TAX FOR THE Owner-Manager

Editor: Thomas E. McDonnell, QC

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The New Passive Income SBD Grind Rules: When Do We Start?

The new passive income SBD grind rules come into effect for taxation years beginning after December 31, 2018. The calculation of the adjusted aggregate investment income (AAII) as defined in subsection 125(7) among associated companies will be a key consideration when one calculates the SBD grind under paragraph 125(5.1)(b).

Essentially, variable E of the formula in paragraph 125(5.1)(b) says the following:

> E is the total of all amounts each of which is the adjusted aggregate investment income of the corporation, or of any corporation with which it is associated at any time in the particular taxation year for each taxation year of the corporation, or associated corporation, as the case may be, that *ended in the preceding calendar year*. [Emphasis added.]

The term "ended in the preceding calendar year" clearly indicates that the AAII will have to be calculated for all calendar year-end corporations for their 2018 tax filings if one is to determine what the AAII, and consequently the "grind" to a corporation's SBD, will be in the taxation year that begins in the 2019 calendar taxation year.

For an associated group in which corporations have both off-calendar and calendar year-ends, the calculation is not as straightforward, as the following example shows.

- A Co has a taxation year-end of December 31, 2018.
- B Co has a loss-restriction event on July 31, 2018 and a stub taxation year-end on October 31, 2018.
- C Co has a taxation year-end of March 31, 2018.
- All three corporations are associated for tax purposes pursuant to section 256.
- Each of the corporations has AAII, and all are also eligible to claim the SBD.

How will the new passive income SBD grind rules under paragraph 125(5.1)(b) apply to these three companies? For A Co, the AAII for itself is calculated as shown in table 1.

Table 1 Calculation of AAII for A Co

Company	In which tax year is A Co's SBD ground by AAII?	For which tax year of the particular company is AAII calculated?
A Co	Tax year beginning January 1, 2019 (December 31, 2019)	As at December 31, 2018
B Co	Tax year beginning January 1, 2019 (December 31, 2019)	As at July 31, 2018 and as at October 31, 2018
C Co	Tax year beginning January 1, 2019 (December 31, 2019)	As at March 31, 2018

The CRA recently issued a TI (2018-0771871E5, September 20, 2018) in respect of this very issue, in which it considered two associated corporations, one with a December 31 year-end and one with a November 30 year-end.

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Editor's Note

Perry Truster, along with Neil Brooks, was named a recipient of the Canadian Tax Foundation's Lifetime Contribution Award at the 2018 annual conference. The award celebrates and honours those individuals who, over their careers, have made substantial and outstanding contributions to the Canadian Tax Foundation and its purposes through their volunteer efforts and their body of work over a number of years.

Perry Truster is a founding and a continuing contributor to *Tax for the Owner-Manager*, and I am very pleased to congratulate him on his receipt of this award. Perry's insights into the practical workings of the income tax system, as expressed in his articles for this newsletter and in the many tax papers that he has delivered at Foundation conferences over the years, are valued additions to the tax literature in Canada.

Information concerning the Lifetime Contribution Award is available on the Foundation's website.

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CTF CANADIAN TAX FOUNDATION
FCF FONDATION CANADIENNE DE FISCALITÉ

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As in the preceding example, the CRA confirmed that the calendar-year corporation (A Co) would have to compute its AAII for its taxation year ending December 31, 2018 and the AAII of its associated corporations for their respective taxation years ending in 2018 for the purpose of the passive income SBD grind.

B Co's AAII must be calculated on both July 31, 2018 and October 31, 2018 because of the phrase "in the particular taxation year, for each taxation year of the corporation, or associated corporation, as the case may be, that ended in the preceding calendar year."

The AAII calculations for the two off-calendar year-end companies, B Co and C Co, are shown in tables 2 and 3, respectively.

Table 2 Calculation of AAII for B Co

Company	In which tax year is B Co's SBD ground by AAII?	For which tax year of the particular company is AAII calculated?
A Co	Tax year beginning November 1, 2019 (October 31, 2020)	As at December 31, 2019
B Co	Tax year beginning November 1, 2019 (October 31, 2020)	As at October 31, 2019
C Co	Tax year beginning November 1, 2019 (October 31, 2020)	As at March 31, 2019

Table 3 Calculation of AAII for C Co

Company	In which tax year is C Co's SBD ground by AAII?	For which tax year of the particular company is AAII calculated?
A Co	Tax year beginning April 1, 2019 (March 31, 2020)	As at December 31, 2019
B Co	Tax year beginning April 1, 2019 (March 31, 2020)	As at October 31, 2019
C Co	Tax year beginning April 1, 2019 (March 31, 2020)	As at March 31, 2019

