CANADIAN TAX Highlights

Editor: Vivien Morgan, JD

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The OECD's Latest Proposals on Taxation of the Digitalized Economy

On October 9, 2019, as part of the ongoing work of the G20/OECD Inclusive Framework on Base Erosion and Profit Shifting, the OECD released a public consultation document proposing a "unified approach" under Pillar One (nexus and profit-allocation rules) of the work program on taxation and the digitalized economy, which was issued on May 31, 2019. (For a review of earlier developments, see "The OECD and Digitalization," *Canadian Tax Highlights*, March 2019 and "OECD Work Program To Address the Digitalized Economy," *Canadian Tax Highlights*, July 2019.) The proposals are presented at a high level and will require further detailed work. They do not yet have consensus support from the 135 participating countries.

The unified approach seeks to harmonize common aspects of the three initial proposals from May 2019, which focused on user participation, marketing intangibles, and significant economic presence. Key features include:

- the reallocation of taxing rights in favour of the user/market country;
- a new nexus rule not dependent on physical presence in the user/market country;
- a departure from the arm's-length principle and the single-entity principle; and
- a focus on simplicity, stabilization of the tax system, and increased tax certainty.

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The scope of the new rules does not cover only highly digitalized business models; it also goes wider, focusing on consumer-facing businesses. Further work will be done on scope and possible carve-outs. The document notes that extractive industries are assumed to be out of scope. Size limitations, such as the €750 million revenue threshold used for country-by-country reporting requirements, will be considered.

The new rules will create a nexus standard that is not dependent on physical presence, but is instead dependent on sustained and significant involvement in the economy of a market, largely based on sales. It is possible that the new nexus could have thresholds, including country-specific sales thresholds calibrated to ensure that countries with smaller economies are included. This measure would be designed as a new treaty provision (in addition to the existing permanent establishment and business profits articles).

New profit-allocation rules are proposed to apply to businesses irrespective of whether marketing and distribution activities in a particular country are carried out by group entities or through third parties. The approach continues to apply the current transfer-pricing rules based on the arm's-length principle where they are considered to be working relatively well, but focuses on a formula-based approach where the current rules are not considered to work well, such as in relation to residual profits from intangibles and distribution returns in market countries. The proposals are designed so that there is no requirement for a country to give up taxing rights over income generated by "routine" business activity physically located in that country.

A three-tiered approach to profit allocation is proposed. Three possible types of taxable profit would be aggregated and allocated to a market jurisdiction:

- Amount A allocates a portion of deemed residual profit to a jurisdiction, regardless of local physical presence, using a formulaic approach. Step 1 determines total profit of the group; the use of consolidated financial statements (with certain adjustments) is being considered, as is the issue of whether profits should be determined on a business line and/or regional or market basis. Step 2 determines the residual profit of the group by excluding what is considered to be routine profit; a simplified approach based on an agreed fixed percentage, with possible variances by industry, is being contemplated. Step 3 allocates a portion of any deemed residual profit to market countries. The actual proportion remains to be determined; consideration will be given to the use of different industry or business line percentages. Step 4 allocates the relevant portion of the deemed residual profit between market countries. The

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allocation will be based on an agreed allocation key, such as sales.
- Amount B provides a fixed "baseline" return for marketing and distribution functions. Profits arising from such activities in market jurisdictions would remain taxable according to existing rules (such as profit allocation to permanent establishments). The use of a fixed rate of remuneration, possibly varied by industry and/or region, would increase certainty.
- Amount C allocates an additional return based on transfer-pricing analysis. This would apply to activities in a market jurisdiction that go beyond the baseline level of functionality, and therefore warrant profit in excess of the fixed return derived under amount B. Any additional profit would be allocated only where supported by the application of the arm's-length principle.

Further work on the detailed interaction of amounts under the three-tiered approach will be required to ensure that profits are not duplicated in the market country. Robust measures to resolve disputes and prevent double taxation will be necessary.

The consultation document highlights a number of areas that require additional technical and political development. These include (1) political agreement on the scale of profits to be reallocated to market jurisdictions; (2) an approach to identifying the entities and countries owning the profit to be reallocated to market countries; (3) potential weightings to reflect the degree of "digital differentiation" between business models; (4) definitions of the activities relevant to a baseline marketing and distribution return under amount B; (5) specific rules for the treatment of losses under the new taxing right in amount A (for example, clawback or earnout mechanisms); (6) processes for enforcement and collection of tax owing by non-residents, including potential withholding tax mechanisms; (7) the changes required to tax treaties; and (8) the need to implement the changes simultaneously in all countries. There is also a strong emphasis on dispute prevention and resolution.

