit the nature and quality of income. An amount has the "quality of income" when a taxpayer's right to it is absolute and under no restrictions, contractual or otherwise, as to its disposition, use or enjoyment. An amount may have the "quality of income", respondent's counsel argued, even though the amount is not actually received by the taxpayer, but only "realized" in accordance with the accrual method of accounting. If the amount is free of conditions or restrictions upon its use, it is taxable in the year that it is received or realized, subject to any contrary provision in the [ITA] or other rule of law" (at para. 36). See also *Ikea Ltd. v. R.*, [1998] 2 C.T.C. 61 (S.C.C.).

29 It may be possible, however, to offset such income against current operating losses incurred in, prior to, or subsequent to, the taxation year in which the SAFT was executed. However, capital expenditures will nevertheless be required to be amortized over the life of the asset.

30 Section 49.1 of the ITA, which states: "For greater certainty, where a taxpayer acquires a particular property in satisfaction of an absolute or contingent obligation of a person or partnership to provide the particular property pursuant to a contract or other arrangement one of the main objectives of which was to establish a right, whether absolute or contingent, to the particular property and that right was not under the terms of a trust, partnership agreement, share or debt obligation, the satisfaction of the obligation is not a disposition of that right."

31 *Supra*, note 22. If the investor has borrowed money (with a legal obligation to pay interest thereon) to enter into a SAFT and the tokens to be delivered pursuant to the terms thereof are to be used by the investor for the purpose of earning income, then interest on the borrowed money should be a deductible expense to the investor (paragraph 20(1)(c) of the ITA). In addition, to the extent that "utility" tokens constitute a current expense or a capital outlay, then the purchase price of such tokens may be, as the case may be, either deductible in the year in which such expenses are made or subject to depreciation.

32 We are of the view that Revenue Quebec will administer the *Act respecting the Quebec sales tax* (chapter T-0.1) and that the provinces that administer Provincial Sales Tax (PST) will do so in a manner consistent with the CRA's approach. That being said, guidance from these provinces would be welcome. The CRA has recently stated that it "is presently considering its position regarding the GST/HST treatment of Bitcoin and similar cryptocurrencies."

33 While tokens may be taxable, consideration should be given to whether the supply is made outside Canada. Under such circumstances, the supply may be either outside the scope of GST/HST or, alternatively, zero-rated for purposes of the ETA. In addition, not all vendors will be required to collect GST/HST in respect of token sales. A vendor selling tokens situated outside of Canada and a "small supplier" will not be required to charge, collect, and remit GST/HST.

34 Under Part VII of Schedule V of the ETA.

35 Under Part IX of Schedule VI of the ETA.

36 The term "commodity" is not defined in the ETA. In the absence of a specified definition, the CRA has adopted the common dictionary meaning of the term, which refers to a bulk good, product, merchandise, article, physical asset, or other type or kind of tangible property (CRA document no. 111598 — Whether a Financial Instrument (January 21, 2010)).The foregoing definition is difficult to reconcile with the fact that tokens are certainly not tangible.

37 If the purchaser uses cryptocurrency as a means of payment (as opposed to fiat), then it will be required to determine if using cryptocurrency as a means of payment constitutes a taxable supply for GST/HST purposes. Assuming it does, the purchaser would then be required to collect and remit GST/HST on the value of the cryptocurrency exchanged for the tokens. The developer will be required to collect and remit GST/HST on the value of the tokens provided.

38 A derivative is a contract, the value of which depends on the value of, *inter alia*, an underlying asset and includes a forward contract.

39 Paragraph (f) of the definition of "financial instrument" set out in subsection 123(1) of the ETA.

40 The term "recognized commodity exchange" is not defined in the ETA. This may leave some interpretative latitude. That said, under the circumstances, such an analysis would be irrelevant given that a SAFT is neither a commodity option nor futures contract.

comes due.[41] There are certainly exceptions to this general rule.[42] However, if the amount is a prepayment of consideration, then GST/HST should be collected according to the normal rules. This is particularly true, for example, in the case of take-or-pay contracts, which are considered to be a contractual advance or pre-payment for tangible personal property to be delivered at a future date. Under such circumstances, GST/HST will be payable in respect of such payment on the earlier of the day that the payment is paid or becomes due.[43] Based on the foregoing (and provided that the characterization of a SAFT as a prepaid forward contract is correct),[44] GST/HST will be required to be collected in respect of SAFT proceeds on the earlier of the date on which the amount is either paid by the investor or becomes due.[45]

## CONCLUSION

It should come as no surprise that developers, originally based in Canada, are increasingly considering making the difficult decision to relocate their DLT projects to a foreign jurisdiction. Admittedly, the upfront inclusion of the proceeds from a direct pre-token sale, ITO or SAFT in income for the taxation year of receipt may potentially serve to discourage some businesses from entering into such transactions.[46] As discussed above, the amount of such proceeds derived from the foregoing will generally be taxable to the developer in the taxation year of receipt[47] and such developer will also be required to collect and remit the GST/HST in respect of the transaction.[48] Depending on the facts, the result may be a considerable tax leakage related token-based financing, especially when compared to the traditional forms of equity or debt investment. Yet, given the amounts that have been raised through token offerings thus far in 2018, liability for tax in respect of SAFT proceeds may actually be of little or no concern to developers. Indeed, the main principal or primary concern related to a consideration of such foreign structures appears to be entirely commercial in nature; the relocation of DLT projects to jurisdictions more favourable to tokens.[49]

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41 Subsection 168(1) of the ITA.
42 For e.g., GST/HST in respect of a deposit is collectable on the supply only when the deposit is applied as consideration for the supply (subsection 168(9) of the ETA).
43 D. Blair Nixon and Craig M. McDougall, "GST and The Oil Patch (1995 update)", Canadian Petroleum Tax Journal, 3 (June 14, 2001).
44 The consequences of incorrectly characterizing a SAFT transaction could have significant GST/HST implications for the developer, the investor, or both, including being liable for interest, and penalties, and possibly inadvertently forfeiting the ability to claim an input tax credit.
45 Subsection 168(1) of the ETA.
46 Practically, the taxation of SAFT proceeds may simply mean that the amount of funds sought by issuers from investors will be grossed up to account for the issuer's eventual exigibility to tax.
47 The Canadian federal and provincial governments levy a tax on income earned by a corporation resident in Canada. Combined federal and provincial general corporate tax rates range from 26.5% (Ontario) to 31% (Nova Scotia). To the extent that the issuer to a SAFT is a corporation, SAFT proceeds will be subject to the relevant corporate tax rate in the year of receipt.
48 In Ontario, GST/HST is levied at a rate of 13.0%. In Quebec, the TPS/TVQ levied on taxable supplies amounts to 14.98%.
49 Some such jurisdictions include Barbados, Bermuda, Cayman Island, Malta, Panama, Singapore and Switzerland, just to name a few.

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## LIMITED FISHING ONLY: COURTS RESTRICT CRA'S INVESTIGATIVE POWERS

By Jenny Du, Associate, Miller Thomson LLP

The Canadian tax system is one which relies upon self-assessment and self-reporting by taxpayers. Each year, the Canada Revenue Agency ("CRA") conducts a substantial amount of audits to ensure and enforce compliance with Canadian tax laws. As provided for under the *Income Tax Act*,[1] (the "ITA"), CRA is armed with broad powers of investigation to carry out this function.

But just how broad are these investigative powers? Apparently, not as broad as CRA would like to think.

### *CANADA (NATIONAL REVENUE) V. HYDRO-QUÉBEC*[2]

In a decision rendered on June 15, 2018, the Federal Court in *Canada (Revenu national) c. Hydro-Québec*, ("*Hydro-Québec*")[3] limited CRA's ability to compel information about unnamed persons and cautioned against the government's potential abuse of powers granted under the ITA.

