CANADIAN TAX focus

Editor: Alan Macnaughton, University of Waterloo (amacnaug@waterloo.ca)

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Non-Canadian-Dollar Loans Involving FAs

The proposed "upstream loan" rules (contained in the foreign affiliate (FA) proposals released on August 19, 2011) have been the subject of much taxpayer discussion and some consternation. However, they have also prompted taxpayers to review the implications of repaying and forgiving cross-border intercompany loans, whether upstream (to the parent) or downstream (from the parent). In particular, foreign exchange issues arise when the loan is denominated in a currency other than the Canadian dollar.

Many smaller companies may not be aware of these issues. Funds are moved around global corporate groups as needed, and companies may not consider that the transactions are loans for tax purposes and that tax consequences can occur when the loans are extinguished.

Consider the situation in which a foreign subsidiary (FA 1) makes a loan in a foreign currency to its Canadian parent (Canco). Such an upstream loan would not be "excluded property," as that term is defined in subsection 95(1), of FA 1. Therefore, any gain or loss arising upon the repayment of the loan must be computed with reference to the Canadian dollar (pursuant to paragraph 95(2)(f.14)). This gain or loss would be included in the computation of Canco's foreign accrual property income (FAPI) or foreign accrual property loss (FAPL) in respect of FA 1. Additionally, Canco would realize a foreign exchange gain or loss under subsection 39(2) (see CRA document no. 2008-0280111I7, January 6, 2009). Because any move in the value of a currency has opposite effects on the two parties, typically a foreign exchange gain that would be included in the computation of Canco's FAPI or FAPL would be matched with a capital loss; conversely, a foreign exchange loss that would be included in the computation of Canco's FAPI or FAPL would be matched with a capital gain. However, one cannot be offset against the other, and so the transaction would likely result in an incremental tax liability for Canco.

Suppose that the upstream loan described above is forgiven rather than repaid. In that situation, neither of the two foreign exchange issues discussed in the previous paragraph applies. The CRA would consider any such gain or loss to have only occurred "on paper" (see CRA document no. 2010-0386881E5, July 20, 2011). This conclusion is consistent with the normal debt-forgiveness provisions, which specify that liabilities are settled at the historical exchange rate. However, the forgiveness of debt would still result in the normal implications for Canco (including the grinding of beneficial tax attributes and/or a section 80 income inclusion). The forgiveness of upstream loans might therefore result in a harsher tax consequence, even though no foreign exchange gains or losses would arise on such a transaction.

For downstream loans, the effects of repayment and forgiveness are similar to those described above. However, there is one big difference—the forgiveness of FA 1's debt in a downstream situation would result in immediate Canadian tax consequences only in the uncommon situation where FA 1 would have otherwise made use of a FAPL to offset other FAPI earned, and then only if interest on the debt would have been deductible in the computation of FA 1's FAPI. Thus, forgiveness of intercompany debt in downstream situations may be a particularly effective strategy for mitigating foreign exchange implications.

In all cases where intercompany debt is repaid or forgiven, other issues such as foreign tax consequences, applicable stop-loss rules, the potential impact on surplus balances of the affiliate, and GAAR should also be considered.

Mark Dumalski
Deloitte & Touche LLP, Ottawa
mdumalski@deloitte.ca

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CTF CANADIAN TAX FOUNDATION
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Assuming Business Liabilities in an Asset Purchase

The sale of a business by way of an asset sale typically includes an agreement by the purchaser to assume legal responsibility for the business's future obligations. Relief from these obligations can be valuable to the vendor, and such value should presumably be added to the purchase price of the business in computing the vendor's proceeds of disposition. However, the amount to be included in the vendor's proceeds is sometimes unclear and may become subject to dispute with the CRA, particularly if the amount of the assumed obligations is uncertain. The recent FCA decision in *Daishowa* (2011 FCA 267) offers a partial road map for resolving this uncertainty.

The taxpayer in *Daishowa* sold two divisions of its pulp mill business to separate arm's-length buyers. The assets of each division included timber-cutting rights in Alberta. Each purchase agreement required the purchaser to assume the reforestation liabilities connected with the timber rights purchased.