The tables show that the off-calendar year-end corporations follow a similar pattern in that their first taxation year of implementing the SBD grind was deferred by one taxation year; therefore, the respective associated group's computation of AAII is also deferred. In contrast with a calendar-year corporation's first taxation year of implementation, its SBD grind and computation of the AAII for the associated group are accelerated by one taxation year. The confusing part in practice will be to distinguish between the two sets of corporations' start dates of the passive income SBD grind and AAII computation rules within one associated corporate group. The rules introduce yet another limitation on the SBD for CCPCs. The new rules, combined with the existing LCT SBD grind rules and the specified corporate income and specified partnership income rules, make the SBD more difficult for corporate taxpayers to access. With the general corporate rate at an all-time low, the question that arises is whether the SBD has outlived its usefulness and whether, for the sake of simplicity, it should be abolished.

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CRA Clarifies TOSI's "Derived Directly or Indirectly from a Related Business" Test

In a recent technical interpretation (TI 2018-0771861E5, November 2, 2018), the CRA considered whether second-generation income or a dividend in kind may be considered an "excluded amount" as defined in subparagraph 120.4(1)(e)(i) in the tax on split income (TOSI) rules. Specifically, the CRA was asked to comment on a situation in which a holding company receives dividends from an operating company and invests those dividends in an investment portfolio of shares in public companies. The holding company then pays its after-tax income (that is, second-generation income) from its investments to an inactive shareholder spouse, or it pays a dividend in kind consisting of the share portfolio.

In its response, the CRA confirmed that the second-generation income that the holding company earns may be considered an "excluded amount" under the definition in subparagraph (e)(i) by the shareholder that receives the dividend, and thus would not be subject to the TOSI rules. For the dividends to qualify as an excluded amount under subparagraph (e)(i), the CRA noted that the holding company must not have a related business in respect of the individual shareholder that receives the dividend. The CRA also said that the portion of the FMV of the distributed stock portfolio that represents the initial investment of the dividends paid by the operating company would not be an excluded amount under subparagraph (e)(i) in the situation described in the TI. It is important to remember that this TI deals with one specific TOSI rule and that an amount can still be an "excluded" amount under another provision in section 120.4.

In the situation described in the TI, Mr. A and Mrs. A, who are over 30 years of age, have each owned 50 percent of the issued and outstanding voting common shares of a holding company, Investco, since its incorporation. Specifically, Mr. A owns 100 class A common shares and Mrs. A owns 100 class B common shares. Investco owns all of the issued and outstanding shares of Opco, which carries on a non-services business. Although Mr. A ("the source individual") is actively engaged in Opco's business on a regular, continuous, and substantial basis, Mrs. A ("the specified individual") is not (that is, Mrs. A is inactive in Opco's business). Opco is a "related business" as defined in paragraph 120.4(1)(a) in respect of Mrs. A because, as noted, Mr. A is the source individual actively engaged on a regular, continuous, and substantial basis in Opco's business.

Historically, Opco paid taxable dividends to Investco from its after-tax earnings, and Investco has invested these into shares of publicly traded corporations, which pay dividends annually.

The CRA was asked whether, assuming that Investco pays all of the dividend income that it receives from the publicly traded corporations to Mrs. A, this dividend income would be considered "derived directly or indirectly from a related business" for the purposes of TOSI. Similarly, the CRA was asked whether, if Investco distributes its stock portfolio to Mrs. A as a dividend in kind, this dividend income would be considered to be "derived directly or indirectly from a related business." The CRA was also asked to clarify whether its conclusion would be different if all of the dividends that Opco paid to Investco were paid prior to 2018 (that is, prior to the enactment of the amendments to section 120.4).

Split income received by a specified individual (Mrs. A) is generally subject to TOSI (that is, it is taxed at the top marginal personal tax rate) unless the income is an excluded amount. For individuals who have attained the age of 18, an "excluded amount" as defined in subparagraph (e)(i) includes income that is not "derived directly or indirectly from a related business" in respect of the individual (Mrs. A) or that is derived directly or indirectly from an excluded business of the individual. For individuals who are 25 or older, an excluded amount also includes income from, or taxable capital gains from the disposition of, excluded shares held by the individual.

An excluded business of an individual for a taxation year is defined in subsection 120.4(1) and generally means a business in which the individual is actively engaged on a regular, continuous, and substantial basis in the taxation year or any five prior taxation years of the individual.

Paragraph 120.4(1.1)(d) clarifies that an amount "derived directly or indirectly from a business" includes an amount that

- is derived from the provision of property or services to, or in support of, the business;
- arises in connection with the ownership or disposition of an interest in the person or partnership carrying on the business; or
- is derived from an amount that is derived directly or indirectly from the business.