CRA can compel any person to produce any information or document relating to any taxpayer pursuant to subsection 231.2(1) of the ITA, as long as such information is sought for a purpose related to the administration or enforcement of the ITA. Through this provision, CRA is able to obtain information about a taxpayer from third parties. However, where CRA requires third parties to produce information on persons that are unnamed, subsection 231.2(2) requires the Minister to first apply for judicial authorization permitting CRA to issue such requirement. In accordance with subsection 231.2(3), judicial authorization may only be granted where the court is satisfied that (a) the person or group is ascertainable; and (b) the requirement is made to verify compliance with any duty or obligation under the ITA.

In the *Hydro-Québec* case, CRA sought information on all business customers of Hydro-Québec (i.e., commercial account holders) (the "Commercial Customers"). As Hydro-Québec was not itself the target of CRA's inquiry, it did not object to the request. However, because CRA did not know the identities of the Commercial Customers, it still had to bring an application for judicial authorization against Hydro-Quebec.

CRA argued that the two conditions under subsection 231.2(3) were met. It argued that there was an ascertainable group because the group can be limited: only certain customers of Hydro-Québec are targeted; large hydro users and domestic rate users are eliminated. With respect to the second condition, CRA asserted that this was easily met because the information is required to verify whether the Commercial Customers are in compliance with the ITA.

1 R.S.C. 1985, c 1 (5th Supp).
2 *Canada (Revenu national) c. Hydro-Québec*, 2018 FC 622 (F.C.) [*Hydro-Québec*].
3 2018 FC 622 (F.C.).

The position of CRA rested upon an interpretation of subsections 231.2(2) and (3) in the widest possible sense. This was definitively rejected by the Court, finding CRA's reasoning to be circular and its construal of subsection 231.2(3) to be excessively broad. If an "ascertainable group" simply meant one which can be identified or limited, any group that is capable of being labelled, with no limitation to its size, composition or characteristics, would meet the first condition. Similarly, the second condition would always be satisfied because any request for information from CRA would become a request required to verify compliance with the ITA.[4] Effectively, CRA would enjoy a virtually unlimited authority to demand any information about any group of persons.[5]

The Federal Court's strong attitude against this position is evident, describing it as an attempt by CRA to discredit subsection 231.2(3).[6] The requirement of judicial authorization had specifically been put into place by Parliament in order to ensure protection for unidentified persons who are unable to defend their own interests. If the expansive interpretation of subsection 231.2(3) advanced by CRA were to be accepted, the safeguard of judicial authorization would be stripped of any impact and be rendered meaningless.

This concern is compounded by the fact that CRA had no reason to suspect that the Commercial Customers were not compliant with tax laws. Further, the information sought did not, in itself, allow for the verification of compliance with the ITA. Rather, in requesting Hydro-Québec to produce information regarding the Commercial Customers, CRA was simply hoping to obtain a database to cross-reference with its own in order to identify potential instances of non-compliance. This was, in the Court's view, "the very definition of a fishing expedition". While acknowledging that the government needs a powerful means by which to enforce the law in a self-assessing tax system, the Federal Court concluded that CRA's "aggressive use" of subsections 231.2(2) and (3) in this instance cannot have been consistent with Parliament's intent. In particular, the Court condemned the use of these provisions as a means to conduct unrestricted fishing expeditions:

> . . .a type of fishing expedition is inherent in the fact that the people targeted by the requirement are unnamed persons. Full-scale fishing expeditions should not, however, be permitted upon judicial authorization. This is not what subsection 231.2(3) allows.[7]

CRA's application was denied.

## *BP CANADA V. MNR*[8]

The *Hydro-Québec* decision is reminiscent of an earlier case, *BP Canada Energy Co. v. Minister of National Revenue*, ("*BP Canada*"),[9] in which CRA similarly sought to interpret its power to inspect under subsection 231.1(1) in the broadest possible sense. Subsection 231.1(1) had been drafted in extremely general terms, as summarized by the Federal Court of Appeal ("FCA"):

> . . .subsection 231.1(1) could not have been drafted in broader terms. Based on the plain language of subsection 231.1(1), a document which "relates or may relate to the information that is or should be in the books or records of the taxpayer or to any amount payable under [the] Act" is accessible under that provision.[10]

During the course of auditing BP Canada Energy Company ("BP"), the auditor identified an issue relating to refund interest. Further inquiry into this issue led to the request of BP's original supporting working papers. Because BP's working papers (the "Working Papers") contained discussions regarding its uncertain tax positions, BP agreed only to provide a redacted version of the Working Papers to CRA.

The redacted Working Papers satisfied the auditor's initial concern regarding refund interest. However, an item titled "tax at risk" in the Working Papers peaked the auditor's interest. This led CRA to make a request for BP's full and unredacted Working Papers. BP steadfastly refused. Acceding to CRA's request meant that BP would essentially be providing CRA with a roadmap of its uncertain tax positions, as well as all of BP's analysis regarding those uncertain tax positions. The matter went to the Federal Court, which found in favour of CRA. BP appealed to the FCA.

It was notable to the FCA that the original issue raised by CRA with respect to the refund interest had already been resolved, yet CRA continued to insist on the production of BP's full working papers. Thus, in the view of the FCA, the real issue (and the sole basis relied upon by CRA) is whether subsection 231.1(1) allows CRA to have general and unrestricted access to such information.[11] The FCA concluded that the proper interpretation of s. 231.1(1) does not give CRA such broad, unrestrained and limitless powers:

> In my view, subsection 231.1(1), properly interpreted, does not make papers such as these compellable "without restriction". When one examines the context and purpose of subsection 231.1(1), it is clear that Parliament intended that the broad power set out in subsection 231.1(1) be used with restraint. . .[12]

The Federal Court's decision allows CRA to utilize subsection 231.1(1) to obtain general access to BP's Working Papers without providing justification for their production. This power would extend to all other taxpayers that maintain similar working papers. Practically, BP and other such taxpayers would be required to routinely provide the Minister with their uncertain tax positions every year. This is not an acceptable result because, as noted by the FCA, auditors cannot compel taxpayers to reveal their soft spots.[13] The obligation to self-assess does not require taxpayers to self-audit and tax themselves on amounts which they believe should not be taxable.[14] Further, if subsection 231.1(1) were interpreted to allow CRA such unrestrained access to information, there would be an incentive for taxpayers such as BP to be less candid about their tax risks. This leads to the undesirable result of decreased reliability of financial statements and reduced protection for the public.[15]

On the basis of the above, the FCA rejected the broad interpretation of subsection 231.1(1) as advocated by CRA, and concluded that subsection 231.1(1) cannot be invoked to obtain general and un-

4 *Ibid,* at para 72.
5 *Ibid,* at para 81.
6 *Ibid*.
7 *Ibid,* at para 63.
8 *BP Canada Energy Co. v. Minister of National Revenue*, 2017 FCA 61 (F.C.A.).
9 2017 FCA 61 (F.C.A.).
10 *Ibid,* at para 58.
11 *Ibid*, at paras 67 and 78.
12 *Ibid*, at para 80.
13 *Ibid*, at para 82.
14 *Ibid.*
15 *Ibid*, at para 87.

restricted access to the portions of the Working Papers which reveal BP's uncertain tax positions.

## THE LIMITATION ON INVESTIGATIVE POWERS

*Hydro-Québec* and *BP Canada* may come as a pleasant surprise to taxpayers because, on a plain reading of the language of sections 231.1 and 231.2, the restrictions found by the courts in these cases are not readily apparent. It is clear from these decisions that courts are wary of the far-reaching investigative powers granted to the state and the potential abuse that may occur if such powers are left unchecked.

The limitations which courts have imposed on the government's investigative powers stem from the condition that the empowering provisions may only be invoked for a "purpose related to the administration or enforcement of [the ITA]" (the "Purpose Requirement"). The meaning of this requirement was the subject of a detailed analysis in *Hydro-Québec*.

