CANADIAN TAX focus

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Americans in Canada: An Amnesty with Broad Appeal

On June 26, 2012, the IRS announced new filing compliance (NFC) procedures for non-resident US taxpayers (IR-2012-65). Starting on September 1, 2012, there will be a new program for US persons who are non-compliant with US law but do not owe substantial US tax. This will greatly benefit the many US persons (US citizens, green-card holders, and resident aliens) living in Canada who are not up to date in the filing of their US tax returns and foreign bank and financial account report (FBAR) information forms (see "Americans in Canada: The End of the Amnesty," *Canadian Tax Focus*, November 2011). The rules seem to be close to what tax practitioners have been seeking for some time.

To qualify under the NFC procedures, the taxpayer must present a low compliance risk. Generally, this means that the taxpayer's returns are simple, with less than $1,500 of US tax due for each of the three most recent years. Indicia that may move taxpayers out of the low-compliance-risk category are higher levels of income and assets, use of sophisticated tax planning, material activity in the United States, a history of US tax non-compliance (other than what is being reported in the present application), and the amount and character of US-source income. Higher-risk submissions made under the NFC procedures may be subject to greater scrutiny and additional filing requirements. Specific details and further clarifications are expected to be released prior to the procedures' September 1 effective date. In some situations, taxpayers may be required to submit a statement signed on penalty of perjury explaining why there was reasonable cause for previous failures to file in order to eliminate or reduce penalties.

Individuals intending to use the NFC procedures will be required to file tax and related information returns for the past three years, FBARs for the past six years, and information regarding compliance-risk factors. The IRS has released a statement ("New Filing Compliance Procedures for Non-Resident US Taxpayers") indicating that for "taxpayers presenting [a] low compliance risk, the review will be expedited and the IRS will not assert penalties or pursue follow-up actions."

Individuals who choose not to use the NFC procedures have several additional options, including "quiet disclosures," "noisy disclosures," and participation in the 2012 offshore voluntary disclosure program (OVDP). Choosing none of these (that is, doing nothing at all) is increasingly risky as US enforcement efforts increase and technology improves (see the *Canadian Tax Focus* article cited above). A quiet disclosure—addressing current-year filing obligations and liabilities without addressing past non-compliance—is not much better: "Those taxpayers making 'quiet disclosures' should be aware of the risk of being examined and potentially criminally prosecuted for all applicable years" (question 15, 2012 OVDP FAQs). Noisy disclosures—which generally consist of the submission of six years of returns and a request for abatement of penalties on the basis of reasonable cause—will likely be used only by taxpayers who are not far outside the simple, low-risk threshold of the NFC procedures.

An option for those in riskier situations is the 2012 OVDP. This program, which was announced on January 9, has no predetermined duration, and may be cancelled or modified at any time. It offers more program structure, waiver of criminal prosecution, and predetermined penalties. To participate in the 2012 OVDP program, taxpayers (which can include business entities) must

- file eight years of US income tax returns, FBAR forms, and other information returns;

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- pay any tax due, a 20 percent understatement penalty, penalties for failure to file and failure to pay, and interest; and
- pay an offshore penalty of 27.5 percent imposed on the highest FMV of the taxpayer's foreign assets and the highest balances in all foreign financial accounts. However, US citizens residing in Canada (or other foreign countries) for each of the years covered by the 2012 OVDP may qualify for a reduced offshore penalty of 5 percent, which will be imposed only on the taxpayer's foreign financial accounts.

Both the NFC procedures and the 2012 OVDP allow taxpayers with RRSP and RRIF accounts to file forms 8891 on a late basis so as to make an election under article VIII(7) of the Canada-US tax treaty. The election will not only defer US income taxation of the investment income earned by the RRSP and RRIF accounts, but it will also exclude the balances in those accounts from the base on which the offshore penalty is computed. Thus, the advantages of the election are that it makes it more likely that a taxpayer who uses the NFC procedures will have less than $1,500 of US tax due, and it reduces the amount of the offshore penalty for a taxpayer participating in the 2012 OVDP. In order to make the election, a taxpayer must submit a statement requesting an extension of time to make the election, along with forms 8891 for each of the tax years and type of plan covered and a statement dated and signed by the taxpayer, on penalty of perjury, which describes

- the events that resulted in the failure to make the election;
- the events that resulted in the discovery of that failure; and
- whether the taxpayer relied on a professional adviser and, if so, the nature of the professional adviser's engagement and responsibilities.

The relief provided for RRSP and RRIF accounts may also be available for other pension and retirement plan accounts.