"Excluded shares" generally are shares owned by the specified individual that must meet several criteria. One criterion is that for the corporation's most recent taxation year, all or substantially all (90 percent or more) of the corporation's income must not be derived, directly or indirectly, from one or more other related businesses.

Before it addressed the issues, the CRA cautioned that its conclusion would depend on whether Investco has a "business." In particular, the CRA noted that because the scenario did not indicate whether Investco operates a "business" of earning income from its investments (which is a question of fact), it is not clear whether Investco has a "related business" in respect of Mrs. A.

In the TI, the CRA noted that dividends that Investco paid out of its after-tax income from its investments in publicly traded corporations (second-generation income) would not be considered to be derived, directly or indirectly, from the related business of Opco in respect of Mrs. A.

The CRA said that if Investco does not have a related business in respect of Mrs. A, the dividends that it pays to her that are derived from income and gains earned from its investments in publicly traded corporations would be an excluded amount in respect of Mrs. A. Conversely, if Investco has a related business in respect of Mrs. A, those dividends would be an amount derived directly or indirectly from that related business and therefore would not be an "excluded amount" as defined in subparagraph (e)(i). The CRA said that in this case, Mrs. A would have to determine whether any of the other exceptions to split income applied.

In response to the question about a dividend in kind, the CRA gave an example in which Opco pays a $1 million dividend to Investco and Investco invests that $1 million in shares of publicly traded corporations. In the following year (year 2), Investco pays a dividend in kind to Mrs. A of its entire stock portfolio of publicly traded corporations, which at that time has an aggregate FMV of $1.1 million. Investco does not have any other retained earnings.

The CRA noted that the portion of the FMV of the distributed stock portfolio that represents the initial investment of the dividends paid by Opco to Investco would be considered to be derived, directly or indirectly, from the related business of Opco in respect of Mrs. A. However, the CRA said that gains earned by Investco as a result of the investment of those dividends would not be considered to be derived, directly or indirectly, from the related business of Opco in respect of Mrs. A. As a result, $1 million of the $1.1 million dividend in kind that Mrs. A receives in year 2 would be considered to be derived, directly or indirectly, from the related business of Opco in respect of Mrs. A.

The CRA noted that if Investco does not have a related business in respect of Mrs. A, $100,000 of the $1.1 million dividend in kind would not be considered to be derived, directly or indirectly, from a related business in respect of Mrs. A, and therefore would be an "excluded amount" as defined in subparagraph (e)(i) in respect of her.

However, the CRA said that if Investco has a related business in respect of Mrs. A, the entire $1.1 million dividend in kind that Mrs. A receives in year 2 would be considered to be derived, directly or indirectly, from the related businesses in respect of her, and therefore would not be an excluded amount under the definition of "excluded amount" in subparagraph (e)(i). She would also have to determine whether any of the other exceptions to split income applied.

The CRA also confirmed that its conclusions would not change if the dividends paid by Opco to Investco were all paid prior to 2018.

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Milne Estate: How Should Multiple Wills Be Drafted in Ontario?

An estate-planning technique that has been used to minimize the Ontario estate administration tax (EAT) is the execution of two wills: one will for assets that require probate (or, in Ontario, a certificate of appointment of estate trustee) in order to be dealt with by the executors (such as a solely owned investment account or bank account), and another will for assets that do not require probate (such as personal effects or shares and debt of private corporations). Assets that form part of a will that does not require probate are not subject to EAT. Now, the recent decision of the Ontario Superior Court of Justice in *Milne Estate (Re)* (2018 ONSC 4174) has called into question the validity of many multiple wills designed to reduce exposure to the Estate Administration Tax Act in Ontario.

The facts in *Milne* were relatively simple. John Milne and Sheilah Milne, who both died on October 2, 2017, each left two wills—a primary will and a secondary will. The executors of the primary wills commenced applications for certificates of appointment as estate trustees (with a will limited to assets referred to in the will). The issue before the court was whether the primary wills of the deceased were valid and should be admitted to probate.

The clauses that carved up the estates into the primary and secondary wills granted discretionary authority to the executors of the primary will to allocate assets into the secondary will by an act of exclusion from the primary will. Both the primary and the secondary wills purported to deal with all of the property of the deceased.

Dunphy J held that a will is a form of trust and therefore must satisfy the three certainties of trust law: certainty of intention, certainty of subject matter, and certainty of object. The question was whether there was certainty of subject matter with respect to the primary wills—that is, whether there was certainty about the specific property that formed the corpus of the primary wills. Dunphy J held that the fundamental problem with the wills was that the primary and secondary wills overlapped entirely (they dealt with the same property) with no exclusions. Dunphy J held that the only way to determine which property fell into the primary will was "based upon the subsequent, subjective determinations of the Estate Trustees as to what is desirable." For this reason, he held that the primary wills of the deceased were invalid for lack of certainty of subject matter.