The Federal Court in *Hydro-Québec* began with a review of the jurisprudential history on the interpretation of the Purpose Requirement, starting from the Supreme Court of Canada ("SCC") decisions *Canadian Bank of Commerce v. Canada (Attorney General)*,[16] and *James Richardson & Sons Ltd. v. Minister of National Revenue*.[17] These cases stood for the view that "s. 231(3) is only available to the Minister to obtain information relevant to the tax liability of some specific person or persons if the tax liability of such person or persons is the subject of a genuine and serious inquiry."[18]

The import of this "genuine and serious inquiry" test was motivated by a desire to curb unrestrained fishing expeditions conducted by the government and the consideration that state power must be balanced against the right to privacy. Given the all-encompassing language used in section 231.2, potential abuse of this provision by enforcement officials is a very real risk. Section 231.2 must, therefore, be subject to limitations.

However, due in part to certain revisions made to section 231.2 in the intervening years, subsequent FCA decisions have departed from the SCC cases. In *Ministre du Revenu national c. Chambre immobilière du Grand Montréal*, (F.C.A.),[19] the FCA declined to follow the SCC decisions and did not apply the "genuine and serious inquiry" test. Instead, it adopted a new test of good faith (the "GMREB Test"):

> [48] It follows from my reading of paragraph 231.2(3)(b) that the MNR's ex parte application will be granted if the applications judge is satisfied that the information or documents are required for a tax audit conducted in good faith. This good faith guarantees that the MNR will act judiciously in the exercise of its audit power under section 231.2 to ensure the administration and enforcement of the Act.

This view was confirmed by the FCA in *eBay Canada Ltd. v. Minister of National Revenue*.[20]

The Federal Court in *Hydro-Québec* considered itself to be bound by the FCA decisions and applied the GMREB Test. It noted that in previous cases, the requirement for a tax audit conducted in good faith was met because CRA had a basis to suspect non-compliance with the ITA. However, in *Hydro-Québec*, the information requested appears to have nothing to do with tax returns, and CRA had no basis to suspect non-compliance with tax laws by the Commercial Customers. Thus, the Court was not convinced that an audit in good faith with a genuine factual basis had been conducted as yet. CRA's attempt to obtain information from Hydro-Québec was merely a preliminary step in determining whether an audit should be commenced at all.

On the basis of the above, the Federal Court strongly rejected CRA's broad interpretation of subsection 231.2(3). It noted that the Purpose Requirement (and therefore the GMREB Test) is a condition that applies to the entirety of section 231.2, including subsection 231.2(3). In its application to the two conditions set out in subsection 231.2(3), the GMREB Test requires there to be "a strong relation to the ITA, in terms of both the definition of an ascertainable group and the quality of the information sought.[21] The ascertainable group must be identified by characteristics relevant to compliance with the ITA. Whether the information is necessary to verify compliance with the ITA must be determined by reference to an existing audit conducted in good faith.

*Hydro-Québec* confirms that despite being incompatible with the earlier SCC cases, the currently accepted test which flows from the Purpose Requirement is the good faith GMREB Test. Notably, language identical or similar to that of the Purpose Requirement (that the use of the section be "for any purpose related to the administration or enforcement of this Act") is found in a number of other provisions in the ITA, such as the power to inspect under subsection 231.1(1) (which was at issue in *BP Canada*), the power to inquire under subsection 231.4(1), and the power to require production of foreign based information in section 231.6. It is anticipated that the good faith GMREB Test should be equally applicable to these provisions, and it will be interesting to see whether courts will adopt the analysis in *Hydro-Québec* when interpreting the same.

*Hydro-Québec* and *BP Canada* are not the first cases in which CRA has attempted to construe the empowering provisions under the ITA in a way which maximizes its investigative powers, nor will they be the last. Taxpayers should be mindful that CRA's powers are not without limitations, and should carefully consider whether requests made by CRA are permissible under the law when responding to such demands.

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16 [1962] S.C.R. 729 (S.C.C.).
17 [1984] 1 S.C.R. 614 (S.C.C.).
18 *James Richardson & Sons Ltd. v. Minister of National Revenue*, [1984] 1 S.C.R. 614 (S.C.C.) at para 20.
19 2007 FCA 346.
20 2008 FCA 348 (F.C.A.).

21 *Hydro-Québec, supra* note 1 at para 80.

# PROVINCIAL OPPRESSION REMEDIES AND UNPAID CORPORATE TAX

By Carolyn Hogan, Associate, Miller Thomson LLP

Editor's note: This paper was originally an academic submission

## ABSTRACT

As a general rule, an arm's length shareholder is not liable for unpaid corporate taxes under the *Income Tax Act*. In most cases, tax legislation respects the limited liability inherent in the corporate structure. Because the Canada Revenue Agency does not have a method of pursuing an arm's length shareholder for corporate tax under the traditional tax dispute process, it may appear that amounts may be stripped out of a corporation to the shareholders without fear of personal liability. In relying on the limited liability of the corporate structure, however, shareholders should also be cognizant of the safeguards built into corporate legislation. In circumstances where the Crown, as a creditor, has been unfairly prejudiced by the payment of a dividend, the Minister may consider bringing an oppression remedy to recover these amounts from the directors and shareholders of a corporation. Given the right circumstances, an oppression action may be an effective tool to allow the Minister to recover unpaid corporate tax.

## INTRODUCTION

The *Income Tax Act*[1] does not generally hold directors and shareholders of a corporation personally liable for the corporation's taxes. A corporation by its very nature is a business vehicle created for the purpose of protecting shareholders from incurring personal liability for the debts of the business, which includes protecting shareholders from incurring personal liability for corporate taxes. While corporate directors can, in certain specific circumstances, be held personally liable for certain amounts that were to be remitted by a corporation to the Canada Revenue Agency (the "CRA") such as unpaid source deductions[2] and GST/HST,[3] the Act does not allow the CRA to personally pursue a director for unpaid corporate income tax. With the exception of section 160 of the Act, which is limited to specific non-arm's length circumstances, the Act also offers no ability for the Minister of National Revenue (the "Minister") to pursue a shareholder for unpaid corporate tax, even in circumstances where a corporation's tax liabilities have been willfully ignored. Given the dearth of personal liability provisions in the Act itself, it may be questioned whether CRA has any remedies available to collect unpaid corporate taxes in circumstances where a corporate tax debt has been stranded in the corporation.

While it may be true that the Minister is not able to pursue directors and shareholders for corporate tax through the traditional tax dispute process, it must be remembered that a corporation is a creature of statute and it is subject to provincial laws regarding property and civil rights in a province. In circumstances where the Minister determines that the Crown's claims as a creditor of the corporation have been left unsatisfied while amounts have been nonetheless paid out to shareholders as dividends, the Crown is entitled to exercise the same remedies and access the same dispute resolution processes available to regular commercial creditors.

In this paper, I will examine section 160 of the Act and how it may be used by the Minister as a method of collecting unpaid corporate tax by reassessing a dividend recipient; I will also look at the limitation of section 160 in circumstances where the dividend at issue is paid from a corporation that is arm's length from its shareholders. I will then examine provincial and federal corporate legislation[4] to show the way in which the Minister, as a corporate creditor, could bring an oppression action against the corporation with the ultimate remedy being an order for the repayment of a dividend to the corporation, which may then be used to satisfy unpaid corporate tax. I will also look at the limitation periods applicable to the bringing of such actions, and detail the ways in which those limitation periods may be incompatible with the general tax dispute process and may make such actions moot in many circumstances. Finally, I will examine the case to be established by the applicant in the event that the Crown chooses to bring an action pursuant to the oppression provisions of the relevant corporate legislation with the goal of having an improperly paid dividend returned to the corporation.

For the purposes of this paper, I have examined the corporate legislation in Canadian common law jurisdictions, and have not examined the civil law of Quebec.

## SHAREHOLDER LIABILITY FOR CORPORATE TAX UNDER THE ACT

There are very few sections in the Act pursuant to which a shareholder may be found personally liable for a corporation's tax. An exception to this general rule is found in section 160 of the Act, in which an individual who receives a transfer property directly or indirectly, by any means whatever, from a tax debtor for less than fair market value consideration, is liable jointly and severally for the tax debt, up to the value of the amount received. The Federal Court of Appeal has confirmed that the payment of dividends by a corporation to a shareholder is a transfer within the meaning of section 160 of the Act.[5] In addition, a shareholder does not provide the corporation with consideration in exchange for dividends meaning that the entire amount of the dividend is potentially subject to a section 160 assessment. The Supreme Court of Canada has said:

> . . .a dividend is a payment which is related by way of entitlement to one's capital or share interest in the corporation and not to any other consideration. Thus, the quantum of one's contribution to a company, and any dividends received from that corporation, are mutually independent of one another.[6]

1 *Income Tax Act,* RSC 1985, c 1 (5th Supp.), as amended (herein referred to as the "Act"). Unless otherwise stated, statutory references in this paper are to the Act.