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FCA Upholds Sommerer re Subsection 75(2) and FMV Sales

The FCA has upheld the TCC's decision in *Sommerer* (2012 FCA 207). The decision will be well received by taxpayers and their advisers with respect to the application of subsection 75(2). It remains to be seen whether the CRA will seek leave to appeal the decision to the SCC.

In *Sommerer*, a Canadian-resident taxpayer sold shares at FMV to an Austrian private foundation of which he was a beneficiary. Some time later, the foundation sold the shares to arm's-length parties and realized sizable capital gains. The Crown took the position that subsection 75(2) applied to attribute the gains back to the taxpayer. The taxpayer appealed to the TCC.

Subsection 75(2) applies to attribute income, losses, capital gains, and capital losses to a person who transfers property to a trust if the property or property substituted therefor may revert to that person, that person may determine who will receive the property, or the property cannot be disposed of without that person's consent or direction. Another adverse consequence arises if this attribution rule applies to a trust at any time: a tax-free rollout of property from the trust to beneficiaries is not available (unless the distribution is made to the transferor or the transferor's spouse). The result is that the trust is deemed to dispose of property at FMV on a distribution to a beneficiary other than to the transferor or the transferor's spouse.

The TCC held that subsection 75(2) does not apply where a trust acquires property from a beneficiary at FMV (2011 TCC 212). Writing for the FCA, Sharlow J agreed with the statutory interpretation analysis and conclusion of the TCC and added that a purposive interpretation of subsection 75(2) should be adopted. The FCA described a scenario in which a mother settles a trust for her children with cash and names herself as a contingent beneficiary. The trust uses the cash to purchase a painting from one of the children, and then sells the painting for a gain. Under the Crown's interpretation, this gain is attributed both to the mother (because the painting is property substituted for the cash she contributed and she is a beneficiary) and to the child (because the child has sold property to the trust and is also a beneficiary). The FCA held that Parliament could not have intended such an absurd outcome, and therefore subsection 75(2) does not apply to attribute income, losses, capital gains, or capital losses to a transferor who receives FMV consideration from the trust.

Provided that the FCA's interpretation is not reversed through a possible appeal, the result is that the application of subsection 75(2) has been greatly narrowed. This will broaden planning opportunities for taxpayers and their advisers.

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Writing Position Letters: Some Tips from an FCA Justice

Editor's note: This article is an edited version of a portion of a May 2012 luncheon address to the Toronto Young Practitioners chapter presented by the Hon. David W. Stratas of the Federal Court of Appeal.

As everyone knows, the minister has many discretions to exercise under the Income Tax Act. Generally, before these discretions are exercised, taxpayers and their advisers (accountants, lawyers, etc.) exchange position letters with the CRA auditors (or appeals officers). Typically, an auditor will propose certain adjustments or results, and the taxpayer will counter with his or her position. These position letters can matter when the minister's exercise of discretion is challenged in court.

On an application for judicial review, the court evaluates whether the minister's decision falls within a range of acceptability and defensibility on the facts and the law. The setting of the range and whether the exercise of discretion falls within the range is a rather subjective matter. Even if the minister's exercise of discretion falls outside the range, the court has a remedial discretion—again, a subjective matter.

Position letters, whether written by the minister or by the taxpayer, are often placed before the court. If a position letter is badly conceived and poorly executed, it may leave a less than ideal impression or even repel the court.

For the benefit of those who will write position letters, whether they are members of the minister's staff or the taxpayer's advisers, here are some tips:

1) *Know your audiences*. Your immediate audience is the other side, but judges are your ultimate audience. Another audience may be the person instructing you. Sometimes you may have to explain to that person that a point they love is one the judges will hate.
2) *Understand the judicial audience*. Judges want to be educated about the matter. They insist on accuracy and prefer temperate language. They try to decide justly, consistent with the law. Most of all, judges are practical problem solvers in search of simple solutions. As you draft your position letter, keep these characteristics in mind.
3) *Identify the controlling matters*. The controlling matters are the particular facts or legal points upon which the outcome will turn. Usually there are very few controlling matters, and sometimes there may be just one. Emphasize the things that most directly lead to success on the controlling matters.
4) *Concentrate on the substance early*. No amount of nice-sounding prose will cover up a weak position. To develop and express a strong position, you need to investigate and identify everything potentially in support of your position—at the outset. Too often this is done later, if at all, and later position letters end up stuffed with new or revised facts and arguments. To a judge, this can look like desperate scrambling to patch a weak case—or, worse, like a fish flopping around in a boat, caught and soon to be fileted.
5) *Engage in selection*. Once you have identified everything that is potentially useful, select the best bits, bearing in mind the characteristics of the judicial audience mentioned in point 2 above. Be courageous: leave the small stuff on the cutting-room floor. The best bits have to shine through, unobscured by trivia.
6) *Write well*. The forthcoming online version of this article (to be published on the Toronto YP pages of the Canadian Tax Foundation's website) will offer more detailed guidance on this point. Some instructional books on writing are worth their weight in gold—for example, Bryan A. Garner, *Legal Writing in Plain English*; Stephen V. Armstrong and Timothy P. Terrell, *Thinking Like a Writer: A Lawyer's Guide to Effective Writing and Editing*; Joseph M. Williams, *Style: Toward Clarity and Grace*; and Richard C. Wydick, *Plain English for Lawyers*.