Dunphy J rejected the executors' argument that the court should not consider the issue of construction (the interpretation of the meaning of the will) at the probate stage of the process. The executors submitted that the probate function of the court should consider only whether there is a will, the fact of its contents, and the validity of its process of execution. On the basis of the decision in *Neuberger v. York* (2016 ONCA 191), Dunphy J held that the role of the court in relation to probate proceedings was "inquisitorial" and not simply to adjudicate disputes between the parties; thus, he declined to ignore issues of construction.

Milne Estate is under appeal, and the outcome is very much of interest to advisers who may have been involved with wills with similar wording that divide an individual's assets into primary and secondary wills. On a positive note, the recent decision in *Panda Estate (Re)* (2018 ONSC 6734), which dealt with a nearly identical scenario, offers hope that the holding in *Milne* will be overturned. In his decision, Penny J admitted substantively very similar wills to probate, and in the process rejected the reasoning of Dunphy J. Penny J held that the probate and construction (interpretation) functions should be kept analytically distinct and that the question of the validity of the discretionary authority under the relevant wills should not have been dealt with in an application for probate. In addition, Penny J rejected Dunphy J's assertion that a will is a form of trust, and therefore further held there was no requirement that the three certainties required for the establishment of a valid trust be satisfied.

It is unclear at this point how the appeal of the *Milne Estate* decision will be resolved, especially in light of the decision in *Panda Estate*. If advisers to owner-managers in Ontario want to ensure that probate planning will be successful in the event that the decision in *Milne Estate* is not overturned, they should ensure that when multiple wills are drafted, the clause dividing an estate into separate wills is clear about which property will form part of each respective will (that is, the clause should not be discretionary). This drafting strategy will sidestep the issue raised in *Milne Estate* entirely. In the case of existing wills, consideration should be given to revising them, as advisable, in light of the decision in *Milne Estate*.

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Profit Trading to Lossco via Partnership Abusive: FCA

In *Canada v. 594710 British Columbia Ltd.* (2018 FCA 166), partnership income was transferred to an arm's-length purchaser with unused tax deductions by means of a series of transactions. The minister assessed the vendors on the basis that the series abused sections 96, 103, and 160 and relied on GAAR. The TCC held that GAAR did not apply (2016 TCC 288). That decision was reversed by the FCA, and the taxpayer has filed an application for leave to appeal to the SCC.

The appellant (Holdco) held shares in another corporation (Partnerco), which had an April 30 year-end. Partnerco was a partner of a very profitable partnership with a May 31 year-end. In a complicated series of transactions, the cash in the partnership was moved to Holdco; shortly thereafter, but still before the partnership's May 31 year-end, Holdco disposed of its shares of Partnerco to an arm's-length party (Nuinsco). Partnerco was then wound up into Nuinsco, and Nuinsco, as a partner of the partnership, received the allocation of income from the partnership and sheltered it with its own loss carryforwards and resource deductions. There were a number of issues in this case, but the only one that I discuss in this article is the issue of partnership income allocation.

The TCC concluded that GAAR did not apply to Partnerco, and it commented that there is no general policy in the Act against profit trading. The TCC described the Crown's failure to fully analyze the relevant statutory provisions as a "fatal shortcoming."

At the FCA, the Crown submitted that the TCC failed

1) to recognize that there is a general scheme against the transfer of profits to a loss company,
2) to determine whether sections 96 and 103 were misused and circumvented in an abusive manner, and
3) to have due regard to an abuse of subsection 111(5) when the ultimate result was a transfer of losses to an arm's-length party.

The FCA did not find it necessary to address points 1 and 3; instead, it focused on issue 2, the misuse and circumvention of sections 96 and 103. Relying on the legislative history of subsection 96(1), the FCA pointed out that a partner is required to include in income its share of the partnership's income to which it was entitled, whether or not the income is withdrawn during the taxation year (paragraphs 52-53). Citing *Mathew v. Canada* (2005 SCC 55), the FCA emphasized that the purpose of the broad treatment of loss sharing between partners is to promote an organizational structure that allows partners to carry on business in common in a non-arm's-length relationship (paragraph 57). The object, spirit, or purpose of subsection 96(1) is frustrated when income is allocated in a manner that "does not assist the organizational structure of the partnership or the efficient conduct of the partnership business" (paragraph 59). That is exactly what happened in this case: Nuinsco's allocation and its participation in the partnership in general did nothing to facilitate either the organizational structure or the partnership business, thereby frustrating the purpose of paragraph 96(1)(f).