2 *Ibid,* at 227.1.

3 *Excise Tax Act,* RSC, 1985, c E-15 at 323.

4 British Columbia — *Business Corporations Act,* SBC 2002, c 57 ("BCBCA"); Alberta — *Business Corporations Act,* RSA 2000, c B-9 ("ABCA"); Saskatchewan — *The Business Corporations Act,* RSS 1978, c B-10 (the "SBCA"); Manitoba — *The Corporations Act,* CCSM c C225 (the "MCA"); Ontario — *Business Corporations Act,* RSO 1990, c B 16 ("OBCA"); New Brunswick — *Business Corporations Act,* SNB 1981, c B-9.1 ("NBBCA"); Nova Scotia — *Companies Act,* RSNS 1989, c 81 ("NSCA"); Prince Edward Island — *Companies Act,* RSPEI 1988, c C-14 ("PEICA"); Newfoundland — *Corporations Act,* RSNL 1990, c C-26 ("NLCA"); Federal — *Canada Business Corporations Act,* RSC 1985, c C-44 ("CBCA"), collectively the "Acts".

5 *Larouche c. R.*, 2010 FCA 32 (F.C.A.).

6 *Neuman v. Minister of National Revenue*, [1998] 1 S.C.R. 770, 98 D.T.C. 6297 (S.C.C.) at 57.

Dividends are transfers for no consideration, which brings them directly within the purview of section 160 of the Act. Therefore, in circumstances where a taxpayer receives a dividend from a corporation to which he does not deal at arm's length at a time when the corporation was a tax debtor, he may be assessed under section 160 for the value of the dividend up to the amount of the tax debt of the corporation.

In looking at the application of section 160 of the Act to corporate dividends, the key issue is generally going to be whether the taxpayer deals at arm's length with the corporation. If taxpayers are not related to the corporation, it will be a question of fact whether they are dealing with the corporation at arm's length. In a wholly-owned corporation, or a family-owned corporation, section 160 would obviously apply to the payment of a dividend to the shareholders, but, as the ownership structure becomes more complex, claims of a non-arm's length relationship will become increasingly difficult to sustain by the Minister. There are cases where a 50 percent shareholder has been found by the Tax Court of Canada not to be dealing at arm's length with a corporation, despite the fact that the shareholder did not control the corporation,[7] but the more shareholders that become involved the more difficult it will become to establish a common mind. The Minister bears the initial burden of establishing the transferor's debt.[8] Once the tax debt is established, the onus shifts to the transferee to demolish the Minister's assumptions.[9] In a situation where there are many shareholders who are unrelated to one another it is not unreasonable to think that, absent special circumstances, the assessed shareholder would be able to demolish the Minister's assumption that he or she was not dealing with the corporation at arm's length.

Given the difficulty of proving a non-arm's length relationship within an extensive class of shareholders, it may appear at first glance that the CRA would be left without a remedy where a dividend has been paid improperly. As more and more shareholders are added, the requirements of section 160 will become more and more difficult to maintain, making it a less appropriate tool for the recovery of unpaid corporate tax. In a widely held corporation that does not intend to continue operations — such as a corporation incorporated for a particular project that is now complete — it would be possible for the directors to pay out a dividend, leave corporate taxes unpaid, and cease corporate operations, essentially leaving the CRA with no remedies under the Act. Alternatively, a corporation may have paid out dividends in good faith and honestly believed that the corporation's taxes were properly paid, but in fact the corporation reported a transaction incorrectly on its return of income, resulting in a reassessment by the CRA; in such circumstances there may be no assets left in the corporation to satisfy the tax bill, and with the corporation no longer active there is little incentive for the shareholders to contribute additional capital to satisfy the tax debt.

In the above circumstances, although the Minister may be without remedies under the Act, it is important to remember that a tax debt is a debt which is subject to the same provincial laws as any other debt. While it may appear at first glance that the shareholders are not liable for the corporation's tax debt, one must first examine the provincial corporate laws governing the payment of dividends to determine whether the Minister has additional methods at her disposal to collect unpaid corporate taxes.

## PROVINCIAL CORPORATIONS ACTS

In most Canadian common law business corporations legislation, there is a prohibition on declaring or paying a dividend if there are reasonable grounds for believing that the corporation is, or would after the payment be, unable to pay its liabilities as they become due.[10] In British Columbia, dividends may be declared unless there are reasonable grounds for believing that the company is insolvent or the payment of the dividend would render the company insolvent;[11] however, "insolvent" is defined as a company being unable to pay the company's debts as they become due in the ordinary course of business,[12] meaning the test is effectively identical. The exceptions are Nova Scotia and Prince Edward Island, who each maintain a provincial *Companies Act* rather than a *Business Corporations Act*. The NSCA declares that "[n]o dividend shall be payable except out of the profits of the Company."[13] In contrast, the *PEICA* declares that "[t]he company shall not make or declare any dividend whereby the capital will be in any degree impaired."[14]

If a dividend is declared in contravention of the corporate solvency requirements, the directors of the Corporation who voted in favour of the dividend are jointly and severally liable to restore to the corporation any amounts paid in contravention of the legislation.[15] This is true for every province with the exception of Nova Scotia. A director in Nova Scotia may be fined $500 for willfully concealing the name of any creditor entitled to object to a reduction of share capital or for willfully misrepresenting the nature or amount of a debt of any creditor,[16] but there is no provision holding a director personally liable in the event that a dividend is paid out of something other than profits.

In Alberta, if a corporation declares a dividend improperly, the corporation's directors, shareholders, and creditors are all entitled to apply to the Alberta Court of Queen's Bench for an order; if the court is satisfied that it is equitable to do so it may order a shareholder to restore the dividend to the corporation, or make any further order it thinks fit.[17] Thus in Alberta, it is possible for a creditor complaining of an improperly paid dividend to apply to the court directly to have the directors found liable for the amount, or to have the amount repaid to the corporation by the shareholders. The ability of creditors to apply under this section is unique to Alberta. In most jurisdictions, in order to obtain such relief the creditor would be required to commence an oppression action.

A director found liable under these provisions is entitled to contribution from the other directors who voted in favour of the dividend.[18] The court may also, if it is just and equitable to do so, order a

7 *Gosselin c. R.* (1996), [1997] 2 C.T.C. 2830, [1996] T.C.J. No. 206 (T.C.C.).
8 *Ellis v. R.*, 2015 TCC 285, 2015 D.T.C. 1224 (T.C.C. [General Procedure]) at 12.
9 *Beaudry c. R.*, 2003 TCC 464, 2003 D.T.C. 1014 (T.C.C. [General Procedure]) at 27.

10 ABCA at 43; SBCA at 40; MCA at 40; OBCA at 38(3); NBBCA at 41; NLCA at 76; CBCA at 42.
11 BCBCA at 70(2).
12 BCBCA at 1(1).
13 NSCA at 159.
14 PEICA at 65.
15 BCBCA at 154(1); ABCA at 118(3); SBCA at 113(2); MCA at 113(2); OBCA at 130(2); NBBCA at 76(2); PEICA at 65; NLCA at 193; CBCA at 118(2)(c).
16 NSCA at 65.
17 ABCA at 118(5).
18 BCBCA at 156(1); ABCA at 118(4); SBCA at 113(3); MCA at 113(3); OBCA at 130(3); NBBCA 76(3); NLCA at 194; CBCA at 118(3).

shareholder to pay to a director any money that was improperly paid to the shareholder contrary to the solvency requirements of the legislation.[19]

In Prince Edward Island, if the directors declare and pay a dividend when the company is insolvent, or if the dividend itself renders the company insolvent, they are jointly and severally liable to the company's creditors for all the debts of company then existing and all debts incurred thereafter during their time in office.[20] To avoid such liability, a director in PEI is required to record his objection in the directors' minutes and to publish his objection in at least one newspaper within 10 days of becoming aware of the dividend.[21] Given that PEI does not have a statutory oppression remedy available, this section would be the only method open to a creditor seeking compensation in respect of an improperly paid dividend.