I hope that you find some of these suggestions helpful. I wish you all the best.

Hon. David W. Stratas
Federal Court of Appeal

The CICA's International Tax Courses

The CICA's Advanced International Tax (AIT) course has been split into two courses—one that was offered for the first time last year, and a second that is still on the drawing board. The coverage of international tax in the CICA's In-Depth Tax Course is unchanged.

Enrolment in the AIT course had declined from 80 participants in 2006 to 40 in 2009. The AIT course was primarily an advanced "foreign affiliate rules" course geared toward international tax specialists with several years of experience in the field. For example, the AIT course timetable included advanced coverage of such topics as transfers and reorganizations of foreign affiliates, outbound structuring and financing, and the foreign accrual property income (FAPI) regime.

According to the report of the CICA's Tax Education Task Force (cpd.cica.ca/TaskForceReport_2012.pdf), one cause of the decline in enrolment may have been an increasing number of younger practitioners joining the tax practice as a result of the waiver of the audit-hours requirement for the CA designation. Many course participants had less than three years' experience in international tax or were non-specialists who did not intend to pursue a career with a strict focus on international tax matters. Participants from industry indicated that the AIT course was too specialized for their purposes. For all these reasons, the course was redesigned. The new Foundations of International Tax (FIT) course was offered for the first time in the fall of 2011 to more than 90 participants, 35 percent of whom had a background in industry.

The four-day FIT course is designed to be part 1 of a two-part international tax curriculum, and is intended to provide broad-based coverage of both inbound and outbound international tax rules. The FIT course will be of interest to practitioners who are beginning their international tax practices, and to non-international tax specialists who want to increase their knowledge base for the purpose of issue identification. The topics covered in last year's sessions included relief from double taxation, basic treaty concepts, an introduction to cross-border personal taxation, transfer pricing, and US international tax concepts. More sophisticated topics such as FAPI, the foreign affiliate surplus rules, and the financing of foreign affiliates were also covered, though at a more introductory level.

The FIT curriculum will undergo further refinement for the November 2012 offering, with enhanced coverage of the foreign affiliate reorganization provisions (albeit still at a relatively introductory level) and an increased focus on the Canada-US tax treaty.

Part 2 of the revised international tax curriculum has yet to be finalized, and may be offered for the first time in 2013. The focus of the course is expected to be on advanced issues in foreign affiliate reorganizations; however, there will also be in-depth coverage of treaty issues, including the Canada-US tax treaty, as well as advanced outbound and inbound financing issues. The delivery mechanism is still under discussion. For example, the CICA is considering whether splitting the course into shorter sessions and moving away from the traditional in-residence format would make for a better learning environment. For more information, write to Vivian Leung of the CICA (vivian.leung@cica.ca).

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Editor's note: The May 2012 Canadian Tax Focus *article on the changes in the In-Depth Tax Course triggered online comments relating to whether the CICA plans to offer a tax specialization. The CICA is assessing all of its specialization programs, and expects to have more information available in the fall.*

The CRA's Revised Fundraising Guidelines: Legislation Needed

In April 2012, the CRA released *Guidance* CG-013 (revising CPS-028, June 2009), setting out in detail its interpretation of the fundraising rules applicable to registered charities. However, these guidelines are not sufficiently backed by legislation to achieve their purpose.

CG-013 says that fundraising is not acceptable if it is a purpose of the charity (as opposed to doing "good works"); delivers more than incidental private benefit; is illegal or contrary to public policy; is deceptive; or (a criterion new to CG-013) is an unrelated business. Further, the CRA applies a classification that is based on a charity's fundraising expenditures divided by fundraising revenues (the fundraising ratio): if the percentage is under 35 percent, the CRA is unlikely to have questions or concerns; if it is over 35 percent but under 70 percent, the CRA may request additional information on expenditures; and if it is over 70 percent, the CRA will generally have concerns.