The purchase agreement for one of these divisions provided for a cash purchase price at closing of $169 million, which was based in part on a good-faith estimate of the reforestation costs being assumed. The cash price would be increased or decreased, dollar for dollar, following delivery of a revised estimate of those costs by the taxpayer's accountants post-closing.

The court concluded that the amount determined by the accountants represented the value that the parties had attributed to the assumption of the liability and should therefore be included in the taxpayer's proceeds of disposition on the sale. Particularly persuasive to the court was the fact that the agreement described the amount as an estimate of "the aggregate value" of the liability. The fact that the estimate did not take into account factors that would normally be considered in valuing a long-term liability, such as discounting for present value, was held not to be relevant.

The basic lesson from this decision is that reference amounts related to the assumption of liabilities used for the purpose of calculating purchase price should not be described as "values" unless the parties' intent is that such amounts are to be included in the vendor's proceeds of disposition. Even more fundamentally, asset purchase agreements should explicitly state the value actually attributed to the assumption of vendor liabilities by the purchaser. If no value is to be assigned to the assumption of a liability (perhaps because the likelihood of a payment-triggering event is remote or the liability has been taken into account in valuing the associated asset), that should also be explicitly stated. This approach could introduce some much-needed predictability to determining proceeds of disposition.

The *Daishowa* decision was based in part on the premise that values determined through negotiation by arm's-length parties reflect fair market value. In situations where this premise does not hold, an explicit agreement on value may not avoid disputes with the CRA over the vendor's proceeds of disposition. For example, where the cash purchase price for an asset sale is negotiated up front on the basis of a valuation of the business as a whole, the attribution of value to specific liabilities will not affect the total cash purchase price being paid. Purchasers may also have little tax incentive to attribute value to contingent liabilities because of the CRA's position that a purchaser's costs of purchased assets only includes the amount of assumed contingent liabilities over time as the purchaser incurs costs to satisfy those liabilities (see, for example, CRA document no. 2002-0164607, October 23, 2002). In these situations, there may be a concern that an agreed attribution of value is not truly the result of arm's-length negotiation.

The decision in *Daishowa* has been strongly criticized (see, for example, "Daishowa: No Tax Patrimony?" *Canadian Tax Highlights*, November 2011). The taxpayer has sought leave to appeal to the SCC.

Andrew Spiro and Josh Jones
Blake Cassels & Graydon LLP, Toronto
andrew.spiro@blakes.com
josh.jones@blakes.com

Personal Services Businesses: Game Over

According to draft legislative proposals, corporations carrying on a personal services business (PSB) will be subject to significantly higher tax rates for tax years beginning after October 31, 2011. A PSB is defined in subsection 125(7), in part, as a business carried on by a corporation through which services are provided by an individual who would, but for the existence of the corporation, be considered an employee of the recipient of the services.

The proposals, released on October 31, 2011, amend the definition of "full rate taxable income" in subsection 123.4(1). The new definition will exclude the corporation's income for the year from a PSB, causing any income earned from a PSB to be ineligible for the general rate reduction in federal corporate tax from 28 percent to 16.5 percent in 2011 and to 15 percent in 2012 (see subsection 123.4(2)). The proposals effectively increase the tax rate on income from a PSB by 11.5 percentage points for 2011 and 13 percentage points for 2012. Provincial rates are not affected.

The changes proposed by the minister of finance are consistent with the attempts of past governments to curtail the use of corporations to carry on PSBs. This has been achieved by not allowing the deduction of most ordinary expenses and denying the eligibility of PSB income for the small business deduction. In recent years, however, decreasing corporate tax rates and reduced rates on eligible dividends have enabled an "incorporated employee" to enjoy the benefits of income splitting with family members and obtain tax deferrals (relative to the personal tax rates that would otherwise apply) on income earned through a PSB. Despite the unavailability of the small business deduction, these benefits created opportunities for tax planning, particularly for individuals who could afford to leave the income in the corporation long enough to benefit from a deferral of taxes.

