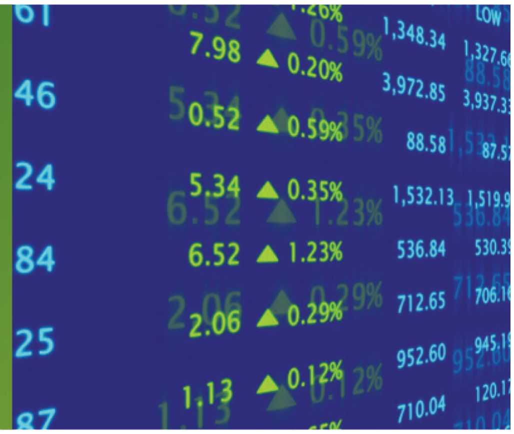
# TAXES & WEALTH MANAGEMENT




PRESERVING WEALTH FOR PEOPLE AND PRIVATE COMPANIES

## *BAKORP MANAGEMENT LTD. V. H.M.Q.*: CRA SETTLEMENTS – WHEN LOSSES ARE TOO REMOTE FOR CONSEQUENTIAL ASSESSMENTS

By John W. Grant, Partner, Miller Thomson LLP

This case presents two key aspects for practitioners and taxpayers when they are considering the application of consequential re-assessments. It reinforces the narrow scope of subsection 152(4.3), as originally pronounced in *Sherway Centre Ltd. v. R.* (*Sherway*),[1] and it invites taxpayers to pursue a *writ of mandamus* in the Federal Court compelling the Minister of National Revenue (Minister) to comply with the duty to consequentially reassess.[2]

For those not familiar with consequential reassessments, subsection 152(4.3) of the *Income Tax Act* (Act) sets out the terms for what is commonly referred to as the consequential reassessment provision.[3] This provision enables the Minister to reassess a taxation year outside the typical limitation periods provided in the Act.[4] The consequential reassessment provision allows (and at times requires) the Minister to make adjustments to taxation years that are otherwise statute-barred based on changes made to a preceding taxation year. Hence, this is a key section of the Act and practitioners should be aware of how the Minister and the Court interpret it.

In this case, the taxpayer was requesting the Minister to implement changes as a consequence of an earlier settlement pertaining to its 1989 taxation year (1989 Settlement). The taxpayer's earlier matter was settled after extensive litigation.

1 *Sherway Centre Ltd. v. R.*, 2003 D.T.C. 5082 (Fed. C.A.).

2 *Bakorp Management Ltd. v. R.*, 2016 CarswellNat 2874 (T.C.C. [General Procedure]) (Amended Judgment dated March 9, 2018, currently unreported) (*Bakorp*) at p. 14.

3 R.S.C. 1985, c. 1 (as amended).

4 Generally, as addressed in subsection 152(4) of the Act, a taxpayer shall be reassessed within the "normal reassessment period" unless the taxpayer has made a misrepresentation (that is attributable to neglect, carelessness, or wilful default, or has committed fraud) or where the taxpayer has filed a waiver.

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The result was a value attributed to shares and the determination of non-capital losses (NCLs) available to be carried forward.

Evidently, the taxpayer received a smaller than expected NCL carry-forward balance from the implementation of the 1989 Settlement. As a result, it appears that decisions were made by the taxpayer to rearrange the revised NCLs that were available. The taxpayer made a written request, pursuant to subsection 152(4.3) of the Act, to the Minister to reduce the amount of NCLs carried forward and already applied by the taxpayer in its January 1992 taxation year by $439,581 and, instead, apply $74,312 of available input tax credits in that year; thereby preserving the NCLs for the March 1992 taxation year.

The taxpayer filed its tax return for the March 1992 taxation year on the assumption that a consequential reassessment would be granted and based on the expected results from the 1989 Settlement. The Minister denied the appellant's request, and in doing so, took the position that the NCLs at issue had been claimed by the taxpayer already in its January 1992 taxation year, and therefore were not available to the taxpayer to claim in its March 1992 taxation year. The taxpayer argued that the Minister was required to give effect to the request because the conditions that give rise to the application of subsection 152(4.3) had been met.

The Court found that the appellant's request constituted *ex-post facto* (after-the-fact) tax planning that was not permitted by subsection 152(4.3). In essence, the Court found that the taxpayer was seeking to have the Minister bring the NCLs back into existence by compelling the Minister to issue a reassessment of the January 1992 taxation year in order to reallocate the NCLs to the March 1992 year.

## WHAT IS A CONSEQUENTIAL REASSESSMENT PER 152(4.3) – HOW CAN IT HELP/HURT THE TAXPAYER?

The Minister is required to issue a consequential assessment per subsection 152(4.3) when the following three conditions are met:

(1) the particular balance of a taxpayer for a taxation year — for a preceding taxation year referred to in the provision as a particular year — must be changed as a result of an (re)assessment[5] or a decision on appeal;

(2) the taxpayer must file a request in writing for a change in respect of the subsequent taxation year; and

(3) the reassessment that the taxpayer seeks to compel the Minister to issue must reasonably be considered to relate to the change in the particular balance of the taxpayer for the particular year. It is this third condition that preoccupies much of the jurisprudence in this area. In *Bakorp*, the Tax Court refers to the third condition as the causal numerical connection test.

Subsection 152(4.3) was enacted to allow the Minister to reassess outside the normal limitation periods in consequence of an assessment or an appeal that changed the balance of a taxpayer in a particular year, "but only to the extent that the reassessment ... can reasonably be considered to relate to the change in the particular balance of the taxpayer for the particular year". Subsection 152(4.3) is an exception to subsection 152(4), which provides that, with some specified exceptions, the Minister may only reassess a taxpayer within the taxpayer's normal reassessment period.[6]

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As such, to invoke 152(4.3), the requested (re)assessment **must be directly related** to the earlier (re)assessment. What exactly does directly related mean in respect of this provision? The Tax Court in *Bakorp* adopted the interpretation in *Sherway,* which indicates that "the reassessment . . . can reasonably be considered to relate to the change in the particular balance of the taxpayer for the particular year".[7] This is the causal numerical connection test — and it is a very mechanical application. In ruling in favour of the Minister for a narrow interpretation of the consequential reassessment provision, the Court echoed *Sherway* that a restrictive approach promotes fairness:

> (T)he interpretation propounded by *Sherway* could, in other circumstances, expose taxpayers to the uncertainty, and potential unfairness, caused by considerably longer reassessment limitation periods. It is the nature of limitation periods that their application will sometimes cause taxpayers to pay either more, or less, tax than they were legally obligated to pay.[8]

*Sherway* is consistent with the traditional rule of statutory interpretation that the application of exceptions to general rules should be strictly construed.[9] That is, the Consequential Reassessment Rule in subsection 152(4.3) is an exception to the general limitation periods set out in subsection 152(4) and was intended to operate only to the extent thereby provided.[10]

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5 In this instance, the reassessment was further to the 1989 Settlement.

6 Subsection 152(4.3), states: "For the purpose of subsection 152(4.3), a balance of a taxpayer for a taxation year is the income, taxable income, taxable income earned in Canada or any loss of the taxpayer for the year, or the tax or other amount payable by, any amount refundable to, or any amount deemed to have been paid or to have been an overpayment by, the taxpayer for the year.

7 *Sherway Centre Ltd. v. R.*, 2003 D.T.C. 5082 (Fed. C.A.) at para 17.

8 *Sherway Centre Ltd. v. R.*, 2003 D.T.C. 5082 (Fed. C.A.) at para 44.

9 Ruth Sullivan, *Sullivan and Driedger on the Construction of Statutes*, 4th ed. (Markham: Butterworths Canada Ltd., 2002) at p. 396.

10 *Bulk Transfer Systems Inc. v. R.*, 2005 D.T.C. 5192 (Eng.) (F.C.A.) at para 36

In disposing of the appellant's argument regarding the causal connection test, the Tax Court in *Bakorp* stated:

> The "relationship" depends entirely on the applicability of the legal principle used to determine the tax effects of payments received in one year to quite separate and independent payments received in subsequent years. *This is not the kind of relationship contemplated by subsection 152(4.3)*. [emphasis added]

Accordingly in the circumstances in *Bakorp*, the Court did not find it reasonable that the change requested by the taxpayer with respect to its January 1992 taxation year related to a change in the balance of its NCL for the 1987 taxation year. Where a certain legal basis for an assessment (such as a NCL balance) is the cause of a variation in a balance but there is no numerical causal connection between that changed balance and a desired adjustment for a subsequent taxation year, the consequential reassessment rule cannot be applied to reassess the subsequent taxation year.

The reasoning in *Sherway* acknowledges that, in certain circumstances, the Minister can be required to look behind the change in the numerical balance if to do so would be necessary to treat one half of a transaction in a manner that is consistent with the treatment of the other half.[11] The decision in *Alameda Holdings Inc. v. R.* (which predates *Sherway*) illustrates the restrictive numerical nature of the causal connection test.[12] In *Alameda*, the Court refused to allow the Minister to rely on subsection 152(4.3) to reduce the taxpayer's refundable dividend tax on hand (RDTOH) balance and corresponding dividend refunds in subsequent taxation years when the effect of the Minister's assessment, which followed a consent judgment, was to increase the taxpayer's RDTOH balance. The Court held that the reduction in the taxpayer's RDTOH balance "did not logically result from the change in the account balance determined by the assessment, following the consent judgment, since that balance was increased at that time."[13] Although it did not occur, this may have lent itself to the look behind the change in numerical balance that was eventually contemplated as an option in *Sherway*.

*Bakorp* has appealed the Tax Court's decision to the Federal Court of Appeal. It will be interesting to see whether the Federal Court of Appeal will shed light on circumstances where the Court will look beyond the numerical causal connection. It is clear that *Sherway* continues to be the leading case on the application of the consequential reassessment rule, and in particular the use of the causal connection test. As discussed, it certainly provides much of the basis for the reasoning in *Bakorp*.