These guidelines seem to go beyond the legal authority provided by the relatively thin case law and Act provisions (notably, the principle in subsection 149.1(1) that a registered charity must devote all of its resources to charitable activities). In addition, jurisdiction arguably lies not with the federal government but with the provincial governments (sections 92(7) and 92(13) of the Constitution Act, 1867). Since these points have been argued elsewhere (Susan M. Manwaring and Andrew Valentine, "Comments on CRA Fundraising Guidance," *Canadian Tax Journal*, 2010), I will turn my attention to a particular example that illustrates the type of regulation that seems to be needed, regardless of whether it is enacted by the federal government or by the provinces.

According to a recent news report, a Canadian charitable organization entered into a seven-year fundraising contract with a US-based direct mail marketing company. Despite a successful campaign that raised more than $13 million in donations, only a small fraction of the funds was reportedly made available for the charity to spend on charitable activities. Further, the charity was reported to be indebted to the marketing company for millions of dollars.

At first sight, this type of fundraising contract seems contrary to CG-013 because it appears to deliver more than an incidental private benefit and it may have resulted (depending on the success of other fundraising) in the charity having a fundraising ratio of over 70 percent. However, this is an after-the-fact evaluation. Those responsible for the governance of the charity probably were not expecting the results that occurred, and would sincerely regret the damage done to the donors' trust and to the public's faith in the reputation of charities in general. The situation is unlikely to be repeated—for this charity, at least—but the damage has been done.

What can be done about such unintended bad outcomes? One could penalize marketing companies that take advantage of charities, although proving intention might be difficult. A better approach may be to prohibit contractual agreements with marketing companies in which the charity is not guaranteed at least a certain percentage of the donations—say, 30 percent, to stay marginally within the CRA's 70 percent fundraising ratio. Some marketing companies might be less likely to do business with charities, but if they only did deals with charities that had good donor prospects, then maybe that outcome would be a good thing.

The solutions suggested above would likely require additional federal or provincial legislation, which so far has not been forthcoming. Until the law is amended, Canadian charities will remain vulnerable to sharp fundraising practices.

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Uncertain Tax Positions: Navigating Accounting Policy Choices

The conversion to international financial reporting standards (IFRS), which is now complete, has led to some indecision when it comes to reporting and disclosing uncertain tax positions (UTPs). Organizations should develop a well-documented accounting policy for UTPs and ensure the consistent application of the policy.

A UTP is an item for which the tax treatment is unclear or is a matter of dispute between the organization and the taxation authority. International accounting standard (IAS) 12, "Income Taxes," addresses the reporting and disclosure requirements associated with accounting for income taxes, but it contains no specific guidance on recognizing or measuring tax assets or liabilities that are subject to uncertainty.

Currently, two approaches are being used in practice. The first is a "one-step" approach whereby all UTPs are recognized regardless of the probability of economic outflow. Under this approach, the probability of economic outflow will be taken into account when the liability is measured.

The second approach is the "two-step" approach, whereby a UTP is recognized only when it is probable that the obligation will result in an economic outflow (similar to FIN 48 under US GAAP). This approach mimics IAS 37, "Provisions, Contingent Liabilities and Contingent Assets," in that it uses a "probable" threshold to determine whether a UTP should be recognized. "Probable" in this context is accepted to mean that the probability of the event occurring is greater than the probability that it will not occur (that is, more than a 50 percent chance of occurrence). The question then is whether each UTP should be considered in isolation or as part of the tax liability as a whole. This decision can affect the accounting analysis, since IFRS imposes a much higher recognition threshold for uncertain assets than for uncertain liabilities.

Under either approach, after it is determined that a UTP will be recognized, the liability must be measured. This introduces further choices for practitioners, since measurement alternatives may include (1) the average weighted probability of outcomes, (2) the most likely single outcome, and (3) an all-or-nothing approach. Based on professional judgment, the "weighted average probability" approach assigns a probability of occurrence to several potential outcomes and includes all potential outcomes in the measurement of the liability. The "most likely single outcome" approach uses a similar method, except that the outcome that is considered the most likely to occur is used to quantify the liability, rather than an average of all potential outcomes. Under the "all-or-nothing" approach, no liability is recorded for UTPs with a probability below a selected threshold, and full liability is recorded for UTPs with a probability exceeding the threshold.

Typically, a UTP that affects current tax is presented as a current tax liability. In some circumstances, however, the

UTP affects the tax base of an asset or liability, and is presented as a deferred tax asset or liability. IAS 12 contains no provision that allows or requires the offset of current tax and deferred tax.