The punitive effect of the proposed amendments means that tax planners should reconsider any planning that involves the use of a corporation to earn income from a PSB. Taxpayers who provide or receive independent contractor services through a corporation should review all their contracts and terms of engagement and reassess the characterization of the independent contractor's employment; under the proposed new rules, a CRA determination that an incorporated independent contractor is actually an incorporated employee is certain to raise the cost of doing business.

S. Simi Dosanjh
Boughton Law Corporation, Vancouver
sdosanjh@boughton.ca

Bad News for RRSP and RRIF Investments in Private Companies

Legislation stemming from the 2011 federal budget that received royal assent in December 2011 has made the rules for RRSP and RRIF investments in private company shares so restrictive that new investments may not be feasible in most circumstances. Investments that existed as at March 22, 2011 should be reviewed, because the grandfathering provisions are limited in scope.

Under the old rules, an investment in private company shares for an RRSP or RRIF account could be considered a qualified investment if, at the time of purchase, the private company was a specified small business corporation (regulation 4901(2)), and the annuitant and non-arm's-length persons held less than 10 percent of the company's shares. The 10 percent rule did not apply if the annuitant dealt at arm's length with the company and the original cost of the investment was less than $25,000.

The new rules are phrased in terms of what is not allowed. A "prohibited investment" (subsection 207.01(1)) for an RRSP or RRIF includes, among other things, an investment in an entity (corporation, partnership, or trust) in which the annuitant and non-arm's-length parties have a significant interest (10 percent or more, in most cases) and a prescribed property. If a prohibited investment is acquired or an existing investment becomes a prohibited investment, the RRSP or RRIF annuitant will be required to pay a 50 percent tax on its fair market value (subsection 207.04(1)), and a 100 percent tax will apply on any income and capital growth (subsection 207.05(1)). These rules, which previously applied only to TFSAs, now apply to RRSPs and RRIFs.

Much recent discussion has focused on the fact that it is no longer possible to go beyond the 10 percent limit on the basis that the original cost of the investment is less than $25,000. While this point is important, it is the inclusion of prescribed property in the definition of a prohibited investment that could catch taxpayers off-guard. Essentially, regulation 5001 provides that in order for private company shares to avoid becoming prescribed property, the company must be a specified small business corporation at all times—not just at the time of purchase.

If the company begins to accumulate a significant amount of non-active business assets, or if it increases its foreign operations or becomes subject to a non-resident acquisition, its status as a specified small business corporation could be jeopardized. Thus, taxpayers will need to monitor their private company investments at all times during their ownership. It may be difficult, in some circumstances, to obtain the required financial information.

Grandfathering provisions allow taxpayers to avoid the taxes described above for investments that became prohibited investments under the new rules immediately after their announcement on March 22, 2011. The grandfathering provisions provide a mechanism to remove the prohibited investment from the RRSP or RRIF account over a period of time (before 2022), and any income related to those investments will not be subject to the 100 percent tax as long as that income is taxed as a withdrawal from the RRSP or RRIF within 90 days after year-end. Investments that become prohibited after the grandfathering provision dates have less favourable tax consequences.

In addition to all the problems noted above, owning private company shares in an RRSP or RRIF account prevents the taxpayer from accessing the capital gains deduction (if available) on those shares. The lifetime capital gains deduction, now $750,000, can permanently save the taxpayer a significant amount of tax. That permanent tax saving could be greater than any long-term tax benefit of a tax deferral available in an RRSP or RRIF account.

Tristan Gilbertson
Deloitte & Touche LLP, Edmonton
tgilbertson@deloitte.ca

Holding Company ITCs: New CRA Memo

Holding companies (holdcos) are commonly used for share acquisitions and for other income tax purposes. From a GST/HST perspective, holdcos are generally involved in exempt activities—acquiring and holding shares. Because input tax credits (ITCs) under section 169 of the ETA are available only in respect of commercial activities and not in respect of exempt activities, holdcos are normally unable to claim ITCs, absent special rules. Subsection 186(1) allows holdcos to claim ITCs for inputs reasonably regarded as "relating to" shares or debt of a related corporation engaged exclusively in commercial activity. Subsection 186(2) allows holdcos to claim ITCs for inputs that "relate to" the acquisition or proposed acquisition of all or substantially all of the voting shares of another corporation engaged exclusively in commercial activity. If all the other conditions of subsection 186(1) or (2) are met, the holdco is deemed to have acquired the inputs for use in the course of its commercial activities and is thereby entitled to claim ITCs.