With respect to subsection 103(1), the FCA said that the TCC failed to have due regard to the breadth of the language used in the provision. Because income from a partnership is allocated at the end of a fiscal period on the basis of the income for that entire period, subsection 103(1) must potentially apply to all persons that were partners during the fiscal period of the partnership (paragraph 63). Accordingly, former partners should not be excluded from this analysis. On that premise, the FCA ruled that having Nuinsco become a partner one day before the end of the partnership's fiscal year-end was abusive, since it divorced the economic consequences of the arrangement from the allocation of income (paragraph 68). Furthermore, the FCA stressed that subsection 103(1) is intended to apply to transactions that are devoid of any material substance and appears to apply on its own without the operation of GAAR (paragraph 76).

This approach to the wide-ranging scope of section 103 echoes the decisions in *XCo Investments* (2007 FCA 53) and *Penn West* (2007 TCC 190), in which a taxpayer's interest in a partnership turned out to be ephemeral and the partnership allocation of income produced a fiscally inappropriate result. This situation is particularly likely to arise when the new partner bears little or no economic risk and merely facilitates another taxpayer in obtaining tax benefits.

One may wonder whether the joint operation of paragraph 96(1.01)(a) and section 103 indicate a policy in the Act against profit trading through a series of transactions. In that regard, the FCA took the position that subsection 96(1.01) would not affect any of its analysis, and that it was not necessary that a partner be an actual member of a partnership at the end of the fiscal period of the partnership for GAAR to be applied to either section 96 or section 103 (paragraph 78).

The FCA declined to express a view on whether there is a general scheme in the Act against profit trading (paragraph 45). As the TCC pointed out in *Stow v. The Queen* (2010 TCC 406), subsections 103(1) and (1.1) do not preclude a taxpayer from deducting the share of losses allocable to the partnership interest held by the taxpayer. A tax-motivated acquisition of a partnership interest would not automatically invoke the application of subsections 103(1) and (1.1). But what if the partnership in *594710* had not been wound up within a week of the completion of the series but had continued to carry on business? Could an argument then be made that the partnership losses could be allocated to the new partner, notwithstanding that the new partner would have been a partner for only a few days of the fiscal period of the partnership?

The loss-restriction rules prohibit the purchase of losses by an arm's-length person. Should the purchase of profits be subject to a similar limitation? A loss-consolidation event may not always trigger the application of subsections 103(1) and (1.1) (CRA document no. 2011-0421261R3, released December 21, 2012). Should a "profit consolidation" escape subsections 103(1) and (1.1) as well? The taxpayer has filed leave to appeal to the SCC. If the court grants leave, it will provide an opportunity for the Crown to ask the court for guidance on these questions. In the meantime, the government's concern about loss trading through transitory partnership arrangements should be substantially reduced as a consequence of this decision. Equally, tax advisers should take note of the FCA's willingness to use GAAR to counter aggressive tax-planning schemes involving partnerships.

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The GST/HST in Breach-of-Contract Disputes

Although the GST/HST is a fact of life for virtually every purchase made in Canada, taxpayers may overlook its potential application to what they erroneously consider "merely payments." Such payments are often consideration for taxable supplies, whether actual or deemed by the ETA—for example, ETA section 182. In most circumstances, ETA section 182 generally deems a payment made to a registrant as a result of a breach of contract to be consideration for a tax-included supply. In the recent case of *THD Inc. c. La Reine* (2018 CCI 147; English translation not yet available), the TCC considered the application of section 182 to an appellant (THD) that had been awarded damages on arbitration.

Facts

THD was a transportation company that had entered into a five-year contract to deliver flyers to Uniprix pharmacies for McKesson Corporation of Canada. McKesson subsequently cancelled or modified some distribution routes under the contract, which led to a dispute between the parties and ultimately to arbitration.

At arbitration, McKesson was ordered to pay THD $727,934.40 in damages, which corresponded to the revenue that THD would have earned if the routes had not been modified or cancelled. Additionally, McKesson was ordered to pay costs and interest thereon of $50,677.60, for a total award of $778,612.00. This award was certified by the Superior Court of Quebec, and leave to appeal to the QCCA was dismissed.

Unfortunately, when requesting relief, THD did not request any amount on account of the applicable GST, and the parties (or at least THD's lawyer on arbitration) were unaware of section 182, which in these circumstances has the effect of deeming the award to include the 5 percent GST. Accordingly, Revenu Québec assessed THD for the $37,076.76 in GST (or 5/105) of the full damages of $778,612 on the basis of section 182.

After the assessment, THD wrote to McKesson requesting that it pay the tax on the damages award (although it is not clear exactly what was asked for). McKesson refused to pay the tax.