With respect to the disclosure of specific tax-related contingent liabilities and assets, IAS 12 refers to IAS 37. With respect to contingent liabilities, IAS 37 specifies that a brief description of the nature of the liabilities is required to be disclosed unless the possibility of any outflow of resources embodying economic benefits in settlement is remote. Where practicable, the disclosure is to be extended to provide certain additional information, including an estimate of the financial effect of the contingent liabilities. However, IAS 37 also includes a provision that allows an entity not to disclose some of the required information if it can be expected that the disclosure of the information would seriously prejudice the position of the entity in a dispute with another party—for example, the CRA. On this basis, the standard practice appears to be non-disclosure.

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Foreign Tax Credits: Problems with Timing of Income Recognition

Two of the factors limiting the foreign tax credit (business or non-business) for a year are the foreign tax paid for the year and the estimated Canadian tax on the foreign income for the year. In certain situations, however, the foreign tax in this calculation appears in a different year than the Canadian tax on the foreign income. For taxpayers for whom foreign income does not occur every year, this timing difference can play havoc with the normal relief from double taxation.

Suppose that, for cross-border employee stock options, the employment income is recognized in Canada in the year in which the options are exercised (year 1) but is not recognized in the foreign country until the subsequent disposition of the shares (year 2). If this is the taxpayer's only foreign income in the two years, there is a problem: in the year in which the foreign tax is paid (year 2), no foreign income is recognized in Canada; in the year in which foreign income is recognized in Canada (year 1), no foreign tax is paid. Thus, the foreign tax credits for both years are zero. Can this problem be avoided by paying the foreign tax in year 1, as a prepayment? The CRA is of the view that the reference to "year" in "tax paid by the taxpayer for the year" refers to the year *for which* the foreign tax is paid, not the year *in which* the foreign tax is paid (*Interpretation Bulletin* IT-270R3, "Foreign Tax Credit," November 25, 2004, paragraph 11). Thus, a prepayment is of no help.

A related question arises when the foreign tax year does not coincide with the Canadian tax year, but overlaps to some degree. In that situation, the CRA says that the foreign tax for the Canadian tax year should be calculated as a proration (presumably daily or monthly) of the tax paid for the two foreign tax years that overlap the Canadian tax year ("Revenue Canada Round Table," 1989 Conference Report, question 4). This tends to work to the detriment of the taxpayer who has foreign income in only one year. Suppose, for example, that a Canadian taxpayer earns employment income in the United Kingdom from May to December 2012 and then ceases her employment there. The UK tax year for individuals ends in early April (say March 31, for simplicity). In this example, 9/12 of the UK tax will be eligible for the foreign tax credit in 2012, and 3/12 of the UK tax will be eligible in 2013. However, since the taxpayer has only foreign income in 2012, she will lose part of the potential foreign tax credit.

This timing issue applies to both individual and corporate taxpayers. In CRA document no. 2000-0029575, the CRA considered a similar situation involving a corporation (Canco) that owned an interest in a partnership that had different year-ends for Canadian and foreign tax purposes. Canco earned both foreign business income and non-recurring foreign non-business income (capital gains on the sale of real property). Again, the CRA indicated that its administrative policy would be to accept apportioned amounts of foreign income and taxes paid on the basis of the portion of income earned during the calendar year. If the taxpayer had no non-business income in a preceding or subsequent Canadian tax year, part of the foreign tax credit associated with the foreign non-business income tax paid would be lost. (For a further discussion of these issues, see Ken Snider, "The Foreign Tax Credit Rules," in the 2001 Conference Report.)

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Science Fiction: Bagtech on CCPC Status and USAs

In *Bioartificial Gel Technologies Inc. c. La Reine* (2012 CCI 120) *(Bagtech)*, the TCC found that a unanimous shareholders' agreement (USA) caused a corporation to qualify as a

CCPC, and thus to be eligible for the refundable SR & ED tax credit, even though more than 50 percent of the voting shares of the corporation were held by non-residents. The USA specified that the Canadian-resident shareholders were to maintain the ability to elect a majority (or, for part of the period, one-half) of the directors on the board.

Paragraph (b) of the definition of "Canadian-controlled private corporation" in subsection 125(7) is a two-step test. First, all shares of any corporation that are owned by disqualifying persons (non-residents, public companies, or companies with shares listed on a designated stock exchange) are attributed to a single hypothetical person. Second, it must be determined whether that hypothetical "particular person" would control the corporation whose status is being tested.

The minister reasoned that the USA giving the Canadian-resident shareholders the ability to elect the majority of the board of directors (and thus de jure control) should be ignored because the hypothetical shareholder was not a party to it. This argument was made despite the SCC's decision in *Duha Printers (Western) Ltd. v. Canada* ([1998] 1 SCR 795), which held that USAs, like other constating documents of a corporation, are relevant in determining de jure control. The minister further argued that in any event the only relevant provisions of a USA for the purposes of determining control are those restricting the powers of the directors, not those affecting the voting rights of shareholders. Not surprisingly, the taxpayer argued that the hypothetical "particular person" was a party to the USA and must be considered to be bound by all of its provisions.