Interested parties were invited to comment on the consultation document by November 12, 2019. A public consultation meeting was scheduled for November 21-22 at the OECD in Paris.

The OECD continues its work on Pillar Two (global anti-base erosion) of the May 31, 2019 work program on taxation and the digitalized economy. This work involves developing a global minimum tax regime to permit countries to tax income earned in a jurisdiction that has not been subject to a yet-to-be-determined minimum rate of tax. A consultation document is expected in early November 2019, followed by a separate public consultation meeting in Paris in mid-December 2019.

The OECD hopes that agreement on both Pillar One and Pillar Two can be reached by June 2020. This is an important goal, since unilateral steps are being taken by a number of countries (for example, France and the United Kingdom) that are committed to taxing revenue from the digitalized economy. Canada is one of those countries; the Liberal Party platform (as well as those of the other political parties) in the recent federal election included the introduction of a 3 percent digital services tax as an interim measure until a global consensus can be reached. A speedy global consensus will eliminate the complexity and uncertainty in the international tax landscape that is being created by these unilateral measures.

Albert Baker and Paula Trossman
Deloitte LLP, Toronto

Owner-Manager Year-End Tips: Part 2

An owner-manager should address the following matters before the 2019 calendar year-end and in 2020. (For tips on achieving an optimal salary-dividend mix, see "Owner-Manager Year-End Tips: Part 1" *Canadian Tax Highlights*, October 2019.)

Corporate Income

1) A corporation subject to Alberta's or Quebec's general and/or M & P tax rate should consider deferring income to after 2019 by maximizing 2019 discretionary deductions. Alberta's general and M & P corporate rate decreased from 12 percent to 11 percent on July 1, 2019, and will decrease further to 10 percent in 2020, to 9 percent in 2021, and to 8 percent in 2022. Quebec's general and M & P corporate rate will decrease from 11.6 percent in 2019 to 11.5 percent after 2019.
2) A corporation subject to the small business rate in PEI and/or Quebec (and possibly in Nunavut) should consider deferring income to after 2019 by maximizing discretionary deductions. PEI's small business rate will decrease from 3.5 percent in 2019 to 3 percent after 2019. Quebec's regular small business rate will decrease from 6 percent in 2019 to 5 percent in 2020, and to 4 percent after 2020. For Nunavut, draft legislation decreases the territory's small business rate from 4 to 3 percent on July 1, 2019.
3) A corporation subject to Quebec corporate tax rates should review the qualifying criteria for Quebec's regular small business tax rate (see above). The corporation must meet an activities test or an hours-paid test; if neither is met, the corporation is subject to a provincial tax rate between the province's regular small business rate and its general corporate tax rate. A corporation should ensure that it continues to qualify for either of Quebec's small business rates (regular or M & P and primary sector rates) and consider how to take advantage of the lowest rate possible.

4) A corporation subject to Quebec's small business tax rates should consider structuring its operations to increase the percentage of corporate activities attributable to M & P and the primary sector (based on labour costs in those sectors). Quebec's small business M & P and primary sector rate of 4 percent applies to all active business income up to $500,000 if at least 50 percent of corporate activities are attributable to M & P and primary sector activities. (The primary sector includes agriculture; forestry; fishing and hunting; and mining, quarrying, and oil and gas extraction.) If less than 50 percent (but more than 25 percent) of activities are so attributable, the 4 percent income tax rate increases proportionately (straightline) to the province's regular small business rate or its general tax rate, depending on the circumstances. For attributable activities of 25 percent or less, the income tax rate falls between Quebec's regular small business rate and its general rate.
5) Specific reserves for doubtful accounts receivable or inventory obsolescence should be identified and claimed at year-end.
6) If goods were sold in 2019 and the proceeds are payable after year-end, the income tax may be deferred for tax purposes by a reserve for up to three years.
7) Ensure that intercompany charges are reasonable, given changes in the economy and the transactions' facts. Consider adjustments that reduce overall taxes for the related group, such as charging a reasonable markup for a related corporation's services.
8) An owner-manager should consider making tax-effective withdrawals of cash from his or her corporation (for example, by paying tax-effective dividends, returning share capital, or repaying shareholder loans). If the company has a capital dividend account balance, consider paying non-taxable capital dividends, and pay them before triggering any accrued capital losses on the sale of assets.
9) If a CCPC's taxable capital for federal tax purposes in 2019 exceeds $10 million, together with all associated corporations, it will start losing access to the small business deduction and enhanced (and refundable) 35 percent SR & ED investment tax credit rate in 2020. Monitor taxable capital and consider ways to reduce taxable capital before the company's year-end.
10) Pay final corporate income tax balances and all other corporate taxes imposed under the Act within two months after year-end (three months for certain CCPCs) to avoid non-deductible interest charges.