The TCC's Decision

The TCC properly recognized that section 182 operated to deem the GST to be included in the payment of the damages awarded to THD. In the TCC's view, it was clear that the payment was made to compensate THD for losses flowing from McKesson's modifications to the five-year contract, and the payment was made for something other than the supply under the agreement. Had the payment been consideration for the supply under the agreement, the GST would have still been exigible—but on a tax-extra basis under the general rules rather than on a tax-included basis under section 182.

The deeming rule in section 182 was clear and applied to THD's situation, notwithstanding that THD had tried to argue that ETA paragraph 182(1)(b) should apply only if McKesson had claimed an input tax credit in respect of the damages award.

In the result, the TCC agreed with Revenu Québec and concluded that section 182 deemed the total payment in damages that THD had received from McKesson ($778,612) to include $37,076.76 of GST.

Commentary

The *THD* case is an important caution for owner-managers and legal practitioners alike about the importance of considering possible GST/HST issues when one is settling disputes. In particular, the possible application of ETA section 182 has to be considered during settlement negotiations. If THD had brought section 182 to the arbiter's attention, it is likely that the arbitration award would have been grossed up to take into account the section's expected application, rather than allowing the government to take a share of the damages.

Of particular interest to legal practitioners, THD appeared to also be suing—presumably for the amount of the GST assessed, plus the costs of the unsuccessful TCC appeal—the lawyers who handled the arbitration and who were not aware of ETA section 182.

Finally, one interesting question that the TCC did not appear to pay much attention to was whether section 182 ought to have applied only to the "damages amount" (that is, the $727,934.40 for breach of contract) rather than the "total amount" awarded by the arbiter—which included interest and costs. It appears to us that one could argue that section 182 ought not to have applied to the interest and costs because these amounts might not properly be considered paid or forfeited "as a consequence of the breach, modification or termination . . . of an agreement" because of their indirect connection to the agreement. Additionally, the payment of money or interest could arguably be an exempt financial service.

Unfortunately, this question was not posed to the TCC, and thus we do not know how the court would have ruled on it. But the parties to a dispute resolution agreement are well advised to identify any interest component of a gross settlement award so as to preserve the argument that the interest amount is not subject to GST.

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Atlas Tube Canada ULC: The FC Limits Taxpayers' Protection from Self-Audits

It is well established that the CRA has broad powers to examine and require the production of taxpayer information pursuant to sections 231.1 and 231.2. These powers were the subject of the FC's recent decision in *Canada (National Revenue) v. Atlas Tube Canada ULC* (2018 FC 1086) (*Atlas*), where the court ruled in favour of the CRA's application for a compliance order compelling the taxpayer to produce documentation prepared in the context of an acquisition transaction. The purpose of this article is to highlight the key aspects of the court's decision in *Atlas* in light of the FCA's prior decision in favour of the taxpayer in *BP Canada Energy Company v. Canada (National Revenue)* (2017 FCA 61) (*BP Canada*).

BP Canada

In *BP Canada*, the FCA imposed limits on the CRA's ability to access a taxpayer's tax accrual working papers primarily on the basis that, depending on the circumstances, granting such access would be tantamount to imposing a self-audit obligation on the taxpayer. The FCA affirmed (at paragraph 60) that subsection 231.1(1) generally permits the CRA to access a document when, in the course of the administration of the Act, the document (1) is part of, or is in, the books and records of the taxpayer; (2) relates or may relate to information that is or should be in the books and records of the taxpayer; or (3) relates or may relate to any amount payable by the taxpayer under the Act. However, the FCA held that subsection 231.1(1) did not allow the CRA general access to the taxpayer's tax accrual working papers if all legitimate audit concerns related to this material had been previously addressed. Providing the CRA with the ability to access these documents without advancing any particular justification for their production would be tantamount to compelling a taxpayer to self-audit, given that the taxpayer had a regulatory requirement to document its uncertain tax positions on an annual basis.

Atlas

In *Atlas*, the FC distinguished the *BP Canada* decision and ruled in favour of the CRA's application for a compliance order compelling the production of a draft due diligence report prepared in connection with the taxpayer's acquisition of the shares of an Ontario public corporation, Lakeside Steel Inc. (LSI). The report was prepared by an accounting firm that conducted Canadian tax due diligence on the recommendation of Canadian legal counsel. The report summarized the tax profile of LSI, including the availability of non-capital losses and material tax exposures of LSI and one of its subsidiary corporations. This summary included an assessment of the probability of the tax-filing positions surviving a challenge by the CRA and an evaluation of the reserves taken in respect of such exposure.

Atlas did not comply with the CRA's request for a copy of the report on the basis that (1) the CRA had not established its relevance to a particular issue under audit; (2) the report was protected by solicitor-client privilege; and (3) the report revealed uncertain tax positions that did not relate to the taxation year under audit, which would effectively provide the CRA with a road map for uncertain tax issues that could be raised in the audit and would impose a self-audit obligation on Atlas.