***Takeaways — 152(4.3) reinforced as restrictive but mandamus a possibility***

We can be fairly certain that Courts will continue to narrowly interpret the circumstance in which a taxpayer can be consequentially (re)assessed. As demonstrated in *Sherway,* and now reiterated by the Tax Court in *Bakorp*, the Courts will interpret the application of the provision strictly.

In considering the *Bakorp* decision of the Tax Court, we should be mindful that while consequential assessments can be beneficial to a taxpayer, they can also be very detrimental — depending on whether the taxpayer or the Minister is pushing the consequential (re)assessment. Prior to the provision coming into force, it was widely expected by the tax bar and the government that the provision would have a broad application.[14] That has clearly not been the case. The restricted application of subsection 152(4.3) does perhaps limit Ministerial overreach while acknowledging the importance of limitation periods, and finality, in (re)assessing taxpayers. Consequently, this restrictive approach is likely here to stay.

In *obiter*, the Court in *Bakorp* resurrected the jurisdiction of the Federal Court in the context of consequential (re)assessment requests. The Court indicated that where the Minister refuses to issue a consequential reassessment upon a taxpayer's request, when the criteria are all present, relief could be sought in the Federal Court by way of a *writ of mandamus* compelling the Minister to comply with her statutory duty.[15] This invitation to seek judicial review was somewhat surprising. The language of subsection 152(4.3) indicates that if the criteria have been met, and when requested by the taxpayer, then the Minister shall consequentially reassess. The Court reasons that *Bakorp* cannot pursue this route as it is not disputing the decision of the Minister to not give effect to the request, but is merely disputing the quanta of NCLs available. There is a potential argument that this distinction is artificial.

For those dealing with consequential reassessments, we can expect the Minister to continue to suggest that the denial of a taxpayer's request for a consequential reassessment is not the failure to make a decision (i.e., presumably a judicial review to the Federal Court for *Bakorp*) but rather that subsection 152(4.3) criteria have not been met (i.e., a question of causal connection within the jurisdiction of the Tax Court). It is unclear exactly how a taxpayer would prove that all criteria have been met, in order to fall within the jurisdiction of the Federal Court, when that aspect clearly falls within the jurisdiction of the Tax Court. It seems that *Bakorp* has left the door open to further debate on the proper jurisdiction in which to challenge a request for consequential reassessment.

Aside from the door being slightly ajar for potential *mandamus* applications to the Federal Court, taxpayers should be aware of the highly restrictive nature of consequential reassessments.

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referring to *Sherway Centre Ltd. v. R.*, 2003 D.T.C. 5082 (Fed. C.A.) at para 20.

11 *Sherway Centre Ltd. v. R.*, 2003 D.T.C. 5082 (Fed. C.A.) at para 17.

12 *Alameda Holdings Inc. v. R.* (1999), [2005] 3 C.T.C. 2009 (T.C.C. [General Procedure]).

13 *Alameda Holdings Inc. v. R.* (1999), [2005] 3 C.T.C. 2009 (T.C.C. [General Procedure]) at para 84.

14 "Tax Litigation: Reassessments — the consequential reassessment rule", Tax Litigation Journal, Volume XIX, Issue No. 3 (2015), Thomson Reuters Canada Limited; CRA Views, Documents 9524846, "Consequential assessment" (Date: November 14, 1995); Edwin G. Kroft, QC, Ian S. MacGregor, Jane Meagher, and Al Meghji, "Legislative, Administrative, and Judicial Developments: Currents Cases," *Report of Proceedings of the Fifty-Fifth Tax Conference*, 2003 Conference Report (Toronto: Canadian Tax Foundation, 2004), 9:1–16.

15 *Bakorp* at p. 14.

## TAXATION OF CRYPTOCURRENCIES & TOKENS (PART II) – FORKING-UP TAXES ON FORKS?

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

## INTRODUCTION

As the looming threat of cryptocurrency regulation in the area of securities continues to monopolize the public limelight, little attention by Canadian governmental authorities is being given to the taxation of transactions involving tokens.[1] Yet, the Canadian government's position is unequivocal: "[t]ax rules apply to digital currency transactions, including those made with cryptocurrencies."[2] The Canada Revenue Agency ("CRA") has nevertheless neglected to provide taxpayers with administrative guidance on the tax implications of a slew of cryptocurrency transactions, including in connection with, *inter alia*, entering into a simplified agreement for future equity or tokens (a "SAFE" or "SAFT"), partaking in an initial token offering ("ITO") or engaging in an airdrop or fork as either issuer or recipient. Unfortunately, the absence of such guidance does not exempt taxpayers in a self-assessment system from their obligation to compute and remit their taxable income for a given taxation year in respect of such cryptocurrency transactions.

The following article is the second of a series of four articles,[3] each examining particular transactions involving tokens and considering the tax treatment applicable thereto under the *Income Tax Act* (Canada)[4] and, where applicable, the *Excise Tax Act* (Canada).[5] We here introduce the concept of a "hard fork" and consider certain Canadian federal income tax considerations applicable to holders of original tokens.

## I. AN OVERVIEW OF A HARD FORK[6]

A hard fork consists in a modification (presumably an "*upgrade*") to the blockchain protocol of a cryptocurrency, the effect of which is a binary split (or branching) of its blockchain into two viable and competitive alternatives: the original and a new "forked" token. A hard fork will only occur if there is sufficient support (i.e., economic investment and hashing power) among miners of the original token for both the original and the upgraded blockchain protocols to coexist. Up to the time of the hard fork, both the original and forked token will have a shared blockchain (ownership) history.[7] Upon the occurrence of a hard fork, a holder of the original token will be granted the opportunity to claim control of new tokens — usually in an amount proportionate to the holder's share of original tokens. Transactions involving new tokens will only be verified by miners supporting the new blockchain protocol and will be recorded separately on a new independent ledger; transactions involving original tokens will only be verified by miners having rejected the modifications to the blockchain protocol and such transactions will continue to be reflected in the original ledger. Accordingly, a holder will be able to transact in either of the original or forked tokens.

Such hard forks result in the creation of a new asset with some value and, as such, have been responsible for the generation of considerable value. Such an accretion in value to holders of original tokens certainly begs the question of whether holders of original tokens realize income as a consequence of a hard fork.

## II. CANADIAN FEDERAL INCOME TAX CONSIDERATIONS

### (i) A Hard Fork – Payment from an (un)Enumerated Source

For already a few years, Canadian resident taxpayers have gained control of forked tokens having some value while already holders of other tokens. Consequent to a hard fork, such holders are granted the opportunity to claim control of new tokens — at no pecuniary cost. However, control is not automatic. The initiators of the new protocol provide the holders of the original tokens with downloadable software to be installed on the holder's computer with which such holder can gain control over the new tokens.[8] The holders can then begin to transact with the new tokens. The initiators will obtain an indirect financial return as the token holders begin to transact with the new tokens. While these initiators are undoubtedly engaged in a business, the potential tax liability of the original token holders is uncertain. In fact, the CRA has yet to provide any guidance with respect to the tax considerations relevant to a hard fork. This begs the question: under what circumstances are these forked tokens taxable in Canada? The requisite answer must necessarily be, at the time at which the holder realizes "income from a source".

For Canadian federal income tax purposes, tax will be exigible in respect of a payment to a taxpayer provided such amount is traceable to an identified "source" of income under the ITA. Paragraph 3(a) of the ITA enumerates four sources of income — namely, (i) office, (ii) employment, (iii) business, and (iv) property — to which should be added capital gains.[9] Where a particular payment does

1 The terms "cryptocurrency", "coin(s)" and "token(s)" are used interchangeably 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 the distinguishing features of each type of token.

2 Government of Canada website: https://www.canada.ca/en/financial-consumer-agency/services/payment/digital-currency.html#toc3.

3 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. Subsequent articles will address, in succession: (i) tax considerations in structuring an initial offering of tokens; and (ii) the tax treatment of losses arising from fraud, theft or embezzlement of cryptocurrencies & certain other off-market transactions.

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

5 R.S.C., 1985, c. E-15.

6 A "hard fork" is to be contrasted with a "soft fork". Both involve bringing modifications to a cryptocurrency blockchain protocol. The latter, however, does not result in a split or branching of the cryptocurrency's protocol. A soft fork will occur where the updated protocol remains compatible with the prior version and cryptocurrency miners signal consensus through continued mining activities.

7 The forked token will share a common ownership history with the original token, as reflected in the original token's ledger, up until the time of the hard fork. The concept of a shared history is consistent with the immutable nature of a blockchain. That being said, Ethereum Classic stands out as an exception to this fundamental principle. The 2016 fork of Ethereum involved a "retroactive" fork (prior to the initial coin offering of the Decentralized Autonomous Organization (DAO)) of the Ethereum blockchain protocol resulting in the generation of Ether and maintenance of Ethereum as Ethereum Classic.

8 Currently, centralized exchanges act as custodians of their customer's private keys. In the event of a hard fork, the holder must control the private key associated with such holder's address on the original blockchain in order to gain control of the forked tokens. Accordingly, where an exchange does not support the hard fork, the holder may be required to take further actions, incurring additional costs and delays, in order to gain access to the new tokens.

9 It should be noted that upon undertaking a textual interpretation of the

not fall under an enumerated source in the ITA, Canadian courts have generally excluded such payments from a taxpayer's income as not constituting income from a source.[10] Under the circumstances, there are reasonable arguments to the effect that forked tokens do not constitute income from a source.[11] Accordingly, a holder of original tokens should not realize taxable income for Canadian federal tax purposes either at the time of a hard fork or upon gaining control of the new tokens.[12]

### (ii) Disposition of Forked Tokens – Quantum & Character

That being said, a holder of forked tokens will realize a gain upon a subsequent disposition of the token. At that time, it will be necessary to determine the amount of such gain, which will be equal to the excess of the fair market value over the adjusted cost base ("ACB") of such tokens. Accordingly, a holder must need to establish the fair market value of the new tokens at the time at which the formalities requisite for taking control of such tokens have been completed. There exist a number of competing views regarding the ACB of forked tokens at that time, namely:

i) the price at which such tokens are traded on a cryptocurrency exchange

ii) the estimated price at which such tokens will trade at that time as determined by the futures market;

iii) that proportion of the ACB of the original tokens allocable to the forked tokens; and

iv) a value of zero (i.e., *nil*).