Recent case law supports a broad interpretation of the phrases "relating to" and "relate to." In *Stantec* (2008 TCC 400, aff'd. 2009 FCA 285), the TCC considered the meaning of the phrase "relating to" in section 186 and concluded that it implies a wide rather than a narrow view in connecting two matters (*Slattery (Trustee of) v. Slattery*, [1993] 3 SCR 430). The court stated that the concept of "in relation to" is not one of prominence, let alone exclusivity. The connection need not be primary, substantial, or directly related. The court held that listing services acquired by a holdco to list its shares on a stock exchange in order to acquire the shares of a related corporation qualified under both subsections 186(1) and (2) because the listing services "relate to" the shares of the other corporation and "relate to" the acquisition of those shares, respectively.

As set out in *GST/HST Memorandum* 8.6, "Input Tax Credits for Holding Corporations and Corporate Takeovers" (November 2011), some aspects of the CRA's interpretation of section 186 appear to be significantly narrower than the case law. The memorandum provides an example in which a holdco raises money by the issuance of its own shares so that it can finance the acquisition of additional shares of a related company. According to the memorandum, the holdco would not be entitled to ITCs under subsection 186(1) for legal and accounting services acquired to issue the shares because the services are not reasonably "related to" the shares of the other company. Rather, the services are acquired for use in relation to the holdco's issuance of its own shares (an exempt activity), the "first order of supply."

Interestingly, the TCC specifically rejected the same example (in reference to an earlier policy statement, P-196P) in *Stantec*. Since the memorandum does not indicate whether it distinguishes or otherwise takes *Stantec* into consideration, this point could cause uncertainty for taxpayers. Further, the memorandum's "first order of supply" or direct-use concept appears to be based on the definition of "commercial activity" and the specific wording of section 169 (see *398722 Alberta Ltd.*, 2000 CanLII 15331 (FCA)). It is not entirely clear, however, whether it is appropriate to apply this concept to section 186 of the ETA, since that provision explicitly deems inputs to be acquired for use or consumption in commercial activities when certain conditions are met.

Simon Thang
Moskowitz & Meredith LLP, Toronto
simonthang@mmtaxlaw.ca

Draft Legislation on Deduction for Contingent Amounts

Draft legislation was released on March 16, 2011 in response to the decision in *Collins v. Canada* (2010 FCA 12). If enacted, the proposed changes to section 143.4 of the Act would affect the recognition of a "contingent amount" for tax purposes.

In *Collins*, the FCA found that the taxpayer was entitled to deduct interest as it accrued, regardless of whether the interest was payable in the year deducted. In fact, in this case there was no legal obligation for the taxpayer to pay the accrued interest beyond a minimum amount.

The Department of Finance has two concerns with respect to the *Collins* case. First, taxpayers might engage in tax planning that uses contingent amounts to take advantage of decreasing corporate income tax rates. Second, taxpayers might fail to recapture amounts previously claimed or reduce tax attributes when liabilities are discharged for a lower amount than initially determined.

Proposed section 143.4 reduces the amount of an expenditure to the extent that a portion of the expenditure is a "contingent amount." This occurs when the taxpayer has a "right to reduce" the amount. Further, the new rule applies to the extent that "it is reasonable to conclude, having regard to all the circumstances, that the right will become exercisable."

In a letter issued on November 7, 2011, the CBA-CICA Joint Committee on Taxation expressed two primary concerns with respect to the proposed legislation. First, the definition of "right to reduce" catches a broad range of legitimate commercial arrangements by which the amount of an expenditure may be adjusted. Second, the phrase "reasonable to conclude" is undefined, and thus introduces significant uncertainty for taxpayers. Extensive reviews may be necessary to identify all circumstances in which the amount of an expenditure might be adjusted.

Proposed section 143.4 is effective for taxation years ending after March 15, 2011. However, proposed subsection 143.4(7), which provides the minister with the right to reassess a taxpayer in a taxation year that is otherwise statute-barred, has prompted concerns about retroactivity.