With respect to the CRA's wide powers to access taxpayer documents, the court held that the CRA did not have to establish that the report was relevant, only that it may be relevant. In contrast to *BP Canada*, the request for the report was made in the context of an active audit of particular issues. The FCA in *BP Canada* indicated (in obiter) that, as a general rule, tax accrual working papers *could* be accessible under the Act if required to respond to a specific inquiry made in the context of an audit. Therefore, the court in *Atlas* concluded that the FCA's decision in *BP Canada* was not a basis for precluding disclosure of the report.

The taxpayer's position was that the report was subject to solicitor-client privilege because its "principal purpose was to provide information to [counsel] to inform their provision of legal advice as to how to structure the . . . acquisition." The court accepted that there are circumstances in which solicitor-client privilege can apply to a document prepared by a third party and, in particular, by an accountant. As a general rule, those circumstances will exist when the third party serves as an interpreter of advice from a solicitor to a client or a conduit of instructions from the client to the solicitor, or employs expertise in assembling information provided by the client and in explaining it to the solicitor (based on the decision in *Redhead Equipment v. Canada (Attorney General)*, 2016 SKCA 115).

In the circumstances, however, the court in *Atlas* held that the dominant purpose for the due diligence and the report was to obtain information about tax attributes to inform the business decision about whether or not to proceed with the acquisition, and at what price. Furthermore, the report contained information concerning potential tax exposure and the adequacy of tax reserves taken, topics that the court concluded did not appear to be capable of being characterized as prepared for the purpose of obtaining legal advice on the structuring of the transaction.

Conclusions

The decision in *Atlas* is a reminder that the CRA's ability to access taxpayer information remains exceptionally broad. When a third-party document is prepared in circumstances that could potentially justify a claim of solicitor-client privilege, it is arguable that it will not be privileged in every case if it is also prepared for another dominant business purpose. Taxpayers should be better able to protect a third-party report from disclosure on the basis of solicitor-client privilege if that report is commissioned by legal counsel already engaged to provide legal advice, and the third party is thereafter engaged to specifically provide information or expertise relevant to the legal engagement.

Addendum

On December 5, 2018, Atlas filed a notice of appeal to the FCA asking that the FC's decision be set aside and the minister's application for a compliance order be dismissed. In the notice of appeal, Atlas argued that the FC erred in (1) misinterpreting and applying subsection 231.1(1); (2) interpreting and applying the test for whether the report was subject to solicitor-client privilege; (3) holding that production of the report would not violate the principle against self-audit; and (4) determining the purpose for the report and whether information in the report might be relevant to an amount payable under the Act.

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Proposed CCA Amendments Provide Limited Incentives

Eleven months after the United States enacted historical tax reform, the Canadian government released its long-awaited tax measures on November 21, 2018, with its fall economic update. The measures include a limited package of accelerated capital cost allowance (CCA) provisions that many believe will have a minimal impact on most private businesses (especially in light of the present value of the measures' tax consequences).

Specifically, the amendments to the CCA regime provide

1) a full deduction for purchases of manufacturing and processing (M & P) equipment and certain new green technology equipment acquired after November 20, 2018, and
2) an increase to the first-year deduction for other new depreciable property acquired after November 20, 2018.

As mentioned, the enhancements apply for purchases of property after November 20, 2018, but they also apply for a limited time: the property must be available for use before 2024. A similar enhancement will be available for Canadian development expenses and Canadian oil and gas property expenses of oil and gas companies.

CCA is a longstanding method for Canadian corporations (and other persons) to deduct the cost of depreciable capital property. The Act specifies the rate at which that cost may be deducted. Furthermore, most depreciable property is currently subject to the half-year rule, which reduces the first-year CCA deduction to 50 percent of what it would otherwise be. For example, if an asset is purchased for $100,000 and its CCA rate is 20 percent (computed on a declining-balance basis), then the CCA deduction will be $10,000 in year 1. In year 2, the remaining undepreciated amount of $90,000 will be subject to a 20 percent rate and an allowable deduction of $18,000, and so on, until the asset is ultimately disposed of or is virtually fully depreciated. The new temporary accelerated investment incentive is calculated by a complicated formula.

Boiled down, all this measure really does, for non-M & P and non-green investments, is negate the half-year rule and provide an additional 50 percent deduction in year 1. When this incentive is applied to the example above, the first-year deduction becomes $30,000 ($100,000 × 20% × 1.5), resulting in a one-time deduction boost for new depreciable property purchases made in the applicable time period. For a CCA class that is subject to a declining-balance depreciation rate of 20 percent, the net difference—after the asset is owned for seven years—is an additional 5.2 percent of CCA deductions over that period. For depreciable property that has a straight-line CCA rate over six years, the change has no impact at all. Note that depreciable property transferred on a rollover basis (such as property transferred pursuant to subsection 85(1)) or property transferred between non-arm's-length persons will not be eligible for the enhanced CCA treatment.