Depreciable Assets

1) For a corporation to claim CCA, a depreciable asset must be purchased and available for use at its year-end. A corporation should take advantage of the Accelerated Investment Incentive, which allows an increased first-year CCA deduction for eligible depreciable assets acquired after November 20, 2018 and available for use before 2028 (this generally applies to all capital property subject to the CCA rules except M & P and specified clean energy equipment, which are subject to their own enhanced CCA deduction—see below). The increased first-year CCA deduction will generally be 1.5 times the standard CCA deduction (three times the standard first-year CCA deduction for property subject to the half-year rule), to a maximum of 100 percent; this increased deduction will be gradually phased out for property that becomes available for use after 2023 and before 2028.
2) Purchase eligible M & P and specified clean energy equipment, and zero-emission vehicles, to take advantage of a first-year 100 percent CCA deduction in the year it becomes available for use (available for M & P and specified clean energy equipment acquired after November 20, 2018, and zero-emission vehicles acquired after March 18, 2019, and available for use before 2028; subject to a gradual phaseout if the equipment or vehicles become available for use after 2023 and before 2028).
3) Be aware that a Quebec business that acquires new M & P (class 53), clean energy generation, or computer equipment, or qualified intellectual property, after December 3, 2018 may also deduct an additional 30 percent of the property's CCA deducted in the previous year in respect of the property, if certain conditions are met. Note that the additional CCA deduction of 60 percent for new M & P or computer equipment acquired after March 27, 2018 was eliminated for property acquired after December 3, 2018 (and was restricted if acquired after November 20, 2018 and before December 4, 2018); it was to have been eliminated for assets acquired after March 31, 2020.
4) Consider delaying the sale of a depreciable asset that will result in recaptured depreciation until after the company's 2019 taxation year-end.

Employee Stock Options

1) If there is a possibility of claiming a lifetime capital gains exemption (of up to $866,912 for 2019, to be indexed for subsequent years; higher for qualified farm or fishing property), consider exercising CCPC stock options. A taxpayer must own shares (not options) for at least 24 months to qualify for a capital gains exemption claim. Note that any tax on the exercise of CCPC stock options is payable only when the shares are sold, and must still be paid even if the share value drops after the date of exercise.

2) Be aware that the federal government intends to limit the use of the current employee stock option tax regime, for employee stock options granted after 2019, by proposing a $200,000 annual limit on employee stock option grants that may receive the current preferential tax treatment. However, the limit will not apply to options granted by CCPCs and corporations that meet certain conditions (those with characteristics that identify them as startup, emerging, or scale-up companies).

Sales Tax

1) Ensure that applicable GST/HST was correctly charged, collected, and remitted on taxable supplies and that ITCs have been claimed on eligible expenses incurred throughout the year. Understanding the provincial place-of-supply rules on sales to other Canadian provinces is essential for charging and collecting tax at the correct rates.
2) A business registered for QST should ensure that applicable QST was charged, collected, and remitted on taxable supplies in Quebec and that eligible input tax refunds (ITRs) were claimed as expenses were incurred. An unregistered business should review its operations to determine whether QST registration is required.
3) A business—even if it is not resident in Quebec and has no physical or significant presence in the province—that makes digital and certain other supplies to people whose usual place of residence is Quebec and who are not registered for the QST (referred to as "specified Quebec consumers") may be required to register for QST under a new specified registration system if the value of those supplies exceeds $30,000. Registration is effective (a) January 1, 2019 for a non-resident of Canada that is not registered for GST/HST and (b) September 1, 2019 for a Canadian resident that resides outside Quebec and is registered for GST/HST. Business owners should determine whether the business must register.
4) A business should obtain all necessary written documentation to support ITC (and ITR) claims. The GST/HST and QST registration numbers of a supplier from which a purchase was made can be verified on both the CRA and Revenu Québec websites.
5) Applicable GST/HST and QST should be charged on management fees and other intercompany charges and transactions within a corporate group, unless an election for closely related corporations to treat certain taxable supplies as having been made for nil consideration has been filed with the CRA and/or Revenu Québec. This election deems sales tax on such transactions to be not generally applicable. If the election was not made, determine whether it can be made.
6) Determine whether GST/HST and/or QST must be remitted on amounts reported as an employee's taxable benefit for income tax purposes (for example, company-owned/leased vehicles and memberships).
7) Ascertain whether a business is a "large business" operating in PEI and/or Quebec. For PEI, the requirement for large businesses to recapture or pay back the provincial portion of HST claimed as ITCs in respect of specified property and services is being phased out. The recapture rate decreased from 75 to 50 percent on April 1, 2019, and will continue to decrease by 25 percentage points each April 1, until it reaches zero on April 1, 2021; therefore, PEI's HST recapture rate will decrease to 25 percent on April 1, 2020. For Quebec, the restriction on large businesses claiming ITRs for QST paid or payable on specified goods and services was reduced after 2018 to allow 50 percent of such QST payable in 2019 to be claimed as ITRs. For 2020, 75 percent of the QST paid or payable can be claimed; the ITR restriction will decrease by another 25 percentage points on January 1, 2021, when it will reach zero.
8) If goods are sold or services provided to a customer in British Columbia or Manitoba by a business not registered for provincial sales tax (PST), the business should review its operations to determine whether it must register for PST. Saskatchewan now requires businesses that sell taxable goods and/or services in the province to be registered without exception. If the business is PST-registered, ensure that the tax is correctly charged on sales made in the province and self-assessed on purchases as required. Note that Manitoba's PST rate decreased from 8 to 7 percent on July 1, 2019.