The TCC agreed with the taxpayer's submissions. Bédard J noted that paragraph (b) of the CCPC definition creates a legal fiction. He held that the "particular person" must be deemed to have the same rights and obligations as the actual shareholders of the corporation, relying, in part, on the legal fiction set out at section 146(3) of the Canada Business Corporations Act (CBCA), which provides that a purchaser or transferee of shares subject to a USA is deemed to be a party to the agreement. Bédard J concluded that the hypothetical "particular person" was a party to the USA. Since, having regard to all the provisions of the USA, the non-resident shareholders did not have control of the taxpayer, the taxpayer was therefore a CCPC.

The *Bagtech* decision is noteworthy on two fronts. First, it reaffirms *Duha Printers* and clarifies that all provisions of a USA, not just those affecting the directors' powers, are relevant to determining corporate control. Second, it confirms a line of Canadian jurisprudence suggesting that legal fictions are to be interpreted broadly and extended to their logical consequences. Interestingly, the logical consequence in this case was the result of not one but two legal fictions: the hypothetical "particular person" and the deeming rule at section 146(3) of the CBCA. It remains to be seen whether the TCC's broad interpretation will be maintained; the case is under appeal to the FCA.

Bagtech raises an interesting tax-planning question: will shareholders contemplate adopting this type of USA at least partly for the purpose of obtaining CCPC status? If they do so, non-resident and other disqualifying shareholders will effectively be giving up control of the company (to the extent that they would otherwise have had it), so the tax advantages will have to be weighed against this important non-tax disadvantage.

(The *Bagtech* decision was rendered in French; it is expected to be translated into the other official language [the normal practice for general procedure cases], although this process can take up to a year, owing to the volume of cases.)

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Using Life Insurance To Extract Corporate Funds Tax-Free

For a shareholder of a private corporation, the transfer of a personally owned life insurance policy to the corporation can offer a way to extract value from the corporation without triggering immediate taxation. The strategy works best if the policy has, relative to its face value, a high fair market value (FMV) and a low cash surrender value (CSV)—the amount that the life insurance company will pay if the policy is cancelled.

A high FMV is important because it determines the maximum amount that the corporation can pay for the policy without creating a taxable benefit. This might occur, for example, if the person whose life is insured has a reduced life expectancy (perhaps due to high blood pressure or a heart condition) relative to what is normal for his or her age. In the extreme, the FMV could approach the policy's face value (its death benefit) if the insured person has a terminal illness or has been critically injured and is not expected to recover (*Interpretation Bulletin* IT-416R3, "Valuation of Shares of a Corporation Receiving Life Insurance Proceeds on Death of a Shareholder," July 10, 1987). A lower but still substantial FMV could exist if the insured person is elderly and has had the policy for many years. In either case, an actuary would have to determine the policy's FMV.

A low CSV is important because on a non-arm's-length transfer (as in this case) the policyholder will be taxed on the amount, if any, by which the CSV exceeds the adjusted cost base (ACB) of the policy (see subsections 148(7) and 148(9)). Thus, term policies (including term-to-100 policies) are particularly suitable for this planning technique, since they have no CSV.

Consider, for example, an individual (Mr. A) who is the sole owner of a private corporation (A Co). Mr. A is 65 years old and has recently been diagnosed with some health problems. Mr. A had purchased a $1 million life insurance policy at age 40, when he was in good health. At the time the policy was purchased, its FMV would have been nominal; because of the change in Mr. A's health, it is worth $500,000 now. In this situation, Mr. A can have A Co purchase the life insurance policy for $500,000, thus extracting that amount from the corporation on a tax-free basis (provided that the policy's CSV does not exceed its ACB).

An additional benefit of corporate ownership is that the policy premiums, although they are generally not tax-deductible, can be paid out of corporate funds, which are taxed at a lower rate than income earned by Mr. A.

The CRA is aware of this type of planning and has indicated that such transactions may not be consistent with the intention of the legislation (see, for example, CRA document nos. 2002-0127455, 2003-0040145, and 2008-0303971E5). However, there have been no further indications that this planning is considered abusive or otherwise problematic.

The immediate tax benefits should be weighed against a number of other factors:

- the loss of creditor protection that would generally otherwise exist with personal ownership;
- the difficulty of removing the policy or its proceeds from the corporation in the future (one reason being that the policy will have a low ACB—the amount of the CSV); and
- the potential loss of the capital gains exemption in cases where owning the policy could cause the corporation to fail the 50 percent or 90 percent active business asset test.