## OPPRESSION REMEDIES

To bring an oppression action, the Crown would first be required to establish that it was a "complainant" for the purposes of the relevant corporate law. In Alberta, New Brunswick and Nova Scotia, a complainant is defined to include a creditor.[22] In Saskatchewan, Manitoba, Ontario, Newfoundland, and under the CBCA, a complainant does not directly include a creditor, but does include any other person who, in the discretion of a court, is a proper person, or an appropriate person, to make an application.[23] In bringing an oppression action, an applicant is required to show conduct that is oppressive or unfairly prejudicial to, or that unfairly disregards the interests of, any security holder, creditor, director or officer.

In Prince Edward Island there is no statutory oppression remedy. As stated above, directors in Prince Edward Island may be found directly liable to the corporation's creditors for dividends that have been paid in contravention of the solvency requirements of the legislation.

In British Columbia, the oppression remedy applies to a "shareholder", which is defined to include "any other person the court considers to be an appropriate person to make an application under this section."[24] The terminology chosen in the legislation — shareholder as opposed to complainant — may in practice serve to discourage the use of these provisions by creditors given that oppression claims by creditors are not common in British Columbia as compared to a province such as Ontario.[25]

The powers of the court on a successful oppression remedy are very broad, and would in all likelihood permit the recovery to the corporation of the amount of the improperly paid dividend. In most provinces, the court is explicitly permitted to set aside transactions and to direct any party to the transaction to compensate any other party to the transaction. Most provinces also permit the court to provide compensation to an aggrieved person. In BC, the court is also permitted to set aside a resolution, which in the case of a dividend resolution would make such payment a nullity.[26]

The oppression remedy in all provinces in which it exists is very broad, and would in all likelihood permit the court to order a shareholder to repay to the corporation a dividend that had been paid in contravention of the legislative solvency requirements. The repayment of dividends to an insolvent corporation is a remedy that has been ordered by courts in various Canadian jurisdictions.[27] In British Columbia, for example, a director was found liable for a dividend paid in contravention of the BCBCA, and his wife as shareholder was also found liable for the amounts that were paid to her improperly.[28] A review of the reported case law indicates that, in circumstances where a dividend has been paid in contravention of the solvency requirements of the various business corporations legislation, a court may, on application of the complainant, order that such amounts be restored to the corporation or to the creditors directly.

## LIMITATION OF ACTIONS

In the event that the Minister chose to commence an action to recover an improperly paid dividend, she would have to be cognizant of the relevant limitation periods.

In BC, a legal proceeding against the directors must be commenced within two years of the date of the applicable resolution. This is the same limitation period applicable in Alberta, Manitoba, New Brunswick, Newfoundland, and under the CBCA. Saskatchewan defers to *The Limitations Act*, but specifies that the day of the claim for the purpose of the limitations period is the date of the resolution authorizing the action complained of. In Ontario and PEI there are no limitations periods within the OBCA or the PEICA, respectively, to limit the time in which to bring an action against the corporation's directors, meaning the general limitations legislation would apply.

As previously discussed, the ABCA allows creditors to apply to the Alberta Court of Queen's Bench for an order that a dividend was paid in contravention of the solvency requirements without specifically bringing an oppression action. The legislation specifically limits the bringing of such an action to two years from the date of the resolution declaring the dividend. Given that the ABCA specifically allows creditors to bring a claim under these provisions rather than bringing a separate oppression action, it seems likely that the specific limitation in this section would trump the general oppression remedy. As such, a creditor attempting to bring a claim in Alberta would want to be sure to bring its action within two years of the date of the resolution rather than attempting to rely on the oppression provisions and the general limitations period.

In British Columbia, a court proceeding must not be commenced more than two years after the day on which the claim is discovered.[29] In Saskatchewan, proceedings must be commenced within two years of discovery; as mentioned previously, discovery for the purposes of directors' liability is deemed to be the date of the

19 BCBCA at 156(2)(a); ABCA at 118(6)(a); SBCA at 113(5)(a); MCA at 113(5)(a); OBCA at 130(5)(a); NBBCA at 76(5)(a); NLCA at 195(2)(a); CBCA at 118(5)(a).
20 PEICA at 65.
21 *Ibid,* at 66.
22 ABCA at 239(b)(iii); NBBCA at 163; NSCA, Third Schedule at 7(5).
23 SBCA at 231(b)(iv); MCA at 231(d); OBCA at 245(c); NLCA at 368(b)(iv); CBCA at 238(d).
24 BCBCA at 227(1).
25 Stephen Antle, Stephen T.C. Warnett, and J. Tracy Li, "And Now For Something Slightly Different: The British Columbia Oppression Remedy" *Borden Ladner Gervais LLP, Vancouver,* 2006, (http://blg.com/en/News-And-Publications/documents/Antle_Oppression_Remedy_Paper.pdf).
26 BCBCA at 227(3)(j) and (k).
27 See for example *Royal Bank v. Amatilla Holdings Ltd.*, 1995 CarswellOnt 2383 (Ont. Gen. Div.); *R. v. Sands Motor Hotel Ltd.*, [1984] C.T.C. 612, 36 Sask. R. 45 (Sask. Q.B.) (*Sands Motor Hotel*).
28 *684417 B.C. Ltd. (Trustee of) v. Johnson*, 2013 BCSC 1055 (B.C. S.C.).
29 *Limitations Act,* SBC 2012, c 13 at 6.

resolution declaring the dividend.[30] The limitations period in New Brunswick is also two years.[31] In Manitoba, an action for the recovery of money may be commenced within six years of the cause of action.[32] Interestingly, actions for penalties given by any statute to the person aggrieved must be commenced within two years,[33] meaning it is possible that a tax debt may be recovered for six years while penalties may only be recovered for two. In Newfoundland, the limitation period to enforce an obligation arising from a statute is six years.[34]

Nova Scotia's legislation specifically exempts from the normal limitation period a proceeding to recover money owing to Her Majesty in respect of fines, taxes or penalties, or interest on fines taxes or penalties.[35] A similar exemption exists in Ontario in respect of a proceeding to recover money owing to the Crown in respect of taxes.[36] In both provinces the limitation period is otherwise two years. It may be argued that an oppression remedy is not in fact a proceeding to recover taxes but a proceeding in respect of the provincial business corporations legislation. Although the ultimate goal of the Crown bringing an oppression action would be to make funds available to satisfy the outstanding corporate taxes, the specific application would be based upon the improperly paid dividends. In such circumstances, the court will have to decide which limitation period is ultimately applicable.

The provincial limitations acts generally use wording dating the claim to the time the claimant knew or ought to have known about the claim. Although the claim is with respect to unpaid taxes, the action being complained about is, in fact, an improperly paid dividend. The claim would therefore not begin to run based on the time the income was earned or the time when the notice of assessment or reassessment was sent, because the action complained about is the payment of the dividend and not the actual taxes. The question would then be when the Crown knew, or ought to have known, that a dividend was paid in contravention of the solvency requirements in the applicable corporate legislation. Presumably a T5 would be issued, providing notice of the dividend, but notice of the dividend would not be the same as notice of corporate insolvency. It is likely that notice for the purpose of the limitations periods would have to be determined on a case by case basis.

For directors' liability, however, the legislation specifies that the action must be brought within two years of the resolution declaring the dividend. This raises some interesting issues. For example, the legislation says the date of the resolution rather than the date the dividend was paid; it is not uncommon in corporate law for resolutions to be backdated in circumstances where the parties don't prepare documentation simultaneously with their decision making. It may be necessary for a corporation's bylaws to be examined in order to determine the correct date of the resolution. It may be that a decision is made at one point in time and the resolution is prepared at a different point in time — the court will be required to determine what is the correct date of the resolution for the purpose of the limitation period. In addition, it will be incumbent on the Crown to establish that the action has been brought within the relevant limitations period, but it would not control the relevant documentation.