The better and more accurate approach would be to use the futures price, if available, and alternatively the exchange price. However, with a view to maximizing the collection of taxes, the CRA may very well favour either dividing the ACB of the original tokens between the original and forked tokens, or taking a *nil* position.[13] That being said, given the often significant differences amongst hard forks, taxpayers would be greatly disadvantaged by the adoption of a one-size-fits-all approach by the CRA to the computation of the ACB of forked tokens.

Finally, the character of a gain realized (or loss incurred) on the disposition of forked tokens must be considered. Such a gain (or loss) will be on account of income or capital; the latter being subject to a much more advantageous tax rate. Indeed, different tax character will result in the application of different tax rates, rules

preambles to paragraph 3(a) and subsection 56(1) of the ITA, the named sources of income are not exhaustive. Ostensibly, income can be considered to arise from an unnamed source.

10 See, for example, *R. v. Fries*, [1990] 2 S.C.R. 1322 (S.C.C.). The Supreme Court of Canada held that strike pay was not "income . . . from a source" within the meaning of paragraph 3(a) of ITA. The Supreme Court of Canada appeared to be reluctant to find the gain to be from an un-enumerated source and consequently taxable. See also *Schwartz v. R.*, [1996] 1 S.C.R. 254 (S.C.C.). The Canadian source-based approach is inherently different from the taxation approach adopted by the United States. The Internal Revenue Code (US Code: Title 26) provides for the taxation of any accretion to wealth over which a taxpayer has dominion and control (*Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955)). See Tyson Cross, "Yes, The Bitcoin Hard Fork Really Is Taxable Income. Here's What You Need To Know" (Forbes, October 17, 2017):https://www.forbes.com/sites/tysoncross/2017/10/17/yes-the-bitcoin-hard-fork-really-is-taxable-income-heres-what-you-need-to-know/#14314c302d07.

11 It is useful to refer to Justice Iacobucci's comment in *Ikea Ltd. v. R.*: "Ikea submitted that Bowman J. premised his conclusion on the improper assumption that simply because the receipt was not capital, it was therefore income. Certainly, it is possible that a given receipt might constitute neither capital nor income for the purposes of the Act; if it is not received from a "source" of income, as that term has been judicially defined, an amount may not be taxable at all: see, for example, *Schwartz v. R.*, [1996] 1 S.C.R. 254 (S.C.C.). Each receipt must be considered individually in order to ascertain its true character, and it would certainly be improper to classify a receipt as income automatically upon the determination that it is not capital" ([1998] 1 S.C.R. 196 (S.C.C.) at para 27). See also, *Johnson v. R.*, 2011 TCC 540 (T.C.C. [General Procedure]) (rev'd on appeal).

12 Notwithstanding the foregoing, we considered whether a holder's entitlement to forked tokens could constitute either a windfall or a gift. Canadian tax law exempts both windfalls and gifts from being included in computing a recipient's income. That a hard fork is unsolicited, generally unpredictable, and that the forked tokens come at no pecuniary cost to the holders of original tokens, are certainly elements that support either or both characterizations. However, adopting such a filing position will likely attract the scrutiny of the CRA. The claim that the forked tokens are received by a holder as either a windfall or a gift may be easily dismissed; with respect to the former, by the fact that cryptocurrency holders anticipate or, and at the very least, should not consider hard forks to be unusual, and in the case of the latter, the issuer would be hard pressed to claim that the forked tokens are intended as gifts. The CRA has provided guidance with respect to windfall receipts. Factors in favour of such a characterization include the following: (a) the taxpayer had no enforceable claim to the payment; (b) the taxpayer made no organized effort to receive the payment; (c) the taxpayer neither sought after nor solicited the payment; (d) the taxpayer had no customary or specific expectation to receive the payment; (e) the taxpayer had no reason to expect the payment would recur; (f) the payment was from a source that is not a customary source of income for the taxpayer; (g) the payment was not in consideration for or in recognition of property, services or anything else provided or to be provided by the taxpayer; and (h) the payment was not earned by the taxpayer as a result of any activity or pursuit of gain carried on by the taxpayer and was not earned in any other manner (Income Tax Folio S3-F9-C1, Lottery Winnings, Miscellaneous Receipts, and Income (and Losses) from Crime (November 24, 2015)). See also *R. v. Cranswick*, [1982] C.T.C. 69 (Fed. C.A.). Investors in cryptocurrencies are now aware, or should be aware, of the possibility of a hard fork such that there may very well be reason to expect to gain forked tokens. In fact, some investors have even begun to speculate on the likelihood of a hard fork in making investments in cryptocurrencies. A gift is generally defined as a voluntary and gratuitous transfer of property from one person to another absent any consideration (*Black's Law Dictionary*, 7th ed., Garner, B.A., Editor, (Minnesota, West Group, 1999)). For there to be a gift, the donor cannot benefit, either directly or indirectly, from the transfer (see e.g., *Canada (Minister of National Revenue) v. Burns*, 88 D.T.C. 6106 (Fed. C.A.); *Hudson Bay Mining & Smelting Co. v. R.* (1986), 86 D.T.C. 6244 (Fed. T.D.); and *McBurney v. R.* (1985), 85 D.T.C. 5433 (Fed. C.A.). In addition, value is likely to accrue to the initiators of the hard fork as holders transact with the new tokens; not to mention that the holders must suffer the inconvenience of completing the actions necessary for gaining control of the tokens (see *e.g., Carlill v. Carbolic Smoke Ball Co.* (1892), [1893] 1 Q.B. 256 (C.A.)). In addition to these non-taxable scenarios, common commercial transactions do not provide a likely basis for the taxation of a hard fork. A cursory study of the Canadian tax system suggests that the most pertinent comparables include a declaration and payment of a cash or stock dividend, a distribution of partnership income, a divisive reorganization (*a.k.a.,* spin-off transaction) or a stock split. While each of the foregoing certainly share similarities with a hard fork, neither is sufficiently analogous to a hard fork to be a basis for its taxation. For one, the tax treatment of dividends, divisive reorganizations and stock splits is determined under statutory rules which specifically reference "shares"; and although cryptocurrencies are property, they are not treated as "shares" for Canadian tax purposes. Extending these rules to a hard fork will require the intervention of Parliament.

13 There are reasonable arguments that can be presented to the effect that the cost base might very well be nil. For example, there may not be a readily available market for the new tokens such that it would not be possible to determine the fair market value with any accuracy. The generally accepted definition of fair market value is the following: "[t]he highest price available in an open and unrestricted market between informed and prudent parties, acting at arm's length and under no compulsion to act, expressed in terms of cash."

and permitted items that can offset such income or capital gains. The treatment to be afforded a gain (or loss) on a holder's disposition of forked tokens will depend entirely on the facts at hand.[14]

## IV. CONCLUSION

For some time now, hard forks have been an enduring feature of the evolving cryptocurrency landscape. As reflected by the foregoing discussion, clear guidance from the CRA (and Revenu Quebec) would certainly be welcome. In the absence of such guidance, taxpayers will continue to be susceptible of making mistakes in filing their tax returns and consequently at risk of being held liable for penalties and interest. Such a result is profoundly inconsistent with the virtues of consistency, certainty, predictability and fairness, which are the intended drivers of our tax system.[15]

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# US FEDERAL INCOME TAXATION OF NON-US CITIZENS

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## US CITIZENS ARE SUBJECT TO US FEDERAL INCOME TAX ON THEIR WORLDWIDE INCOME

For US federal income tax purposes, an "alien" is an individual who is not a US citizen. As a general rule, "resident aliens" are subject to US federal income tax on their worldwide income. In contrast, "nonresident aliens" are generally subject to US federal income tax only on their US source "passive" income and on income effectively connected with the conduct of a trade or business in the US.

## RESIDENT ALIEN OR NONRESIDENT ALIEN?

Aliens are treated as nonresident aliens for US federal income tax purposes unless:

i. They are "lawful permanent residents" of the US (i.e., holders of an "alien registration card", commonly referred to as a "green card"); or

ii. They meet the "substantial presence test".

Therefore, a non-citizen and non-green card holder will be treated as a resident alien for US federal income tax purposes only if he or she meets the substantial presence test. However, even if an individual meets the substantial presence test they will be treated as a nonresident alien if they also meet the "closer connection test".

## SUBSTANTIAL PRESENCE TEST

In determining whether or not an individual meets the substantial presence test for the 2018 tax year, the individual must be physically present in the US on at least:

1. 31 days during 2018, and
2. 183 days during the 3- year period that includes 2018, 2017 and 2016, counting:
   a. All of the days that the individual was physically present in the US in 2018;
   b. 1/3 of the days that the individual was physically present in the US in 2017; and
   c. 1/6 of the days that the individual was physically present in the US in 2016.

The substantial presence test is to be applied on an annual basis. A particular individual's status under the substantial presence test can change from year to year. For the purposes of the substantial presence test, an individual is treated as being physically present in the US on any day that the individual is physically present in the country at any time during the day.

There are certain exceptions to the above-noted rule that an individual is treated as being physically present in the US on any day that the individual is physically present in the country at any time during the day, including the exception for regular commuters to the US from Canada and Mexico, days that an individual is in the US for less than 24 hours when they are in transit between two places outside of the US and days that an individual is unable to leave the US due to a medical condition that arose while they were in the US.

The most important exception is the one for days that an individual was an "exempt individual". That is, days that the individual was physically present in the US but for which he or she was an exempt individual do not count in the determination of whether or not the individual meets the 183 day threshold for the purposes of the substantial presence test. The term exempt individual includes individuals temporarily present in the US as foreign government related individuals, certain teachers and trainees and certain students.

## CLOSER CONNECTION TO A FOREIGN COUNTRY

As noted above, an individual who meets the substantial presence test will nevertheless be treated as a nonresident alien if he or she also meets the closer connection test.