To date, the proposed legislation has not been introduced in Parliament, and we can only speculate about how Finance will respond to the concerns raised by the Joint Committee.

Hayley J. Brown
KMPG LLP, Vancouver
hjbrown@kpmg.ca

Will Planning: The Charitable Remainder Trust

Individuals who wish to give to charity by will but also wish to provide enough funds to sustain family and friends for their lifetimes might consider a charitable remainder trust. Essentially, such a trust provides an immediate charitable tax credit even though the funds are not transferred to the charity until the life interests expire.

Subsection 118.1(5) deems a gift made by an individual's will to have been made by the individual immediately before death, enabling the gift to be eligible for a charitable tax credit for the deceased's final taxation year. According to the CRA (document nos. 9918215 and 2000-0053185, and *Interpretation Bulletin* IT-226R), the subsection will apply if

1) it is clear that the testator intended to make a gift to a registered charity;
2) the amount of the gift to the charity is stipulated in the will as a specific amount, a specific property, or a percentage of the residue of the estate;
3) if the gift is the residue (or a portion thereof) of the estate, the will clearly specifies what is to be paid from the estate in determining the residual amount;
4) the will does not provide for discretionary capital encroachments by any person; and
5) there is a gift at law.

In making a will, a testator balances how much to give to family and friends and how much to give to charity. Some testators will want a clear division between property given to charity and property given to family and friends. Others are uncertain and will want the estate to be flexible enough to respond to the needs of the beneficiaries. For the latter type of testator, a charitable remainder trust may be an attractive solution that preserves the tax credit in respect of a charitable gift while ensuring that family members and friends are provided for.

An example of a charitable remainder trust made by a will is described in an advance ruling from the CRA (document no. 2002-0117823, undated). A testator provided in his will that, among other things, certain property was to be held in trust for the surviving spouse as the sole income beneficiary, and on the death of the surviving spouse a portion of the remaining capital of the trust was to be given to a charity. Pursuant to an agreement, neither the trustees nor the surviving spouse could encroach on the capital of the trust. The CRA ruled that subsection 118.1(5) would apply to the gift to the charity to deem the gift to have been made immediately before the testator died.

The charitable remainder trust enables the testator to make a gift of property to a registered charity and obtain the corresponding tax credit while giving a person other than a registered charity income from the same property. It should be noted that the present value of a gift of the remainder interest to charity, and the value of the corresponding tax credit, will be affected by the estimated length of any life interests (in the above example, the estimated life span of the surviving spouse) and other factors. This may significantly reduce the tax credit for the gift of the remainder interest to the trust and lessen the tax advantages of a charitable remainder trust.

Kim Ho
Thorsteinssons LLP, Vancouver
kmho@thor.ca

GlaxoSmithKline in the SCC

On January 13, 2011, the SCC heard its first transfer-pricing case—the government's appeal of the FCA's decision in *GlaxoSmithKline Inc. v. Canada* (2010 FCA 201). The decision in this case could clarify important elements in Canada's transfer-pricing regime.

The facts were as follows. GSK had a licence agreement that granted it the right to manufacture and sell at a premium price the drug known as Zantac in Canada. Under another interrelated agreement, GSK was required to purchase the active ingredient from an affiliate company of the group for a price considerably higher than both the actual production cost and the price paid by generic-drug companies. The minister partly disallowed the deduction for the active ingredient, relying on subsection 69(2) to conclude that the deduction should be limited to the amount that was "reasonable in the circumstances"—the price paid by the generic-drug companies. GSK argued that the transactions were not comparable and that the licence agreement had to be taken into account in the transfer-pricing analysis.