It is also possible that a corporation's financial situation might change between the time the dividend is declared and the time the dividend is ultimately paid. So, for example, if the directors are expecting income in the future they may declare a dividend in advance and indicate it will be paid when the company receives the money; however, by the time the income is actually realized, the corporation's financial circumstances prohibit its payment. If the directors allow the dividend to be paid out to the shareholders, with full knowledge that the corporation is insolvent, this seemingly contravenes the spirit of these provisions.

The two-year limitation periods with respect to directors' liability are in all likelihood going to be too short to be effective in most circumstances. It is not unreasonable to think that two years will easily elapse before the Minister even realizes that such remedies should be pursued. In circumstances where the tax debtor corporation has filed its tax return based on what it believed to be the proper method and has subsequently been reassessed by the CRA, by the time the corporation has exhausted its tax dispute remedies, such as an objection to the CRA and an appeal to the Tax Court, two years will have long since elapsed.

The limitation period to recover dividends on an oppression remedy, however, would have a greater likelihood of being met than the limitation period for an action against the directors, provided that the Minister is able to demonstrate when she received notice of the corporation's insolvency and when she received notice of the dividend. If the Minister is able to establish that she became aware only *after* the normal tax dispute process had already been exhausted that the corporation was unable to pay its corporate taxes, then an oppression remedy might be a viable option to recover dividends paid to the shareholders in contravention of the corporate solvency requirements.

**Table 1 — Summary by Province**

| Province | Directors' Liability | Claimants for Directors' Liability | Limitation for Directors' Liability | Oppression Remedy | Oppression Remedy for Creditors | Limitation for Oppression Remedy |
|---|---|---|---|---|---|---|
| Alberta | Yes | Corporation, director, shareholder, creditor | 2 years following resolution | Yes | Yes | 2 years |
| British Columbia | Yes | Company or a director | 2 years following resolution | Yes | "appropriate person" | 2 years |
| Manitoba | Yes | - | 2 years following resolution | Yes | "proper person" | 6 years |
| New Brunswick | Yes | - | 2 years following resolution | Yes | Yes | 2 years |

30 *The Limitations Act,* SS 2004, c L-16.1 at 5.
31 *Limitation of Actions Act,* SNB 2009, c L-8.5
32 *The Limitation of Actions Act,* CCSM c L150 at 2(1)(i).
33 *Ibid,* at 2(1)(b).
34 *Limitations Act,* SNL 1995, c L-16.1 at 6(1)(f).
35 *Limitation of Actions Act,* SNS 2014, c 35 at 10(a).
36 *Limitations Act,* 2002, SO 2002, c 24, Sch B at 16(1)(i).

| Province | Directors' Liability | Claimants for Directors' Liability | Limitation for Directors' Liability | Oppression Remedy | Oppression Remedy for Creditors | Limitation for Oppression Remedy |
|---|---|---|---|---|---|---|
| Newfoundland | Yes | - | 2 years following resolution | Yes | "appropriate person" | 6 years |
| Nova Scotia | No | - | - | Yes | Yes | None/ 2 years |
| Ontario | Yes | - | - | Yes | "proper person" | None/2 years |
| Prince Edward Island | Yes | Company, shareholders and creditors | 6 years | No | - | - |
| Saskatchewan | Yes | - | 2 years following resolution | Yes | "proper person" | 2 years |
| Federal | Yes | - | 2 years following resolution | Yes | "proper person" | Provincial act applies |

## ONUS OF PROOF

As a general rule, in proceedings before the Tax Court of Canada, the onus of proof is on the taxpayer. The appellant in a tax appeal must demolish the Minister's assumptions, at which point the onus shifts to the Minister to rebut the Taxpayer's *prima facie* case.[37] It is generally understood that the burden is on the taxpayer because "It is the taxpayer's business. He knows how and why it is run in a particular fashion rather than in some other ways."[38] The Tax Court has recognized that there may be instances "where the pleaded assumptions of fact are exclusively or particularly within the Minister's knowledge. . .as to require a corrective measure".[39] The burden is also explicitly shifted to the Minister in other sections of the Act, such as for the imposition of gross negligence penalties.[40] Unless a taxpayer falls into one of these exceptions, however, the taxpayer has a burden to meet because the Minister's assumptions are deemed to be true unless demolished by the taxpayer.[41] This could be problematic if the taxpayer's records are incomplete or no longer in their possession.

In contrast, if the Minister were to bring an action in provincial superior court, the burden of proof would be on the Minister. As the party making the application, the Minister would be required to prove on a balance of probabilities that a dividend had been paid improperly.[42] The Minister would be required to tender evidence showing the relevant legislation had been contravened. Each element of the alleged offence would have to be established by the Minister.

## CASE TO BE MET

The Ontario Superior Court of Justice has said that to pay out a corporation's assets to the shareholders as dividends without paying taxes and creditors first would breach the solvency provisions of the OBCA.[43] Based on this statement, it appears that the case to be established by the Minister would be straightforward; however, the case law applying the dividend solvency requirements indicates that an applicant must not be lax in ensuring that the correct evidence is before the court. The onus is on the Crown, as applicant, to show its interests have been adversely affected.[44]

The Minister may be required to tender expert evidence on the issue of whether the corporation was insolvent at the time any dividends were paid.[45] In cases where the nature of the payment is unclear, it may also be necessary to establish that the payment was actually a dividend.[46] If the legal character of the payments is unclear at the time they are made to the shareholders, the relevant time for the purpose of the solvency test may be the date that the payments are declared to be dividends rather than at the time the payments were made.[47]

## TIME OF THE DEBT

The dividend solvency tests are a point in time snapshot of a corporation's finances. In order for the Minister to take advantage of these provisions, she will have to establish that the corporation was liable for taxes at the time the dividend was declared or paid. In circumstances where a corporation has come into a large amount of capital through a sale or through some other commercial transaction, the corporation may not yet have received a tax assessment at the time such an amount is paid out to the shareholders as a dividend. In circumstances where a corporation pays a dividend but has not yet received a tax bill from the CRA, it might be questioned whether the CRA was a creditor at the time the dividend was paid for the purposes of the solvency tests in the provincial business corporations acts.

Liability for tax, however, results from the Act and not from the assessment or reassessment.[48] A taxpayer is liable for tax even though the Minister of National Revenue has not assessed it.[49] As such, the Crown becomes a creditor of a corporation as soon as the corporation experiences a taxable event and not when the corporation's return is filed and the assessment is issued. If a corporation earns income or realizes a capital gain it becomes taxable at the time of the transaction, not at the end of its taxation year.

In circumstances where the corporation has not yet realized a taxable event, it is unlikely that the CRA could be considered a creditor for the purpose of the oppression remedies under the provincial business corporations acts even if the taxable event is contemplated. The Ontario Superior Court of Justice has said that

37 *Hickman Motors Ltd. v. R.*, [1997] 2 S.C.R. 336, 148 D.L.R. (4th) 1 (S.C.C.).
38 *Voitures Orly Inc. / Orly Automobiles Inc. v. R.*, 2005 FCA 425, [2005] F.C.J. No. 2116 (F.C.A.) at paragraph 20.
39 *Anchor Pointe Energy Ltd. v. R.*, 2007 FCA 188, [2008] 1 F.C.R. 839 (F.C.A.) at 36.
40 Act at 163(3).
41 Act at 152(8); *Supra* note 38.
42 *C. (R.) v. McDougall*, 2008 SCC 53, [2008] 3 S.C.R. 41 (S.C.C.).
43 *Clarke v. Clarke*, 2013 ONSC 5352 (Ont. S.C.J.) at 37.
44 *Royal Bank v. Amatilla Holdings Ltd.*, 1995 CarswellOnt 2383 (Ont. Gen. Div.) at 14.
45 *Malley v. Copper Rock Homes Ltd.*, 2016 ABQB 653 (Alta. Q.B.) at 26.
46 *Ibid*, at 29.
47 *Supra* note 27 at 31.
48 *Heavyside v. R.* (1996), [1997] 2 C.T.C. 1 (Fed. C.A.).
49 *Wannan v. R.* (2002), [2003] 2 C.T.C. 2303 (T.C.C. [General Procedure]).

an applicant must be a creditor at the time the dividends are paid to be granted the status of a complainant with respect to such payments.[50] In reality, however, it is unlikely that such concerns would ever be a genuine issue to be determined, as a corporation would need to have actual money available in order to pay a dividend to its shareholders, and if the income or gains have not yet come to fruition the corporation is unlikely to have the cash in the bank available to pay out to the shareholders.