In order to meet the closer connection test, an individual must:

- Be present in the US for less than 183 days during the year,
- Maintain a "tax home" in a foreign country during the year, and
- Have a "closer connection" during the year to one foreign country in which the individual has a tax home than to the US.

[14] Canadian courts have looked principally to the taxpayer's intention at the time the property is acquired in order to determine the character of a gain. If a taxpayer acquires property with the intention to resell the property at a profit (i.e., trade), then any gain or loss should be treated as income from a business. The sale of long term investments, on the other hand, should receive capital gains treatment. In the case of forked tokens, it would be consistent with the above analysis for the primary intention of the taxpayer to be assessed at the time at which the taxpayer gains control over the new tokens.

[15] A sound approach might be for the CRA and Revenu Quebec to adopt a safe harbor rule until taxpayers can be provided further certainty. See, for example, letter to the Internal Revenue Service from the American Bar Association requesting the adoption of a safe harbor provision: https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/031918comments2.authcheckdam.pdf.

An individual's tax home is the general area of the individual's main place of business, employment or post of duty, regardless of where he or she maintains their family home. An individual's "tax home" is the place where they permanently or indefinitely work as an employee or as a self-employed individual.

As a general rule, an individual will be considered to have a closer connection to another country than to the US if it is established that the individual has maintained more significant contracts with the foreign country than with the US. Some of the factors that are evaluated in making the determination include the location of the individual's permanent home, where the individual's family resides, the location of the individual's business activities and the country of residence that the individual designates on forms and documents.

## POSSIBLE APPLICATION OF INCOME TAX TREATIES

In general, where an individual is considered to be a resident of both the US and a foreign country under the domestic laws of each country, the individual's residency status for income tax treaty purposes is determined by the successive application of a series of residency "tie-breaker" rules. Most (if not all) bilateral income tax treaties entered into between the US and other countries include residency tie-breaker rules. For example, under the Canada-US Income Tax Treaty, the first test prong of the residency tie-breaker tests is the location of the individual's "permanent home". If the individual has a permanent home in both jurisdictions (or in neither jurisdiction), the next test is where is the individual's "centre of vital interests". As a general rule, a taxpayer's centre of vital interests is considered to be where his or her personal and economic relations are closer. The location of an individual's centre of vital interests is determined by examining his or her family and social relations, occupation, political, cultural and other activities, place of business, and the place from which his or her property is administered.

In almost all cases, the determination of a single state of residency is made by applying the centre of vital interests prong of the residency tie-breaker tests. In those cases where an individual's single state of residency still cannot be determined by applying the centre of vital interests test, factors such as "habitual abode" and citizenship are considered. Where application of all the residency tie-breaker tests does not give rise to the conclusion that a particular individual is a resident of one Contracting State and not the other, the determination is to be made by mutual agreement of the competent authorities of the two Contracting States.

An individual who is determined to be a resident of a foreign country (and not the US) by application of treaty residency tie-breaker rules is treated as a nonresident of the US for the purposes of determining his or her US federal income tax liability.

## US FEDERAL INCOME TAXATION OF NONRESIDENT ALIENS

Nonresident aliens are subject to US federal income tax on two separate and distinct categories of income:

(i) income that is effectively connected with the conduct of a trade or business in the US (referred to as "ECI"); and

(ii) income that is not ECI.

### Taxation of Effectively Connected Income

ECI is taxed at the same graduated income tax rates that apply to citizens and resident aliens. The most common type of income of a nonresident alien that is considered to be ECI is income derived from the provision of personal services in the US. Other examples of types of income of a nonresident alien that are considered to be ECI include scholarship or fellowship income received by a student or trainee, income derived from the ownership and operation of a business in the US and income allocated to a nonresident partner by a partnership that is engaged in a trade or business in the US.

### Taxation of Non-Effectively Connected Income

Nonresident aliens who are not actively engaged in the conduct of a US trade or business (i.e., passive investors) are subject to US federal withholding tax on Fixed or Determinable, Annual or Periodical ("FDAP") income which they receive from US sources.

## FIXED OR DETERMINABLE, ANNUAL OR PERIODICAL INCOME

FDAP income is generally passive investment income and includes dividends, interest, rents and royalties. The US federal withholding tax rate on US source FDAP income is 30%. However, the 30% domestic withholding rate on FDAP income may be reduced under the provisions of an applicable income tax treaty entered into between the US and the nonresident alien recipient's country of residence. For example, under the terms of the Canada-US Income Tax Treaty, the general withholding tax rate on dividends that can be imposed by the country of source is 15% and the withholding tax rate on interest that can be imposed by the country of source is zero percent.

Under US tax principles, interest and dividend income received by a non-resident payee are considered US source income if the payer of the income is resident in the US. Rents are US source income if the rental producing property is located in the US. Similarly, royalties paid for the use of intellectual property are US source income if the intellectual property is used in the US.

Non-resident recipients of US source income are able to establish their right to treaty-reduced withholding rates by timely submitting certain Internal Revenue Service ("IRS") forms to the payer of the income. The withholding forms do not have to be filed with the IRS. Payers of the income are generally entitled to rely on such withholding forms to withhold at the applicable treaty reduced rate, and not at the otherwise applicable US domestic withholding tax rate of 30%.

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## *CLICC V. CANADA (ATTORNEY GENERAL)*: EQUITY'S LAST STAND

By Hunter Norwick, Summer Law Student (2018), Miller Thomson LLP

The recent ruling in *Canada Life Insurance Company of Canada v. Canada (Attorney General)* ("*CLICC*")[1] is very much worth fretting about. The Ontario Court of Appeal's ("ONCA") decision comprehensively denies any role for equity to correct transactions that inadvertently incur tax liabilities. As *CLICC* demonstrates, this regime of zero-tolerance means that even the slightest tax planning imperfection may carry a heavy cost.

### THE FACTS

In December 2007, Canada Life Insurance Company of Canada ("CLICC") entered into a series of transactions to realize a tax loss of $168,000,000 that would offset gains of a similar amount. Nearly five years later, the CRA issued a Notice of Reassessment that disallowed CLICC from deducting its losses. CLICC had made a multi-million dollar mistake. Because CLICC GP — the general partner in a partnership in which CLICC was a limited partner — was wound up in December 2007 and not April 2008, the transaction was caught by s. 98(5), a "roll-over" provision of the *Income Tax Act*.[2]

Denuded of all its turgid language, subsection 98(5) simply states that, upon the dissolution of a partnership, if a former partner intends to realize its losses from any decline in the value of its interest in that partnership, it must avoid either:

(1) carrying out that partnership's business as a sole proprietor within a period of three months subsequent to that partnership's dissolution; and

(2) using the property it received as proceeds of disposition for its interest in the partnership to carry out the business described in (1).

CLICC managed to satisfy both.

Initially, the application judge issued an order to "rectify" CLICC's mistake. But when the case reached the ONCA, the SCC in *Fairmont Hotels* had already precluded rectification from being used to generate better tax consequences. Consequently, CLICC sought two other equitable remedies on appeal: (1) the court's inherent jurisdiction to relieve a party from the effects of its mistake in the interests of fairness and equity; and (2) relief based on the equitable remedy of rescission.

### RECTIFICATION'S TORTUOUS ROAD

CLICC justified its access to an equitable remedy on the grounds that the CRA would not suffer any prejudice and would only be deprived of a windfall. This was thoroughly rejected by the ONCA. To understand the court's reasoning, a brief survey of the four most relevant tax cases is required. They are: *Bramco*, *Juliar*, *Fairmont Hotels,* and *Jean Coutu*.[3]

In *Bramco*, Ms. Ho, the owner of two companies, incurred an unintended tax liability of $1,700,000 after she transferred land to her company that was considered a non-resident. Had she transferred it to her other company, the tax payable would have been a mere $84,745. Despite feeling "sympathetic," the ONCA refused to correct her mistake. As Justice Galligan put it: "tax liability is based upon what happened, not upon what, in retrospect, the taxpayer wish had happened."[4]

The court in *CLICC* divided *Bramco's* ratio into two prongs. The first prong established that "[r]ectification [is] unavailable in circumstances where the transaction had achieved its intended purpose."[5] The second prong precluded the use of the court's inherent jurisdiction to correct mistakes because (a) "courts do not look with favour upon attempts to rewrite history in order to obtain a more favourable tax treatment," and (b) equity will not intervene when there are alternative remedies provided by law.[6]

*Bramco's* first prong underwent major modifications over the past two decades. In *Juliar*, a rectification order was issued to allow for better tax consequences. The ONCA "distinguished" *Juliar* from *Bramco* on the grounds that Ms. Ho, unlike the Juliars, did not have the required "continuing intention" to avoid incurring a tax liability when conducting the relevant transactions. But, in fact, *Bramco* was not distinguished — it was overruled. After *Juliar*, rectification expanded to enable parties to substitute or revoke a transaction, provided the parties had a continuing intention to achieve a tax outcome that was not realized because of a mistake.

Then came *Fairmont Hotels*. Here, the SCC defined the "intentions" of parties separate from their "motives." A party's "true intention" now spoke to the transaction itself, not the tax objectives it otherwise would have served. Thus, the doctrine of rectification was restored to its pre-*Juliar*, post-*Bramco* status.

### THE COURT'S INHERENT JURISDICTION TO CORRECT MISTAKES – FORGOTTEN BUT STILL THERE

CLICC could not access equitable remedies primarily because it overlooked — or hoped to simply avoid — *Bramco's* unscathed second prong. Justice Rensburg recognized not only that *Bramco's* impediments to the intervention of equity still stood, but that they now enjoyed the support of the SCC through its rationale in *Fairmont Hotels* and *Jean Coutu*.

Consequently, all three of CLICC's attempts to circumvent the SCC's restrictive stance on equity failed.

(1) The ONCA rejected CLICC's argument that its request to simply delay/cancel CLICC GP's wind up somehow distinguished it from the ruling in *Fairmont Hotels*, which focused specifically on rectifi-

1 *Canada Life Insurance Company of Canada v. Canada (Attorney General)*, 2018 ONCA 562 (Ont. C.A.) [*CLICC*].