In the GSK appeal, there are three key issues that might be addressed by the SCC:

1) The FCA's decision interpreted subsection 69(2) according to the view that all relevant circumstances have to be considered—that is, it applied the "reasonable business person" test (*Gabco Ltd. v. MNR*, 68 DTC 5210 (Ex. Ct.)). Will the SCC follow this inherently subjective test in deciding whether an arm's-length Canadian distributor of Zantac would pay the price that GSK did?
2) It is possible that an arm's-length Zantac distributor would have agreed to pay a premium on the active ingredient in order to realize a higher margin on the sale of the branded drug. By choosing whether or not to consider the licence agreement in its analysis, the SCC will provide guidance on the degree to which the business context surrounding intercompany transactions should be considered.
3) Canadian transfer-pricing jurisprudence has accepted that elements resulting from a non-arm's-length situation are to be considered in the interpretation and application of the arm's-length standard (for example, the implicit support given by a parent corporation to its subsidiary, as in *Canada v. General Electric Capital Canada Inc.* (2010 FCA 344)). Following this decision, will the price imposed under GSK's licence agreement be regarded as an element that can be considered in the analysis?

At the January 13 hearing, the SCC showed considerable interest in the question of GSK's business reality in the analysis. Some judges noted that the subsection 69(2) "reasonable in the circumstances" wording was broad enough to include the consideration of business reality.

By addressing the points described above, the SCC can provide much-needed guidance on the application of transfer-pricing legislation and further refine the concept of "reasonable in the circumstances" when applying and interpreting the arm's-length standard from a Canadian perspective.

Nathalie Perron
Deloitte & Touche LLP, Montreal
nperron@deloitte.ca

Atlantic Canada Fishing Licences: Past Section 85 Transactions

Because Fisheries and Oceans Canada (DFO) now allows the transfer of Atlantic Canada fishing licences to corporations (see "Atlantic Canada Fishing Licences: New Policy Announced," *Canadian Tax Focus*, May 2011), the CRA has stated that such licences became eligible for transfer to a corporation under a section 85 rollover effective April 1, 2011. However, unresolved transitional issues surround corporate structures put in place before that date.

The CRA statement, "Eastern Canada Commercial Inshore Fishing Licences Administrative Guidelines," was released in June 2011. The guidelines are intended to provide direction to CRA auditors regarding inshore licences governed by *Commercial Fisheries Licensing Policy for Eastern Canada 1996* (CFLPEC). The CRA guidelines consist of five parts; parts 2 to 4 discuss the CRA's position on the income tax treatment of transactions involving eastern Canada fishing licences, including section 85 rollovers.

The CRA maintains that if a taxpayer attempted to transfer a fishing licence to a corporation before April 1, 2011, the transfer was not effective because transfers to corporations were not then permitted by the DFO. For such transactions, the CRA takes the position that the corporation has received no value. Thus, where non-share consideration such as cash was taken back on the transfer, the amount received could be reassessed as a shareholder benefit under subsection 15(1), and a licence holder who transferred a licence to a corporation with a view to using the capital gains exemption could now face a significant tax liability. On the other hand, in instances where only share consideration was received, there will usually be no tax consequences if the existence of a price adjustment clause in the licence transfer agreement can be used to adjust the values of the shares downward (to follow the CRA's policy).

The tax risk with respect to licence-transfer transactions occurring prior to April 1, 2011 depends on their timing:

- Transactions that occurred within the normal reassessment period (three years for a CCPC) may be subject to a subsection 15(1) reassessment.
- Transactions that occurred before that period but on or after July 1, 2003 (the announcement date of the previous CRA policy) may be considered for a potential reassessment under subsection 15(1) on the basis of the misrepresentation exception in subsection 152(4), because the taxpayer ought to have known of the CRA policy.
- Transactions that occurred before July 1, 2003 will not be the subject of reassessment, although reassessments could occur if there are subsequent transactions affecting the licence.

The guidelines address a number of scenarios dealing with the income tax treatment of various types of transactions, but the list is not exhaustive. Part 3 of the guidelines broadly covers the general treatment of certain section 85 rollover transactions, particularly with respect to the time when the initial transaction occurred, and it provides some insight into how the CRA will deal with subsequent transactions. However, given the volume of previous section 85 transactions and related subsequent transactions, it is unclear exactly how the CRA will apply these guidelines in a practical and reasonable manner.

The CRA has indicated that anyone who wishes to unwind offending transactions may inquire about doing so, and that inquiries will be dealt with on a case-by-case basis. Taxpayers are facing a difficult decision: do they approach the CRA about unwinding, or do they challenge any possible reassessment if and when it comes?