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NPOs' Response to CRA "Education Letters"

Since 2010, the CRA has sent almost 1,500 "education letters" to not-for-profit organizations (NPOs), typically advising the organization of its potential non-compliance with the Act and urging it to adjust its activities accordingly. No specific action or response is requested. Although these letters may be considered a form of audit by the CRA, they do not seem to lead directly to the imposition of any penalty. Nonetheless, NPOs should think carefully about whether any organizational or other changes should be made.

The stated purpose of these letters is to educate NPOs about their compliance obligations and to encourage them to comply. The letters are part of the NPO Risk Identification Project, which the CRA initiated to gather intelligence about the nature and extent of compliance by NPOs with the Act. The CRA views these letters as more cost-effective than traditional audits in promoting compliance. The "education letter" approach is also being used for individuals in connection with rental and business income, employment expenses, and capital gains or losses. The CRA's website says that 47,000 such T1 letters were to be sent out in January and February 2012, so the NPO letters are part of a much bigger CRA strategy.

Paragraph 149(1)(l) of the Act defines an NPO as a club, society, or association that is not a charity and requires it, among other things, to be organized and operated exclusively for social welfare, civic improvement, pleasure or recreation, or any other purposes except profit. Golf, curling, and ski clubs, condominium corporations, and professional associations are often organized and operated as NPOs.

The CRA's letters appear to focus primarily on whether NPOs carry on their activities for "any other purposes except profit." Court decisions that consider the scope of paragraph 149(1)(l) seem to suggest that an NPO may have a planned profit, provided that the organization uses it for an overall non-profit purpose. For example, in *Gull Bay Development* (84 DTC 6040 (FCTD)), a corporation earned more than $25,000 in profit from a logging operation in order to ameliorate the economic and social welfare of Gull Bay Indian Reserve members.

The chief concern is whether NPOs should ensure that *all* of their activities are not profitable. The Canadian Chamber of Commerce states that the current practice of almost all of its association members (which are probably among the largest NPOs) is to have at least some profit-oriented activities.

Responses to the "education letters" have included lobbying for changes, increasing directors' liability insurance, and resignations of concerned directors. In at least some cases, however, dealing directly with the CRA's concerns may not require significant changes. NPOs can review their constating and internal documents—such as incorporation certificates, letters patent, or articles of incorporation; financial and accounting records; meeting minutes; budgets;

and internal policies—to determine whether they conform to the requirements of a tax-exempt entity. They can also document the reasons for and the sources of accumulating funds; avoid budgeting for profit; segregate funds held for capital projects; and consider financing capital projects, to the extent possible, with membership contributions. Condominium corporations can specify long-term plans to set aside monies for planned expenditures (for example, a new roof every 20 years), as many provinces already require them to do, rather than simply reporting an annual profit and budgeting for more profits for the future. If an NPO pays or receives intercompany fees, the fees should be examined to determine the financial impact and to avoid accumulating an unreasonably high surplus, which the CRA may interpret as an indicator of a for-profit purpose.

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Crown Unsuccessfully Asserts Solicitor-Client Privilege

Solicitor-client privilege is most commonly raised in tax disputes to shield taxpayers' communications from disclosure to the CRA or to the Crown: it is an important exception to the CRA's otherwise substantial authority to require taxpayers to provide information upon audit or issuance of a "requirement for information" under the Income Tax Act and the Excise Tax Act (sections 231.2 and 289, respectively) and to the obligation to produce for inspection relevant documents at discovery.

In *506913 NB Ltd.* (2012 TCC 210), the Crown asserted solicitor-client privilege to prevent the taxpayer from using communications between the Department of Justice and the CRA. In the course of an appeal by a taxpayer of GST/HST assessments, the Crown brought a motion for a court order prohibiting the taxpayer from using certain documents on the basis that they contained legal advice from Justice to the CRA and were therefore protected by solicitor-client privilege. The documents in question had been inadvertently disclosed to the taxpayer in the course of related criminal proceedings against the taxpayer several years earlier.

The TCC noted that the fact that a lawyer works for an in-house government legal service does not affect the creation or character of the privilege (*R v. Campbell*, [1999] 1 SCR 565), and it cited case law specifically confirming that legal advice given by Justice to the CRA is privileged (*Global Cash Access (Canada) Inc.*, 2010 TCC 493). The court reviewed each of the documents at issue and found that they were protected by solicitor-client privilege, at least at the time that they were created. However, the court concluded that the privilege had been waived because the Crown had inadvertently disclosed the documents to the taxpayer in the course of the related criminal proceedings, and therefore they could be used by the taxpayer. Although inadvertent disclosure alone is insufficient, knowledge and silence on the part of the person claiming privilege and reliance on the person in receipt of the privileged communications may constitute an implied waiver (*Chapelstone Developments Inc.*, 2004 NBCA 96). (Waiver of solicitor-client privilege is to be distinguished from loss of litigation privilege, which by its nature applies only while litigation is contemplated or is under way.) In this case, the Crown had been aware for a number of years that the documents had been disclosed, and it had not objected to their use in the criminal proceedings.