2 *Income Tax Act,* R.S.C. 1985, c.1 (5th Supp), s 98(5).

3 *771225 Ontario Inc. v. Bramco Holdings Co.*, 1995 CarswellOnt 194 (Ont. C.A.), leave to appeal refused (1995), 48 R.P.R. (2d) 320, [1995] S.C.C.A. No. 147 (note) (S.C.C.) [*Bramco*]; *Juliar v. Canada (Attorney General)*, 2000 CarswellOnt 3518 (Ont. C.A.), leave to appeal refused 2001 CarswellOnt 1805 (S.C.C.) [*Juliar*]; *Canada (Attorney General) v. Fairmont Hotels Inc.*, 2016 SCC 56 (S.C.C.), reversing *Fairmont Hotels Inc. v. Canada (Attorney General)*, 2015 ONCA 441 (Ont. C.A.) [*Fairmont Hotels*]; *Jean Coutu Group (PJC) Inc. v. Canada (Attorney General)*, 2016 SCC 55 (S.C.C.) [*Jean Coutu*].

4 *Bramco* at para 9.

5 *CLICC* at para 49.

6 *Ibid*. at para 92.

cation and not equity generally. Justice Rensburg clarified that the precedent emerging out of *Fairmont Hotels* and *Jean Coutu* clearly militates against equity substituting *any* series of transactions for another series to avoid an unintended tax result. The chosen vehicle for this substitution is immaterial.

(2) CLICC argued that since it implemented the transactions with a continuing intention to achieve a taxable loss, it was not engaging in retroactive tax planning. That, too, was rejected. Attempting to escape a tax liability, even one inadvertently incurred while trying to avoid taxes, falls squarely within the proscribed activity of retroactive tax planning. As Justice Wagner put it in *Jean Coutu*: a broader reading of rectification (read: equity) would allow taxpayers to "immunize themselves from unforeseen tax consequences. . . [and that this would provide a] catch-all insurance for their inadvertence or mistakes, or for those of their tax advisor, in planning transactions."

(3) Finally, CLICC relied on *TCR Holding* where the court set aside an amalgamation that incurred an unintended liability against a third party. However, the ONCA found that the court set aside the amalgamation to prevent unjust enrichment, not to prevent unintended tax liabilities. And since *Fairmont Hotels* held that unintended tax liabilities do not amount to unjust enrichment for the government, *TCR* provided no assistance to CLICC's claim.

## EQUITABLE RESCISSION – EQUITY'S LAST STAND

As a last ditch effort, CLICC requested relief in the form of rescission. CLICC relied on the B.C. Court of Appeal's decision in *Re Pallen Trust*, which established an equitable remedy to achieve certain tax consequences, even when rectification was unavailable.

The remedy was fixed to apply only to voluntary transfers of property. CLICC, however, despite its claims to the contrary, was trying to rescind a *contract* entered into by mistake. Thus, Rensburg J. subjected CLICC's claim to the governing, four-part test in *Miller Paving Ltd. v. B. Gottardo Construction Ltd.*:

(a) the parties were under a common misapprehension of the facts or their respective rights;

(b) the misapprehension was fundamental;

(c) the party seeking to set the contract aside was not itself at fault; and

(d) one party will be unjustly enriched at the expense of the other if equitable relief is not granted.[7] None of these conditions were either satisfied or argued by CLICC.

The ONCA added that rescission is an all or nothing remedy. CLICC's request to only rescind part of the transaction is a remedy found neither in law nor equity. For the court to grant rescission, it would have to restore CLICC to the position it occupied immediately before the transactions, which would not fulfill CLICC's objective of realizing a taxable loss.

[7] *Miller Paving Ltd. v. B. Gottardo Construction Ltd.*, 2007 ONCA 422 (Ont. C.A.) at paras 29-32.

## QUESTIONS OUTSTANDING

Reading through *CLICC,* one cannot help but notice the creeping annexation of equity by the SCC's rationale in *Fairmont Hotels*. First, the SCC truncated rectification. Then, the ONCA hollowed out the "inherent jurisdiction" of courts to correct mistakes. And finally, the requirements for rescission were divined as insurmountable for all parties attempting to secure more favourable tax consequences. But despite a near-comprehensive blow to equity, a couple of questions remain outstanding.

1. *Bramco*, and now *CLICC*, held that the availability of a legal remedy precludes a party seeking recourse in equity. But what if the fairness of the legal recourse is wanting? Indeed, allowing for equity's intervention in the absence of a legal remedy, but barring it even when the law's recourse is unsatisfactory, hardly fulfills equity's goals of providing fair, practical justice.

2. Do courts even have the inherent jurisdiction to correct mistakes under equity? The ONCA sidestepped this question in both *CLICC* and *Bramco*. *CLICC* also avoided determining the existence of a remedy of equitable rescission — to effect a tax objective — in the event there was a "voluntary distribution." The Court's silence on this issue may hinder future attempts by parties to access this remedy, especially since policy considerations enunciated in *Bramco*, *Fairmont*, and *Jean Coutu* appear to tilt against its availability.

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## INTERNATIONAL TAX EVASION & MONEY LAUNDERING RISES TO NEW HEIGHTS[1]

By David S. Kerzner, Ph.D., Kerzner Law and David W. Chodikoff, Editor-in-Chief of *Taxes & Wealth Management* and Partner, Tax & Customs Dispute Resolution Group at Miller Thomson LLP

On September 14, 2018, Paul Manafort pleaded guilty to two of the seven charges he faced the previous month in a Federal Court in Virginia — conspiring to defraud the United States and conspiring to obstruct justice. Manafort, was convicted in August 2018 of crimes involving tax and bank fraud. Although Manafort was not required to enter a guilty plea on all of the charges he faced at trial, Manafort was required to admit to the facts contained in the prosecution's Superseding Criminal Information which detail his perfidious actions involving bank fraud and money laundering and other illegal actions.

Manafort, who held the position of campaign manager for President Donald Trump, generated more than $60 million in income as a result of acting as an agent of the Government of Ukraine and a political party in that country. From approximately 2006-2016, Manafort, with assistance, laundered money through numerous US and foreign corporations, partnerships and bank accounts. In fur-

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therance of these fraudulent schemes, Manafort channeled millions of dollars in payments into foreign nominee companies and bank accounts opened by him and straw underlings in nominee names and in various countries including Cyprus (13 entities), Saint Vincent & the Grenadines and the U.K.

Manafort used these offshore accounts to purchase multi-million dollar properties in the US. Manfort then borrowed millions of dollars in loans using these properties as collateral, enabling him to obtain cash in the US without reporting and paying approximately $15 million of taxes owed on his income to the IRS. Manafort laundered more than $30 million to buy property, goods and services in the US. As part of his scheming, Manafort, avoided paying taxes by disguising tens of millions of dollars in income as alleged 'loans' from nominee offshore corporate entities and by making millions of dollars in unreported payments from foreign accounts to bank accounts controlled by him and by various US vendors. Manafort also used the offshore accounts to purchase real estate in the US and to make improvements to and refinance his properties in the US.

The legal arrangements and financial shenanigans employed by Mr. Manafort while malevolent in their intentions are hardly unique and are rather standard fare served up in these kinds of offshore criminal pursuits. Interestingly, both Cyprus and St. Vincent and the Grenadines failed the OECD's early reviews for standards on availability of information to meet the standards of transparency in exchange of information. It remains to be seen whether Mr. Manafort would have been detected and prosecuted at all without the spotlight which was shone upon him as part of the probe being conducted by Special Counsel Robert S. Mueller III. Although touted as the new messiah to end tax evasion by fiscal authorities everywhere, exchange of information through FATCA and its offspring, the Common Reporting Standard, are profoundly flawed and enable rather than disable the worst offenders of tax and financial crimes. Due to a combination of extraordinary complexity making these systems impossible to understand, reliance on honest certifications from taxpayers who can cheat with one stroke of the pen, and tax havens which have neither the infrastructure to support transparency nor the incentive to dig through the maze of legal structures and trickery, the Manaforts of the US and Canada can and are continuing unabated in their criminal activities. Perhaps the most shocking aspect of these recently discovered crimes by those in the Pantheon (Michael Cohen included) is that they are occurring and thriving many years after the Swiss Bank scandals of UBS, and years after the Panama Papers and the Paradise Papers. Neither the Canadian nor the American policies to combat international tax evasion, money laundering, and financial crime seem to be deterring people of the means to benefit from our society without paying their share.

In Canada, over the past several years, the government has invested hundreds of millions of dollars in an effort to staff the Canada Revenue Agency (the "CRA") and to improve its technology and related investigative needs in order to crackdown on tax evasion and tax fraud. In March 2018, it was reported that as a result of the leak of secretive information contained in the Panama Papers, the CRA planned 150 audits.[2] However, the leak of offshore financial records contained the names of more than 625 Canadians. Given the numbers of Canadians named in the Panama Papers, one would have expected that there would be more than 125 CRA audits. The Panama Papers leak was brought to the public's attention in April 2016 and a month later the CRA has obtained all of the information through various channels. More recently, in November 2017, the International Consortium of Investigative Journalists (the "ICIJ") published information about more alleged illegal offshore tax activity in the Paradise Papers. The information contained in the Paradise Papers named 2,700 Canadians. Exactly how many of the 2,700 Canadians are now under audit by the CRA has not been publicized. Yet, the first person named in the Panama Papers against whom the CRA brought criminal charges only went to a preliminary hearing on September 12, 2018.[3] This development only confirms the obvious — that the prosecution of the Canadian tax evasion cases moves at a glacial speed. Moreover, in the particular instance of the Reynolds case, it seems that the CRA did not know that the man they had been investigating for three years was named in the Panama Papers! Plainly, this may have been an innocent oversight. Then again, it also raises the question; Why weren't the CRA investigators aware of this?