Ryan Power
Grant Thornton
Kentville, NS
ryan.power@ca.gt.com

The SCC's Framework for Reversing Its Precedents

In *Copthorne Holdings Ltd. v. Canada* (2011 SCC 63), in a short four-sentence passage (at paragraph 57), the SCC imports into tax jurisprudence a framework for the reversal of its own precedents first presented in *Ontario (Attorney General) v. Fraser* (2011 SCC 20), a labour law case dealing with a constitutional issue. In *Copthorne*, the precedent in question was the SCC's statements in *Canada Trustco* (2005 SCC 54) regarding the words "in contemplation of" in subsection 248(10). Whether this importation is appropriate is worthy of some discussion.

The *Fraser* framework is based on the following (presumably non-exhaustive) factors: (1) whether the reasons in favour of following the precedent—certainty, consistency, predictability, and institutional legitimacy—outweigh the need to overturn a precedent that is "sufficiently wrong"; (2) whether the error can be readily corrected in a lasting way by the legislative branch (for example, a constitutional issue cannot be readily or easily addressed by a legislative amendment); (3) whether the precedent is workable; and (4) whether there has been intense academic criticism of the precedent.

From a tax practitioner's perspective, certain questions arise from paragraph 57 of *Copthorne*. The *Fraser* decision was rendered by the SCC three months after the pleadings in *Copthorne*; it is surprising that neither the taxpayer nor the Crown appears to have been asked to make any representations in respect of it.

Although *Fraser* appears to deal with the reversal of the ratio decidendi of a prior precedent, the statements of the SCC in *Canada Trustco* with respect to subsection 248(10) are not of the same precedential weight. They can be more appropriately described as either judicial dicta or obiter dicta. The statements were cursory, although a fuller analysis was not required for the purposes of that appeal. Thus, the SCC in *Copthorne* appears to have broadened the situations in which the *Fraser* doctrine might apply.

In substance, on the basis of the *Fraser* principles, one might posit that *Canada Trustco*'s interpretation of subsection 248(10) was incorrect, unworkable, and severely criticized in academic publications. As a counterargument, however, one could say that Parliament could theoretically legislate and codify its view of what a "series of transactions" should be.

More fundamentally, since the SCC has the constitutional authority to reverse its own precedents on any basis, notwithstanding the principles enunciated in *Fraser*, one might question whether it is appropriate to import this framework into tax jurisprudence, or into any field of law that does not have the same degree of permanence as other fields that are subject to significant constitutional restrictions and frameworks. Indeed, one might argue that the question, set out in *Fraser*, of whether the legislative branch can readily "correct" a perceived judicial error suggests instead that the principles in *Fraser* should be restricted to precedents dealing with constitutional issues and that, for other issues, the standard should simply be correctness, thus leaving policy considerations to the legislative branch rather than the judiciary.

One might further argue that in appeals (such as tax appeals) that are subject to an application for leave, such a framework may seem superfluous in that if an appeal is of sufficient national importance to be heard by the SCC, then it follows that there is no need for a stricter threshold than simple correctness.

In the final analysis, it is plain that the SCC imported the *Fraser* framework into tax cases with the laudable objectives of certainty and predictability in mind. However, the workability and appropriateness of those principles in the context of tax law may one day be the subject of further debate.

Olivier Fournier
Davies Ward Phillips & Vineberg LLP, Montreal
ofournier@dwpv.com

Lack of Disclosure Fatal to Government's Case

The recent judgment of the Federal Court in *Canada (National Revenue) v. RBC Life Insurance Company* (2011 FC 1249) underscores the obligation of the minister of national revenue to make full and frank disclosure of all relevant documents and information on ex parte applications under subsection 231.2(3).

Ex parte proceedings are initiated by a party without notification to or representation by the opposing party. It is well settled that in this context the applicant bears the burden of presenting all material facts, including adverse facts, since the normal checks and balances of the adversarial system are absent. Thus, full and frank disclosure is essential. The minister's failure to make full and frank disclosure of all material facts in *RBC Life* was fatal to her position.