What many in the business community were hoping for—the ability to compete with the US package on significant corporate and personal tax rate reductions—was clearly missing. The immediate expensing of certain M & P and green equipment and limited accelerated first-year depreciation for new purchases of other equipment will assist some capital-intensive businesses (that have budgets available to purchase new equipment); in my experience, however, most private entities are in the service business and are not capital-intensive. Accordingly, the incentive for these types of businesses will likely be minimal at best and will not be helpful in dealing

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with the competitiveness issues posed by the dominant force south of the border.

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Stewart v. The Queen: Why Was This Case in Court?

Sometimes I read a case and ask myself: why did this case ever get to court? Most often, such cases involve an individual taxpayer caught up in the technicalities of the Act. Usually there is not a lot of money at stake and no obvious point of principle on which the CRA is looking to establish a judicial precedent. Nonetheless, the taxpayer is in court to defend a deduction, or to resist including an amount of some type in income. *Stewart v. The Queen* (2018 TCC 210) is a recent example of such a case.

The taxpayer and his wife entered into a separation agreement. He agreed to pay spousal support following their divorce. One payment was for ongoing health-care premiums. At his wife's request, the taxpayer made annual payments directly to Blue Cross "to save some money and to convenience her" (paragraph 9). The separation agreement did not refer to the possibility that he would pay any of the support amounts directly to a third party. The taxpayer, who acted on his own behalf, testified that he could have just as easily paid his wife the amounts directly but instead paid the insurance company in order to simplify things for her (paragraph 10). He deducted $2,056.06 (the annual premium payment) in his 2015 tax return, and she included a corresponding amount in her income for that year.

Anyone other than a technical tax nerd might have thought that this was the end of the matter: an amount was paid on account of spousal support and was deductible. But the CRA disallowed the deduction. Subsections 60.1(1) and (2) deal with the deduction of third-party support payments. Such amounts are deductible if made under a written separation agreement and the "written agreement . . . provides that this subsection and subsection 56.1(2) shall apply to any amount paid . . . thereunder." In this case, there were no references to the relevant subsections in the separation agreement. And on this basis, I assume, the assessor responsible for the file decided to disallow the deduction. The reasons for judgment do not indicate the specific reason for the disallowance. Whatever it was, the court was satisfied that the parties expected that the Blue Cross payments would be treated as spousal support payments that were deductible by the taxpayer and taxable to his wife (paragraph 7).

After a taxpayer objects to an assessment, the matter is reviewed by an independent Appeals officer. It's here that my complaint with the CRA's handling of the case really heats up. Remember that we are talking about an additional tax of what was likely no more than about 30 percent of $2,056, or about $615. The Appeals officer should have been aware that when both the taxpayer and his wife were taken into account, any tax gained by assessing the taxpayer, net of any refund to the wife (assuming that one was made), would have been very small. Wouldn't a realistic Appeals officer have recognized this outcome and allowed the objection? Apparently not. The assessment was confirmed, and the taxpayer was left with the option of taking the matter to court.

When a taxpayer appeals to the TCC, the file moves from the CRA to the Department of Justice. One wonders why Justice didn't dispose of this matter quickly, without taking up the time of the court. It is true that the separation agreement did not refer to section 60.1 and subsection 56.1(2). But this very point was dealt with by the FCA in favour of the taxpayer: see *Veilleux v. R* (2002 FCA 201) and *Gagné v. The Queen* (2002 CanLII 53 (TCC)). Those cases held that a reference to sections of the Act is not required in the written agreement as long as the parties understand the tax consequences of their agreement. The court in *Stewart* cited those cases in the course of allowing the appeal. Did the Justice lawyer not bother to review the law before deciding to file a reply to the taxpayer's notice of appeal?

Neither the CRA assessor nor the Appeals officer nor the Justice lawyer seems to have tried to address this case in a way that was fair to the taxpayer and that respected the integrity of the tax system. It seems that starting with the decision to assess, no one was prepared to exercise any real judgment and deal with a very minor tax matter in a way that made sense.

I am well aware that the reasons for judgment in a case don't necessarily tell the full story behind an appeal. One has to have been there to appreciate all the subtleties of the case. That said, on the facts of *Stewart* as reported, and on the basis of the clear statements of law from the FCA, this matter should never have wound up in court. Unless there is more here than is apparent from the reasons, the fact that this case went to the TCC reflects badly on those in the CRA and the Department of Justice who are responsible for allowing it to get that far.

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