International tax evasion and money laundering are continuing to this day and from our respective observation posts appears to us to be ballooning at a continuing, uninterrupted pace. Given the resources that have been dedicated to the prevention of tax evasion and tax fraud, the results of tax enforcement in Canada is less than impressive. This should be of concern to all Canadians.

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## PLAYING CATCH-UP: CRA'S EFFORTS TO CLOSE THE TAX GAP

By Honor Lay, Summer Law Student (2018), Miller Thomson LLP

### ABSTRACT

Understanding the tax gap is critical to a strong tax system, which funds a healthy and supportive Canadian society. The federal government has had to play catch-up in recent years in order to, first, calculate the tax gap, and second, devise strategies to close the gap. Canada Revenue Agency ("CRA"), in collaboration with several other countries, has made strides in addressing the offshore tax gap. By comparison, any headway the CRA has made in decreasing the domestic income tax gap or the GST/HST tax gap is unclear from their recent reports.

[2] Zach Dubinsky, "CRA Audits just 5 Canadians out of hundreds of RBC Panama Papers accounts", CBC News, March 23, 2018 www.cbc.ca/news/businesscra-audits-just-5-canadians-out-of-hundreds-of-rbc-panama-papers-accounts-1.4590306.

[3] Zach Dubinksy, "B.C. Stock Promoter led 'Lavish Lifestyle' while evading millions in tax, CRA alleges", CBC News, September 11, 2018 www.cbc.ca/new/Canada/british-columbia/Damien-reynolds-panama-papers-cra-1.4818326.

## WHAT IS THE TAX GAP?

When individuals understate or fail to report their income in order to pay less tax than what is due, a "tax gap" is generated, meaning a deficit between the taxes that would be paid if individuals reported their finances accurately and honestly, and the taxes that are actually received by the government each year.

Factors that contribute to the tax gap include:[1]

- tax evasion: the deliberate decision to not include specific amounts on one's tax return;
- unacceptable tax avoidance: structuring one's finances so that they comply with the letter of the law technically, but contravene the spirit and intent of the law;
- unwitting errors made by taxpayers on their returns; and
- nonpayment by taxpayers after a tax liability has been assessed against them.

## BACKGROUND

With the release of the Panama Papers in 2015, unprecedented attention was brought to the ubiquitous phenomenon of money-sheltering in offshore tax havens. This scandal triggered an international wake-up call about just how insidious the problem of tax evasion had become.[2]

Several western countries had either already or immediately commenced calculating the tax gap in the wake of the scandal. These countries include Australia, Sweden, Poland, Belgium, Portugal, Mexico and Denmark.[3]

Under the previous Conservative government, meanwhile, the CRA refused to estimate the tax gap, dismissing any such calculations as unreliable.[4] Since 2012, the Parliamentary Budgetary Officer ("PBO") had repeatedly requested information from the CRA to enable him to study the tax gap, but was persistently rebuffed. Only after the PBO apparently threatened to take the CRA to court did it finally relinquish the necessary records.[5]

The CRA has finally released its own estimates in the last two years, though some expect the PBO's independent review of the numbers to be more accurate.[6]

## CRA'S TAX GAP ESTIMATES

In the last two years, the CRA has published the following estimates of the tax gap:

1. A domestic tax gap of Canadian resident income for 2014 of approximately $8.7 billion.[7]
2. An offshore tax gap for 2014 of between $800 million and $3 billion.[8]
3. An average gap or loss of roughly 5.6% of GST/HST revenue each year between 2000 and 2014.[9]

## CRA'S EFFORTS OFFSHORE

The CRA conducted audits in 2014-15, 2015-16, and 2016-17 of taxpayers deemed by the CRA to be at risk of non-compliance, such as closely-held corporations and trusts. According to the report, these audits resulted in $1 billion of assessed income and $284 million in additional federal tax.[10] Comparing 2014-15 to 2016-17, the CRA says it carried out an increase of 98 to 223 audits and that its analysis of electronic funds transfer transactions increased from 3,095 to 41,289.[11]

The CRA has established or joined the following programs and organizations to help combat offshore tax evasion: (1) the Voluntary Disclosure Program, which incentivizes taxpayers to admit any undeclared income on previous returns in exchange for lesser financial penalties; (2) the Offshore Tax Informant Program, which pays whistle-blowers for identifying tax evasion suspects; (3) the Related Party Initiative, which focuses on high net worth individuals; and (4) the Organisation for Economic Co-Operation and

1 The Conference Board of Canada, "Closing the Tax Gap in Canada Would Increase Revenues Available to Governments and Fairness to Taxpayers" (13 February 2017), available online: https://www.conferenceboard.ca/press/newsrelease/17-02- 12/Closing_The_Tax_Gap_in_Canada_Would_Increase_Revenues_Available_to_Governments_and_Fairness_to_Taxpayers.aspx?AspxAutoDetectCookieSupport=1.

2 For further reading, see David W. Chodikoff & David S. Kerzner, *International Tax Evasion in the Global Information Age* (London, UK: Palgrave MacMillan, 2016).

3 Alex Boutilier, Marco Chown Oved, and Robert Cribb, The Star, "Federal Liberal government to release tax gap data" (12 February 2018), available online: https://www.thestar.com/news/canada/2018/02/12/federal-liberal-government-to-release-tax-gap-data.html .

4 Alex Boutilier, Marco Chown Oved, and Robert Cribb, The Star, "Federal Liberal government to release tax gap data" (12 February 2018), available online: https://www.thestar.com/news/canada/2018/02/12/federal-liberal-government-to-release-tax-gap-data.html .

5 Percy Downe, The Province, "Sen. Percy Downe: It's good CRA is finally agreeing to quantify Canada's tax evasion problem" (5 April 2018), available online: https://theprovince.com/opinion/op-ed/sen-percy-downe-its-good-cra-is-finally-agreeing-to-quantify-canadas-tax-evasion-problem .

6 Charlottetown, P.E.I., Senator Percy Downe expects the estimates of the PBO to be more accurate, because as far as Downe is concerned, "[t]he CRA's numbers can't be trusted." The PBO's study is expected this fall. Marco Chown Oved, The Star, "Canadians with offshore holdings evade up to $3 billion in tax per year" (28 June 2018), available online: https://www.thestar.com/news/canada/2018/06/28/canadians-with-offshore-holdings-evade-up-to-3-billion-in-tax-per-year.html .

7 Canada Revenue Agency, "Tax Assured and Tax Gap for the Federal Personal Income Tax System" (June 2017), at 31-33, available online: https://www.canada.ca/en/revenue-agency/corporate/about-canada-revenue-agency-cra/tax-canada-a-conceptual-study/tax-assured-tax-gap-federal-personal-income-tax-system.html.

8 Canada Revenue Agency, "International Tax Gap and Compliance Results for the Federal Personal Income Tax System" (June 2018), at 4, available online: https://www.canada.ca/en/revenue-agency/corporate/about-canada-revenue-agency-cra/tax-canada-a-conceptual-study/tax-compliance.html.

9 Canada Revenue Agency, "Estimating and Analyzing the Tax Gap: Related to the Goods and Services Tax/ Harmonized Sales Tax," at 2 (June 2016), available online: https://www.canada.ca/en/revenue-agency/corporate/about-canada-revenue-agency-cra/tax-canada-a-conceptual-study/estimating-analyzing.html.

10 *Supra* note 8, at 4.

11 Canada Revenue Agency, "Cracking down on tax evasion and aggressive tax avoidance and getting results," (3 November 2017), available online: https://www.canada.ca/en/revenue-agency/campaigns/about-canada-revenue-agency-cra/cracking-down-on-offshore-tax-evasion-aggressive-tax-avoidance/cracking-down-getting-results.html#rslts .

Development ("OECD"), an international network for information sharing between countries.[12]

The OECD launched the Common Reporting Standard, a new international agreement among some 100 countries including Canada, with the purpose of sharing information about non-resident bank accounts. Beginning in September 2018, the CRA will start to receive information from other countries about Canadian accounts in foreign countries. Likewise, in May of this year, Canadian financial institutions started to send non-resident bank account information to the home countries of those account holders.[13]

In a recent decision where France had disclosed the bank account information of a Canadian resident to the CRA, the Federal Court rejected the taxpayer's argument that the investigation rose to the level of a criminal investigation implicating her *Charter* rights.[14] The decision signals that taxpayers with undisclosed offshore accounts should take note that the CRA has forged new alliances to bolster the enforcement of its tax laws and collect on any taxes due.

## CRA'S DOMESTIC EFFORTS

While the CRA places the offshore tax gap at somewhere between $800 million and $3 billion, it estimates the domestic income tax gap to be somewhere in the range of $8.7 billion.[15] In other words, the domestic tax gap more than doubles, at the very least, the offshore tax gap.

The CRA identifies the following self-employment or cash income industries as contributing disproportionately to tax revenue loss: the construction industry, tips as wages (restaurants and bars, for instance), the trades, and rent or rooming income.[16] Whereas the CRA can easily assess traditional employment income, matching the employee's reported income against the T4 issued by the employer, self-employment and cash income often lack a similar third-party verifier to authenticate the income and deductions claimed.[17]

The CRA lists the following as entities helpful in detecting unreported income among Canadian residents: (1) the Voluntary Disclosures Program, once more; (2) the Informant Leads Program, another entity directed at tapping and rewarding the public for information on tax violations; and (3) the Minister's Underground Economy Advisory Committee.[18]

The results of these initiatives, however, when considered in light of the strides the CRA has made offshore, are comparatively unclear. The CRA's report on the domestic income tax gap states that 60% of the disclosures made in 2015-16 through the Voluntary Disclosures Program involved domestic sources, as opposed to offshore sources, but what additional tax collection came from this program is unclear.[19] Similarly, the CRA's publication notes that it received over 32,000 leads through the Informant Leads Program, but again, the number of these reports that resulted in penalties, convictions, or additional tax collection — i.e., whether the program is working or not — is uncertain.[20]

## CRA'S EFFORTS WITH THE GST/HST TAX GAP

The GST/HST gap constitutes the estimated amount of additional revenue that would result from all businesses accurately charging and reporting GST/HST tax.[21] The CRA's report on the GST/HST tax gap over a 15-year period from 2000 to 2014 measures the gap at about 5.6% of lost tax revenue each year.[22]

The report, however, does not state the approximate dollar value — i.e., how many billions of dollars — have actually been lost over this 15-year period.[23] Neither does the report shed light on the sectors of the economy most prone to non-compliance with GST/HST payments.[24]

In comparison with the CRA's reports on the offshore tax gap and the domestic tax gap, this report does not identify the sources of the gap in revenue, such as the taxpayers or industries most prone to non-compliance with tax laws. This information seems most essential, particularly given the trend from the graph in the report which reveals an inclining slope of lost revenue from 2010, at a 2% loss, to 2014, at a 6-8% loss.[25]

## CONCLUSION

So far, the CRA has been effective in joining forces with other countries to begin cracking down on the concealment of assets offshore. This is as much a feat for the CRA as it also sets the standard for the other two major gaps in revenue which continue to bleed billions.