## SANDS MOTOR HOTEL

The Minister of National Revenue has, at least once, pursued a Taxpayer in the provincial superior courts for a dividend paid in contravention of provincial corporate legislation. In *R v. Sands Motor Hotel Ltd.,*[51] the Minister applied to the Saskatchewan Court of Queen's Bench for an order to set aside dividends that had been paid to the shareholders until such time as the corporation's liability under the Act had been paid or secured.

In *Sands Motor Hotel*, the taxpayer sold a property and recognized a capital gain. The taxpayer declared a dividend in anticipation of the sale proceeds. Prior to the payment of the dividend, the taxpayer received a letter from the Department of National Revenue advising that it would be reassessing on the basis that the sale was an adventure in the nature of trade. The dividends were paid out in spite of this letter, and the taxpayer was subsequently reassessed by the Minister.

The Minister made an application to the court to be declared a complainant for the purposes of the oppression provisions of the SBCA. The court in *Sands Motor Hotel* accepted that tax liability under the Act exists as soon as the income is earned, and found that there was a debt owing at the time the letter was written. In commenting on whether the Minister, as a creditor of the corporation, could be considered a complainant for the purposes of the SBCA, McLellan, J stated:

> if a creditor does not come within the definition of complainant one wonders how a creditor can obtain remedies for breaches of those provisions of the BCA which are obviously inserted for the protection of creditors such as the solvency tests contained in sections 34 and 40.[52]

The Court in *Sands Motor Hotel* found that there were reasonable grounds, at the time the dividend was paid, for believing that the corporation would be unable to pay the additional income taxes they were advised were going to be assessed. The payment of the dividends was deemed to be "unfairly prejudicial to and unfairly disregarded the interests of Her Majesty the Queen as a creditor of the taxpayer"[53] and the shareholders were ordered to repay the dividends to the taxpayer corporation.

While the *Sands Motor Hotel* case shows that it is possible for the Minister to recover improperly paid dividends, the decision also points to potential shortcomings in this method of collection. The court in *Sands Motor Hotel* places a lot of emphasis on the letter sent to the taxpayer prior to the dividend being paid. Justice McLellan specifically mentions that the letter was sent prior to payment, and that there was "a debt owing at the time that the letter was written to the taxpayer." When determining whether there were reasonable grounds for believing the corporation would be unable to pay its liabilities, the court referred to "the additional income taxes that [the taxpayer] had been advised were in the process of being assessed."[54] The court's reasoning places focus on the taxpayer's knowledge, and specifically on the receipt of the letter, rather than the correctness of the assessment. It is said that ignorance of the law is no excuse — *ignorantia juris non excusat* — so presumably it should not matter whether the taxpayer is notified of a reassessment prior to the payment of a dividend. This view is also reinforced by the interpretation that a tax debt arises by operation of law when the income is earned and not from an assessment.[55] In circumstances where a taxpayer does not receive a letter from the Minister, but the assessment is nonetheless valid at law, does that constitute "reasonable grounds"? Is it reasonable to expect ordinary taxpayers to understand complex distinctions in tax legislation? For some taxpayers, perhaps, the courts may not consider it reasonable that they would know that a reassessment was possible. For other taxpayers, such as sophisticated taxpayers with professional advice, it is possible that the courts may find that ignorance of the law was not reasonable in the circumstances.

Nonetheless, it is important to remember that this burden must be met by the Minister, and not by the taxpayer. It is the Minister who must show that the taxpayer was not acting reasonably, which may be a difficult burden to overcome. In a situation where a corporation pays a dividend rather than paying its corporate tax, it would likely be straightforward to show that the dividend was not reasonable in the circumstances; a taxpayer should know that it is required to pay tax on its income and it is reasonable to think that if you don't leave any money in the corporation you will be unable to pay your tax when it comes due. The further a taxpayer gets from its original filing, however, the more difficult it will be to prove the dividend was unreasonable. If a taxpayer's filing position was reasonable, even if it wasn't correct, it is possible that the taxpayer could convince a court that a reassessment wasn't foreseeable in the circumstances.

## CONCLUSION

Most provincial business corporations legislation makes directors jointly and severally liable for dividends declared in contravention of the solvency requirements in their respective acts. In practice, however, this remedy is unlikely to be useful to the Minister in any province except for Ontario and Prince Edward Island, as most jurisdictions limit the ability to recover from directors to two years after the date of the directors' resolution declaring the dividend. Although it is possible that the Minister could pursue the directors for corporate tax pursuant to these provisions, the tax dispute resolution process would in most cases exceed the two-year limitations period. It is therefore unlikely that the directors' liability provisions in the provincial business corporations acts are a viable method of collecting unpaid corporate taxes.

However, in circumstances where the Minister is unable to pursue arm's length shareholders under section 160 of the Act, provincial oppression remedies may be a viable alternative to recover amounts improperly paid out by a tax debtor corporation. Re-

50 *Devry v. Atwood's Furniture Showrooms Ltd.*, 2000 CarswellOnt 4176, [2000] O.J. No. 4283 (Ont. S.C.J. [Commercial List]).
51 *Sands Motor Hotel, supra* note 26.
52 *Ibid,* at 18.
53 *Ibid,* at 22.
54 *Supra* note 26 at 21.
55 *R. v. Simard-Beaudry Inc.* (1971), 71 D.T.C. 5511 (Fed. T.D.).

gardless of the date of the assessment or reassessment, if the Minister is able to show that taxes were owing pursuant to the Act at the date of the dividend, it would be within the power of a provincial superior court to restore that dividend to the corporation. Unlike in traditional tax litigation, the onus will be on the Minister to establish the elements of the claim on the balance of probabilities; however, provided the Minister is able to prove that the payment at issue was a dividend, and that the company was insolvent at the time of payment, it seems likely that the Minister would be successful in having the dividends restored to the corporation. The biggest obstacle for the Minister to overcome would likely be the burden of establishing the relevant limitations period, which is not always readily apparent based on the Act and on the tax dispute resolution process. If the Minister is able to obtain some guidance from the courts as to when the time periods begin to run, then oppression remedies may be an untapped collection tool available to the Minister for unpaid corporate tax debts.

Although reported case law indicates that oppression remedies have not been widely pursued as a tax dispute technique in the past, the *Sands Motor Hotel* decision indicates that an oppression remedy is a viable option in the right circumstances. Shareholders assessing their potential personal liability for corporate tax should be aware that not only must the Act be considered, but also the relevant corporate legislation. A shareholder is generally only responsible for personal tax on corporate distributions, but to be genuinely entitled to those distributions they must be in accordance with sound corporate principles. In circumstances where a corporation has not adhered to the relevant corporate law principles in declaring a dividend, both shareholders and directors may potentially be held personally liable for unpaid corporate tax.

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## *JOHNSON V. M.N.R.*: EMPLOYEE OR INDEPENDENT CONTRACTOR – A TWO-STEP ANALYSIS

By Pritika Deepak, Associate, Miller Thomson LLP

In *Johnson v. M.N.R.*,[1] the Tax Court of Canada ("TCC") ruled in favour of a taxpayer and set aside the rulings of the Minister of National Revenue ("MNR") that deemed a worker to be self-employed for the purpose of Employment Insurance and Canada Pension Plan contributions. The main issue in this case is whether a worker is an employee for the purposes of insurable employment as defined in section 5(1) of the *Employment Insurance Act* (the"Act").