While the court noted that privilege can be waived only by the client, not by the solicitor, it did not explain how the Crown's disclosure and inaction constituted waiver by the CRA—that is, the client—which presumably was not involved in the criminal proceedings.

Although the Crown was ultimately unsuccessful in this instance, the case illustrates how solicitor-client privilege can be raised to resist disclosure of communications between Justice and the CRA to the taxpayer during litigation. The same principles should apply to disclosure to the taxpayer in other situations, such as access-to-information requests, and to communications between the provincial counterparts of Justice and the CRA. The case also underscores the importance of safeguarding privileged communications from inadvertent disclosure and of taking timely action once disclosure is discovered.

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FCA To Rule on Post Mortem Pipeline Planning

Tax advisers will be interested to learn that the CRA has appealed *MacDonald* (2012 TCC 123; notice filed with FCA May 16, 2012), which validated post mortem "pipeline" planning. Such planning aims to eliminate the double taxation that can occur when there is a deemed disposition of private company shares on death (creating a taxable capital gain) followed by a distribution from the company (a dividend or deemed dividend). The goal is to eliminate the second level of tax—the tax on the dividend—by providing a tax-free pipeline through which the funds can be flowed out.

An alternative strategy to eliminate the double taxation is the use of the subsection 164(6) election to eliminate the first level of tax (on the taxable capital gain) through the carryback of an allowable capital loss triggered by the estate. The pipeline strategy is generally preferred because capital gains are more lightly taxed than dividends.

The steps involved in a basic pipeline strategy are as follows:

1) Mr. A, the sole shareholder of A Co, dies and is deemed by subsection 70(5) to dispose of his A Co shares immediately before death at fair market value (FMV). (The estate's adjusted cost base in the shares is also equal to FMV.)
2) The estate transfers the A Co shares to a new corporation, B Co, in exchange for shares of B Co and a note having a principal amount equal to the FMV of A Co at the time of Mr. A's death.
3) A Co pays intercorporate dividends to B Co, which uses the funds to repay the note to the estate.

Thus, the pipeline strategy allows A Co's funds, up to the FMV of the A Co shares at the time of Mr. A's death, to ultimately be distributed to the estate tax-free by way of intercorporate dividends to B Co and subsequent repayments of the note.

The central issue is that this result would not be achieved if subsection 84(2) were to apply to deem the repayment of the note to be a dividend paid to the estate. (Subsection 84(2) deems a dividend to arise to the extent that the value of property distributed by a corporation to its shareholders on the windup, discontinuance, or reorganization of a business exceeds the reduction of paid-up capital of the shares as a result of the distribution.) The CRA's position on this point has been confusing. Earlier technical interpretations (for example, 2002-0154223 and 2005-0142111R3) set out conditions that, if satisfied, would avoid the application of subsection 84(2). Subsequent CRA opinions issued in 2009 and 2010 (for example, 2010-0389551R3 and 2011-0401861C6) appeared to withdraw this escape hatch; since then, the conditions have been restored (2012-0435131R3).

MacDonald involved a pipeline-type strategy used not on a taxpayer's death, but on a taxpayer's emigration to the United States. The CRA assessed the taxpayer on the basis that subsection 84(2) applied to deem the repayment of the note to be a dividend, relying on *RMM* (97 DTC 302 (TCC)) for the proposition that a purposive interpretation of subsection 84(2) should be undertaken. The TCC disagreed and held that in order for the subsection to apply, the precise conditions laid out by Parliament must be satisfied. The TCC specifically commented on the CRA's application of subsection 84(2) in the context of post mortem pipeline planning and strongly criticized the conditions that the CRA had previously suggested must be satisfied to avoid its application.

The *MacDonald* decision provides some comfort to planners and those who disagree with the CRA's approach. Unfortunately, that comfort may be short-lived; it now falls to the FCA to decide whether the pipeline is actually leaking.

For more details on *MacDonald*, see Paul Hickey, "MacDonald: Surplus-Strip GAAR Attack Fails," *Canadian Tax Highlights*, May 2012, and Nick Moraitis and Manu Kakkar, "MacDonald: Is the Pipeline Flowing Again?" *Tax for the Owner-Manager*, July 2012.

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