Given the appearance of a growing GST/HST gap, and the CRA's evaluation of the domestic income tax gap as the weakest link in our tax system, we await further details from the CRA on the strategies planned to address these outstanding problem areas.

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## CANADA WITHOUT POVERTY: WHEN IS POLITICAL ACTIVITY CHARITABLE?

By Florence Carey, Partner, MLT Aikins, Graham Purse, Associate, MLT Aikins and Danielle J. Dubois, Associate, MLT Aikins

Should a registered charity be permitted to engage in advocacy? What if that advocacy — letter-writing, advertising, contacting Members of Parliament — is the best way for the charity to achieve its charitable purpose and benefit the community?

12 *Supra* note 8, at 5.
13 Elizabeth Thompson, CBC News, "'Come to CRA before we go to you: International deal designed to expose offshore tax cheats" (18 July 2017), available online: https://www.cbc.ca/news/politics/tax-evasion-banks-cra-1.4209208.
14 *Canada (National Revenue) v. Stankovic*, 2018 FC 462 (F.C.).
15 Note these are 2014 statistics, as previously mentioned.
16 *Supra* note 7, at 31-33.
17 *Ibid*, at 5-6.
18 *Ibid*, at 33-34.
19 *Ibid*.
20 *Ibid*.
21 *Supra* note 9, at 3: "While this estimate is useful in providing a rough benchmark of the extent of GST/HST non-compliance in Canada, it cannot be used to pinpoint which groups or sectors are the most likely to be non-compliant."
22 *Ibid*, at 2.
23 *Ibid*.
24 *Ibid*.
25 *Ibid*, at 7.

On July 16, the Ontario Superior Court of Justice released the judgment of Justice Morgan in *Canada Without Poverty v. AG Canada*,[1] which wrestled with this question.

Justice Morgan ultimately concluded that certain provisions of the *Income Tax Act* (Canada)[2] are unconstitutional due to the limits they impose on a charity's ability to engage in political activities. This article explains the historical context in which this case arose and then examines the court decision in some detail.

Traditionally, charity law has distinguished between conducting charitable activities and advocating for policy change — even when these activities are all intended to serve the same charitable purpose (e.g., relieving poverty).

Subsection 149.1(6.2) of the *Income Tax Act* specifically provides that non-partisan political advocacy is permissible, provided it only constitutes a small proportion of the total activities of a charity. This section requires a charity to devote "substantially all" of its resources to non-advocacy. In CRA Policy Statement CPS-022, the CRA states that it considers "substantially all" to mean "90% or more" of a charity's activities. In other words, a charity could not devote more than 10% of its activities to advocacy.

## HOW DID WE GET HERE?

In the 1985 Federal Budget, the federal government made changes to rules pertaining to political activities in the *Income Tax Act*. The amendments were intended to recognize that incidental advocacy activities that supported a charitable cause were an appropriate use of a charity's resources. The Budget also asserted that partisan political activities — such as activities in support of a particular political party or candidate — were impermissible. These 1985 amendments were at issue in the *Canada Without Poverty* decision.

In the 2012 Budget, the federal government made numerous changes to charities rules in the *Income Tax Act*, in part over concerns that there should be additional compliance regarding political activities of charities.

The 2012 Budget changes and ensuing CRA audits led to a flurry of highly publicized interactions between charities and the federal government. The Toronto Star reported audits of charities focused on foreign aid, human rights and poverty. The CBC reported that Oxfam had a dispute with the CRA, in which the CRA apparently took the baffling position that the relief of poverty was acceptable, but preventing it was not. It appears the CRA's reasoning was that one has to be allowed to fall into poverty before being lifted out. Predictably, these kinds of interactions created considerable political scrutiny.

In response to these criticisms, the head of the Charities Directorate at CRA indicated that the Directorate was attempting to ensure that it was not focusing audits on either side of the political spectrum, but rather was taking a balanced approach.

## THE COURT CASE

The *Canada Without Poverty* case appears to have its genesis in the charities audits that commenced in 2012. Specifically, in 2015, the CRA conducted a political activities audit of the Canada Without Poverty organization and concluded that virtually all of the activities were based in political engagement and public policy advocacy. Thus, the CRA took the position that Canada Without Poverty was offside of CRA's interpretation of subsection 149.1(6.2) of the *Income Tax Act* requiring a charity to devote no more than 10% of its resources to political activities.

In the judgment, Justice Morgan noted this 90% percent rule stems from a CRA Policy Statement, rather than from the jurisprudence or the *Income Tax Act* itself. Other case law has established that the Tax Court of Canada may accept lower thresholds for what constitutes "substantially all," such as 80 per cent.[3]

The CRA objected to Canada Without Poverty's campaign entitled "Dignity For All: The Campaign for a Poverty-Free Canada". The CRA noted that the campaign "features a call for vigorous and sustained action by the federal government to combat the structural causes of poverty in Canada" (cited at para 40). Justice Morgan, however, concluded that this "activity is, of course, squarely within the charitable purpose of relief of poverty" (para 41).

In finding for the charity, Justice Morgan made repeated reference to the 2017 *Report of the Consultation Panel on the Political Activities of Charities*, assembled by the Minister of National Revenue. This Consultation Report addressed the political activities of charities in Canada. It recognized that charities have an important role in public policy dialogue and could be seen as "an essential part of the democratic process" (cited at para 25). The 2017 Consultation Report also recommended amendments to the *Income Tax Act* which would delete any reference to non-partisan political activities, thereby allowing charities to fully engage in non-partisan public policy in order to further their charitable purposes (para 26).

Justice Morgan was concerned that the CRA's interpretation of subsection 149.1(6.2) restricts "virtually all aspects of the Applicant's communications to the public regarding law reform or policy change" (para 23). Moreover, Canada Without Poverty led evidence that it was dependent on charity status for its financial viability (para 32), while the Attorney General appears to have filed no evidence to undermine that assertion (para 43).

## THE DECLARATION OF UNCONSTITUTIONALITY

It is rare for a section of the *Income Tax Act* to be held unconstitutional. Yet, Justice Morgan held that subsection 149.1(6.2) of the *Income Tax Act* violates the freedom of expression guaranteed by paragraph 2(b) the *Canadian Charter of Rights and Freedoms* and is not saved by section 1, which imposes reasonable limits on rights as prescribed by law.

Justice Morgan further ordered that the phrase "charitable activities" used in subsection 149.1(6.2) be read to include political activities without quantum limitation (para 71). He also made a declaration that paragraphs 149.1(6.2)(a) and (b) are of no force and effect pursuant to section 52 of the *Charter*. Finally, Justice Morgan concluded that the exclusion from charitable activities of partisan political activities found in paragraph 149.1(6.2)(c) remains in force and is not contrary to the *Charter*.

1 2018 ONSC 4147 (Ont. S.C.J.).
2 R.S.C 1985, c.1 (5th Suppl.).
3 *Louiseville Automobile Ltée c. R.*, 2010 TCC 505 (T.C.C. [General Procedure]) at para 24.

## POLITICAL ACTIVITY IN SUPPORT OF WHAT PURPOSES?

As Donald Bourgeois has noted in *The Law of Charitable and Not-For-Profit Organizations*,[4] the parameters of "the box of acceptable engagement in public policy" has been unclear. The *Canada Without Poverty* decision is of particular importance as it suggests that broader political engagement may now be permissible for registered charities.

One of the driving forces behind this decision seems to have been the broad acceptance for the charitable purpose at issue: the relief of poverty. Justice Morgan expressed no doubts that this was a charitable purpose beneficial to the community. Justice Morgan's decision was bolstered by reliance on the 1995 UN Copenhagen Declaration and Programme of Action, as well as a more recent standing committee report from the House of Commons and the above-mentioned 2017 CRA Consultation Report on political activities of charities.

It will be interesting to see how this judgment is applied to other fact scenarios, in which the alleged charitable purpose and benefits to the public are more contested.

The courts have in fact addressed such issues in the past. In 1998, the Federal Court of Appeal in *Human Life International In Canada Inc. v. Minister of National Revenue*,[5] rejected a similar argument advanced by a pro-life charity that had engaged in political advocacy.

The Court concluded that the promulgation of pro-life views was not necessarily a purpose beneficial to the community, and that this was not an appropriate decision for a court to make:

> *Any determination by this Court as to whether the propagation of such views is beneficial to the community and thus worthy of temporal support through tax exemption would be essentially a political determination and is not appropriate for a court to make.*

Here, we see the contrast between the two decisions and the difficult tax policy issues that underlie such disputes. Which views should be subsidized and which should not? It will be interesting to see if and how political activities in support of more controversial purposes are upheld by the courts and Parliament.

The federal government filed notice of appeal on August 15, 2018. In a related press release, the government citing the need to address uncertainty created by "significant errors of law" in the decision of Justice Morgan. Notwithstanding the appeal, Minister of Finance, Bill Morneau, and Minister of National Revenue, Diane Lebouthillier, reaffirmed the federal government's intention to amend *Income Tax Act* to allow for non-partisan political activities, in line with the 2017 Consultation Report. Those changes are expected in fall 2018.