Under subsection 231.2(1), the minister has the power to require any person to provide any information or document. However, that power is subject to the limitations of subsection 231.2(2), which requires the minister to obtain judicial authorization (on an ex parte basis under subsection 231.2(3)) before issuing a requirement on a third party with respect to "unnamed persons."

Pursuant to the minister's ex parte applications, the FC had issued orders requiring the respondent insurers to produce documents and personal information concerning their unnamed clients who were engaged in "10-8 plans." A 10-8 plan is an insurance leveraging strategy with two aspects: a life insurance policy with an investment account, and a loan that is secured by the policy in an amount equal to the balance of the investment account. A 10-8 plan creates a tax benefit: the policyholder pays deductible interest of 10 percent on the loan and receives tax-exempt interest of 8 percent from the investment account because it is part of the life insurance policy.

The respondents brought motions under subsection 231.2(5) for a review of the FC's decisions to authorize the requirements. The FC decided in their favour, cancelling the orders it previously granted on the basis that the minister fell short of her obligations in two ways. First, she did not disclose to the FC that the applicants had provided very substantial information concerning 10-8 plans and had complied with her requests for documents and information, except for the identities and personal information of the 10-8 plan participants. Second, and more troubling, she did not disclose CRA internal documents and information that suggested that 10-8 plans complied with the letter, if not the spirit, of the Act. The FC held that this non-disclosure was material, and that if the documents had been disclosed they could have affected the outcome of the ex parte applications.

The government has appealed the decision to the FCA.

John Sorensen
Gowling Lafleur Henderson LLP, Toronto
john.sorensen@gowlings.com

Gift Tax Planning for US Citizens in 2012

US citizens living in Canada should consider gifting assets in 2012 to avoid a planned increase in US estate and gift taxes.

At death, a US citizen living in Canada is subject to both Canadian income tax (through the rules related to a deemed disposition at death) and US estate tax. The US estate tax applies to everything the taxpayer owns (that is, US and non-US assets, including those assets that have been subject to deemed disposition at death in Canada). Estate tax is based on the fair market value (not just the increase in value) of all the property held by the taxpayer at his or her death.

It might be thought that the US estate tax does not increase total tax liability because Canadian income tax will be reduced by an equal amount through federal and provincial foreign tax credits. However, the federal credit is limited to the amount of federal tax, which will be less than the

US estate tax because the latter is imposed at a high rate on the full value of assets. Further, there is no provincial foreign tax credit for the US estate tax (at least in Ontario and British Columbia: see CRA document no. 2010-0379381E5, September 14, 2010).

One way for an individual to reduce a potential estate tax liability is to give away property during his or her lifetime. However, the United States also has a gift tax regime that applies to any gifts made to individuals other than a spouse who is a US citizen. Although US gift tax rates are the same as the estate tax rates, gift tax planning is possible because of the existence of three exemptions:

1) the exemption for certain gifts made to prescribed educational institutions or made for medical payments on behalf of a person other than the taxpayer;
2) the exemption for gifts of US $13,000 per year to an unlimited number of individuals, and US $139,000 per year to a spouse who, not being a US citizen, is not eligible for the unlimited exemption; and
3) the "unified exemption" (shared between the gift and estate tax regimes).

For 2012, the unified exemption is US $5.12 million, and any excess is taxed at graduated rates of up to 35 percent. Current legislation calls for this exemption to drop to US $1 million and for the top tax rate to rise to 55 percent in 2013. Therefore, there is a powerful incentive to make gifts in 2012. Since legislative action could reverse these changes (subject to the uncertainties of US politics), some advisers may choose to wait until later in the year.

Even if there was no planned decrease in the unified exemption or an increase in the rates, gifting is attractive for another reason. Although the use of the unified exemption during a taxpayer's lifetime reduces his or her estate tax exemption by an equal amount, the value of the property gifted could increase significantly between the time of the gift and the time of death.

To access the exemption, a taxpayer will need to ensure that any gift is completed before the end of 2012 and file a 2012 US gift tax return within the permitted time—that is, at the same time that the taxpayer files his or her US income tax return.

Christopher Gandhu
PricewaterhouseCoopers LLP, Calgary
christopher.s.gandhu@ca.pwc.com

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