### Facts

In June 2014, Ms. Renee Johnson ("Johnson" or the "Appellant") was first hired by The Butler Did It Inc. ("BDI") as a banquet server. At this time, the Appellant was also working for a small agency called Server, Servers and Shakers for a few days of the year. The Appellant never signed any written contract when she was first hired by BDI but was aware that there would be no deductions at source from her remuneration of $14 per hour.

The Appellant's duties as a banquet server included serving food and beverages at various venues, as requested by clients of BDI. The Appellant provided her services based on her own availability and could refuse or accept a work assignment based on her discretion. Johnson was paid by way of cheque on a monthly basis. She was not entitled to vacation pay or provided any benefits by BDI. She provided her tools such as a lighter, corkscrew, note pad and pen and provided her own uniform consisting of black dress pants, socks, shoes and a classic dress shirt. The Appellant was responsible for the replacement of her tools and uniform.

In April 2015, Johnson signed an agreement with The Food Handlers (the "FH Agreement"), a division of BDI, which was an independent contractor agreement. Specifically, paragraph 5 of the FH Agreement stated that the Appellant was a subcontractor and not an employee of Food Handlers. However, Johnson never actually worked for Food Handlers.

A similar agreement was established with BDI (the "BDI Agreement"), however no executed copy was produced. Instead, Johnson's confirmation of reviewing the BDI Agreement was evidenced through the Appellant's signature on the sign-off sheet which indicated that she had read and agreed to the terms of the BDI Agreement.

For the period of January 1, 2015 to November 28, 2015 (the "relevant period"), BDI had ten permanent employees and two part-time employees, as administrative staff. At this time, Johnson was not working anywhere else as a waitress. BDI issued Johnson a T4A slip for the relevant period.

### TCC Decision

Justice Pierre Archambault of the TCC held that the relationship between BDI and Johnson was one of employer and employee primarily due to the degree of control exercised by BDI.

The Court's decision involved an analysis of whether Johnson provided services pursuant to a contract *of* services (employment contract) or a contract *for* services (an independent contractor agreement) to determine her role in relation to BDI for the purpose of section 5 of the ETA. To qualify as insurable employment under the ETA, Johnson would be required to provide services pursuant to a contract *of* services.

Citing the Supreme Court of Canada ("SCC") in *671122 Ontario Ltd. v. Sagaz Industries Canada Inc.*, ("*Sagaz*"),[2] the TCC explained that determining whether a worker is performing services as his or her own business on his or her own account is a two-step process. The first step involves ascertaining the subjective intent of each party to the relationship while the second step assesses the objective reality of each party's subjective intent.

#### *Subjective Intent of the Parties*

The TCC determined that while BDI's intent was to treat Johnson as an independent contractor, the Appellant had not established a clear intent.

[1] *Johnson v. M.N.R.*, 2018 TCC 201 (T.C.C. [Employment Insurance]).

[2] 2001 SCC 59 (S.C.C.).

Factors generally used to assess intent include written documents and actual conduct of each party. Although BDI's intent was made clear through the BDI Agreement and the fact that it did not withhold deductions at source, BDI's conduct was inconsistent with its intentions. For example, BDI titled itself as the employer in relation to Johnson, when filing Workplace Safety and Insurance Board ("WSIB") forms and paid WSIB premiums and general insurance to protect itself from potential vicarious liability claims for all its butlers.

Interestingly, although Johnson was aware that source deductions were not being withheld and acknowledged reading the BDI Agreement, Justice Archambault held that her conduct was consistent with "someone who entered into a contract of adhesion".[3] Justice Archambault explained that although Johnson was aware of BDI's intention to treat her as an independent contractor, the Appellant's intention arose "out of necessity because she needed the money", and thereby did not indicate any clear intent.[4]

Given that neither party's subjective intent was clear as their conduct conflicted with the written agreements, the objective reality of the situation was heavily weighted.

#### *Objective Reality*

When determining whether the relationship between BDI and Johnson was one of employer-employee or that of client-independent contractor, the TCC based its analysis on *Sagaz*, where the SCC plainly stated that there is no set formula or 'universal test' to determine whether a person is an employee or an independent contractor. However, the SCC explained that many factors may be considered including:

(i) the level of control the employer has over the worker's activities;

(ii) the equipment used by the worker;

(iii) whether the equipment was supplied by the employer;

(iv) whether the worker hires his or her own help;

(v) the degree of financial risk taken by the worker;

(vi) the degree of responsibility for investment and management held by the work; and

(vii) the worker's opportunity for profit.

It is important to note that the list above is not an exhaustive list and the type of factors used and their weight will vary on a case by case basis.

#### *Control of Where, When and How*

The TCC found that BDI exercised its right of control over Johnson's work in terms of where, when and how she performed her services as a butler.

Mandatory orientation and training sessions applied to all staff that were hired by BDI, where the wait staff would be told how to serve, how to dress and how to conduct themselves for various clients. Once the staff was trained and had accepted an assignment, BDI determined the role of each staff member, the timing of breaks and the method of fulfilling the client's needs. In particular, Johnson, along with the other butlers, was instructed by onsite supervisors on how to serve, when to start service and when to leave each event. Essentially, BDI "managed the workers during the event to ensure cohesion".[5] Reports and disciplinary measures were also exercised by BDI when Johnson failed to work at an event after accepting the assignment. Further, even the invoices submitted by Johnson were templates developed by BDI. The Court found such a degree of control to be very unlikely in an independent contractor relationship and thereby determined an employer-employee relationship between BDI and Johnson.

#### *Number of Employees and Clients*

Johnson only worked as a waitress for BDI during the relevant period and had no contractual relationship with any of BDI's clients. She had no workers working under her while BDI hired approximately 600 butlers, in addition to its administrative staff. Further, the BDI Agreement included a non-competition clause that prohibited waiters and waitresses from providing services to BDI's clients for a period of 12 months after termination of the BDI Agreement. The Court found that a clear indicator of BDI's role as an employer was the protection of its clientele as only BDI could profit from its clients, unlike Johnson who was only entitled to her salary based on the number of hours that she worked.

#### *Lack of investment*

The Court held that Johnson's role as a butler was more akin to the existence of an employment relationship as she provided tools and equipment only to a minimal extent, such as a lighter, a corkscrew, a note pad and a pen. There were no capital investments by Johnson as BDI maintained and operated most capital assets like office space, computers, phones, furniture and working capital. Johnson's main contribution to BDI was her labour, as is the case with most employees.

#### *Minimal Risk of Loss/Opportunity for Profit*

The TCC determined that Johnson's risk of loss was almost non-existent as she was not held accountable for accidents that took place during assignments or events. For example, accidents that resulted in her injury while on the job were covered by WSIB, while injury to clients would be covered by BDI's insurer. BDI bore the risk of loss that resulted from any damage to third parties.

Similarly, it was only BDI that could make a profit as Johnson was simply compensated monthly for the service she provided. She was not allowed to ask for gratuities from BDI's clients and like any other employee, the more hours she worked the more money she made.

## CONCLUSION

In deeming Johnson to be an employee of BDI despite having acknowledged an independent contractor agreement, the Court highlights the importance of substance over form. As stated by Justice Archambault, if it "waddles like a duck, quacks like a duck and looks like a duck, it must be a duck".[6]

[3] *Ibid*, at para 122.
[4] *Ibid*, at para 121.
[5] *Ibid*, at para 158.
[6] *Ibid*, at para 171.

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## EDITOR'S CORRECTION

Please note a correction to footnote number 2 that appeared in "Bakorp Management Ltd. v H.M.Q.: CRA Settlements — When Losses Are Too Removed For Consequential Assessments", October 2018 — Issue 11-3.

The Correction is as follows: Bakorp Management Ltd. v H.M.Q. (25 January 2018), Toronto, TCC, 2015-1101 (IT)G (Transcript of Oral Reasons for Judgment) (Bakorp) at p. 14.