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[4] Donald J. Bourgeois, *The Law of Charitable and Not-for-Profit Organizations* (LexisNexis Canada, 2016).

[5] 1998 CarswellNat 1646, [1998] F.C.J. No. 365 (Fed. C.A.).

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## DONATING WINE AND DETERMINING FAIR MARKET VALUE

By Jennifer A.N. Corak, Associate, Miller Thomson LLP

When engaging in the estate planning process, one often considers what charitable donations to make either during one's lifetime or following one's death. Donations may be in the form of cash gifts or may be made in kind (for example, one may donate a piece of art or bottles from a wine collection). When gifts are made in kind, the question of fair market value ("FMV") arises.

Recently, in the case of *McCuaig Balkwill v. The Queen*,[1] Justice Boyle of the Tax Court of Canada was faced with the task of determining "the fair market value of collectible wines donated to charities for their charity auctions in 2005 and 2006." In his decision, he confirmed that the Court had less than complete, perfect evidence to make this determination.

The taxpayer, who was a resident of Ontario and a wine collector for nearly 30 years, donated 21 bottles of wine made up of 19 different labels and vintages, none of which were available at the Liquor Control Board of Ontario (the "LCBO"), to two Ottawa charities — the Ottawa Food Bank and the Ottawa Chamber Music Society. The charities appraised the donated bottles' FMV at $23,600; the appellant based the value of her tax donations in question upon receipts issued by the charities to her. The Canada Revenue Agency ("CRA") reassessed the taxpayer using a value of approximately $4,700.

The taxpayer took the position that "the [FMV] of a bottle of wine in Ontario is the amount that would have been charged for each bottle had it been ordered through LCBO's Private Ordering program". This methodology, the LCBO's Private Ordering pricing methodology,

> begins with the cost to buy the particular wine ordered by the LCBO in the global wine market, presumably whether directly from the vineyard or from a reseller. To that are added markups, levies, taxes, tariffs, duties, freight transportation costs, etc.

The appellant's expert, after providing 2016 data on list, retail or asking prices (not actual sales prices) from an online wine source website whose sellers are wine sellers around the world, arrived at a determination that the total wine sellers' 2016 prices for the wines was approximately $5,500. She then applied her understanding of the LCBO pricing methodology and arrived at a total 2016 FMV of approximately $17,200.

The respondent's expert took a different approach to valuation, opining that "the appropriate valuation methodology was to base value on known sales circa 2005/2006 at wine auctions available to the taxpayer/donor to sell her wines as a resident of Ontario." Providing data on actual auction sales in the United States around that time for the same label and vintage of the wines with one exception, the respondent's expert arrived at an aggregate FMV for the donated wines of approximately $2,650 in 2005 and 2006.

[1] 2018 TCC 99 (T.C.C. [General Procedure]).

Justice Boyle was prepared to assume the difference between the $2,650 value and the $5,500 value reflected appreciation in the market over the 10 plus years between 2005/2006 and 2016.

The parties agreed that the appropriate definition of FMV was summarized by the Federal Court of Appeal in *Nash v. R.*,[2] citing Justice Cattanach in *Henderson v. Minister of National Revenue* (1973).[3] Such summary provides that FMV means:

> . . .the highest price an asset might reasonably be expected to bring if sold by the owner in the normal method applicable to the asset in question in the ordinary course of business in a market not exposed to any undue stresses and composed of willing buyers and sellers dealing at arm's length and under no compulsion to buy or sell. . . the essential element [being] an open and unrestricted market in which the price is hammered out between willing and informed buyers and sellers on the anvil of supply and demand. . .
>
> [Emphasis removed.]

The Court saw no need to consider creating a fictional and hypothetical proxy market not existing in fact since actual, normal, functioning, lawful and available real markets existed in which an Ontario resident wanting to maximize the price received for a bottle of wine could participate.

After providing that "the use of the LCBO Private Ordering pricing methodology in the way the Appellant in this case used it is devoid of common sense and out of touch with ordinary commercial reality," Justice Boyle found that the markets in which the wine should be valued are the real, existing, markets that are used by residents of Ontario, which include LCBO auctions, the non-LCBO global consignment auctions and sellers, and Ontario charity auctions, and that

> [p]rices for a purchase and sale in these markets are obviously relevant to, but not necessarily determinative of, a wine's fair market value determination by this Court.

When determining FMV, legislative restrictions are relevant and to be considered, but provincial regulatory restrictions do not result in a market that is not open and unrestricted and which should therefore be dismissed (i.e., they do not automatically result in the need to create a proxy market). Regulatory, tax, customs and import duties, transportation and other costs imposed by Ontario or any other jurisdiction will generally either be borne by the purchaser, reduce the seller's proceeds of disposition, or may be deductible expenses. For the purposes of a valuation, if the related expenses are expected to be borne by the purchaser, this may reduce the available market of purchasers or reduce the amount a purchaser may be willing to pay.

Overall, Justice Boyle determined that the best evidence of value in 2005/2006 before the Court was the circa 2005/2006 data provided by the Respondent's expert from completed auction sales at a single large U.S. consignment auction house and consignment seller. Since the value from such data was lower than those used by CRA in the reassessments, the appeal was dismissed.

It is noteworthy that the parties in this case invited Justice Boyle to offer comments beyond the reasons necessary to decide the case in hopes of being able to look to the case for guidance on how to resolve other wine donation appeals and objections. In these comments, Justice Boyle clarifies that:

1. The decision should not "raise concerns that fundraising activities by charities should be in any way curtailed."
2. The decision "does not preclude a vintage or label of wine being purchased by a taxpayer at an LCBO store for the purpose of donating it to a charity for an upcoming auction or other event being considered to have [an FMV] equal to its purchase price."
3. There could be, in another case involving wine, "other or better evidence on either side in which the same or similar methodology is to be used to value wine; for example, actual purchase and sale prices in auctions, consignments, charity auctions, and any other available markets; or the use of comparable wines that are not identical labels and vintages."
4. The decision does not conclude that "using its Private Ordering methodology, the LCBO's retail prices — properly applied to full cases and their actual starting market prices, and using accurate transportation and other costs and amounts, and fully supported with evidence — can never be a relevant consideration in determining a wine's [FMV] or the range of its [FMV]." Justice Boyle's decision was that it is not determinative on its own, and that it is not helpful if not properly and accurately applied.

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## INVESTMENT LIMITED PARTNERSHIPS – CRA GUIDANCE

By Jane Loyer, Associate, Miller Thomson LLP and Colleen Ma, Associate, Miller Thomson LLP

On September 8, 2017, the Department of Finance ("Finance") introduced draft legislation affecting "investment limited partnerships" ("ILPs"), a new term in the ETA. The 2018 Federal Budget made some relatively minor amendments. This draft legislation (the "ILP Rules") are proposed to be effective as of September 8, 2017. While the ILP Rules have not been introduced in Parliament, the CRA did release GST/HST Notice 308, "GST/HST and Investment Limited Partnerships" in July 2018, which provides some guidance.

### WHAT ARE INVESTMENT LIMITED PARTNERSHIPS?

"Investment Limited Partnership" is broadly defined in the draft legislation to include any limited partnership whose primary purpose is to invest funds in property consisting primarily of financial instruments, such as shares, debt and partnership interests, and meets either of the following criteria:

(a) it is, or forms part of an arrangement or structure that is represented or promoted as a hedge fund, investment limited partnership, mutual fund, private equity fund, venture capital fund, or other similar collective investment vehicle; or

[2] 2005 FCA 386 (F.C.A.).
[3] 73 D.T.C. 5471 (Fed. T.D.) at 5476.

(b) 50% or more of the total value of all the interests in the limited partnership are held by listed financial institutions.

## PROPOSED LEGISLATION

Pursuant to the newly proposed subsection 272.1(8) of the *Excise Tax Act* (Canada)[1] (the "Act") the supplies of any management or administrative service by a General Partner ("GP") to an ILP will be considered a separate taxable supply subject to GST/HST. "Management or administrative service" is broadly defined under subsection 123(1) of the Act to include an asset management service, which is further defined to encompass most activities performed by a GP, such as managing, researching or analyzing the assets or liabilities of the ILP, or determining which assets or liabilities to acquire or dispose of. As a result, GPs will have to charge and collect GST/HST on the fair market value of any management or administrative services performed for the ILP, and will have to register for GST/HST purposes.

## CRA GUIDANCE – GST/HST NOTICE 308

Under the existing rules, anything done as a member of the partnership is deemed to have been done by the partnership in the course of the partnership's activities and is not subject to GST/HST. However, if a member of the partnership makes a supply of property or services to the partnership otherwise than in the course of the partnership's activities, those supplies are deemed to be subject to GST/HST.

The ILP Rules deem a general partner of an ILP to be providing management or administrative services to the limited partnership in the course of their own activity and not as a member of the partnership, resulting in the payment (or deemed payment) of GST/HST from an ILP to the general partner on the fair market value of the service.

Many advisors consider management or administrative services provided to a limited partnership by the general partner to be done as a member of the partnership, which is not subject to GST/HST. Notice 308 states that the ILP Rules clarify the existing rules, not introduce a new one. This comment is concerning because it suggests that general partners may have an obligation to collect and remit GST/HST for management or administrative services from the limited partnership under the existing legislation, whether or not they are considered an ILP.

The Notice provided examples with respect to how the ILP Rules will be administered. One example addressed a situation where a limited partnership was established and promoted to investors under a prospectus. The capital that was raised by the limited partnership was used to acquire interests in other limited partnerships which make supplies of residential and commercial property. The CRA commented that the upper-tier limited partnership would be considered an ILP.

The Notice did not address a tiered partnership structure where the units are not promoted by a prospectus and the underlying activity is a single active business, such as a construction project.

If you are concerned about how any of the above measures will impact you, please contact a member of our Sales Tax, Customs, and International Trade Group.

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[1] R.S.C., 1985, c. E-15.