Giancarlo Di Maio
PricewaterhouseCoopers LLP
Windsor, ON

Yola Szubzda
PricewaterhouseCoopers LLP
Oakville, ON

TOSI Reasonable Return Exception: Joint Bank Account

In a recent technical interpretation, the CRA clarifies that where a taxpayer contributes funds to a corporation from a joint bank account held with his or her spouse, only the taxpayer is considered to have made a contribution for the purposes of meeting the "reasonable return" exception to the tax on split income (TOSI) rules (2019-0814161E5, August 7,

2019). In considering the type of contributions made from the joint account in the TI, the CRA confirms that it does not consider the taxpayer's spouse to have made a direct or indirect contribution to the corporation. As a result, the CRA's view is that the taxpayer's spouse cannot rely on the reasonable return exception to prevent TOSI from applying to dividends designated to him or her through a family trust. In addition, the CRA advises that the taxpayer's spouse also cannot rely on the "excluded business" exception under the TOSI rules.

In the TI, the CRA considers a situation in which Spouse A and Spouse B are Canadian residents who are both over 24 years old. Spouse A is the trustee of a discretionary family trust, and both Spouse A and Spouse B are beneficiaries of the trust.

The trust owns the common shares of a holding company (Holdco), which in turn owns the common shares of a non-services business (Opco). Opco pays taxable dividends to Holdco, which then pays the taxable dividends to the trust. The trust designates its taxable dividend income equally to Spouse A and Spouse B. Although Spouse A is actively involved in the business of Opco on a regular, continuous, and substantial basis, Spouse B has never been involved in Opco's business.

Opco was not always owned by Holdco. Originally, Spouse A incorporated Opco and subscribed for Opco common shares in cash, using funds from a joint account that Spouse A held with Spouse B. Spouse A also used the joint account to make a cash loan to Opco, which Opco subsequently repaid.

Generally, the TOSI rules provide that a "specified individual" who receives "split income" is taxed on that amount at the highest marginal tax rate, unless that amount is an "excluded amount" under section 120.4. "Split income" is defined in subsection 120.4(1) and, in general terms, includes taxable dividends from a private corporation and such amounts allocated from a trust under subsection 104(13), unless they are excluded amounts. For individuals who are 25 or older, an excluded amount includes a reasonable return in respect of the individual (subparagraph (g)(ii) of the "split income" definition). For individuals who are 18 or older, an excluded amount also includes income derived directly or indirectly from an excluded business of the individual (subparagraph (e)(ii) of the "split income" definition).

In the TOSI explanatory notes for subsection 120.4(1), Finance states that a "reasonable return" in respect of a specified individual generally refers to a reasonable return from a business, taking into account the relative contributions made to the business by the individual and persons related to the individual. This test takes into account several factors, including (1) work the individual performed in support of the related business; (2) property contributed by the individual, directly or indirectly, in support of the related business; (3) risks assumed by the individual in respect of the related business; and (4) the total of all amounts that were paid or that became payable by any person to the individual in respect of the business.

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

In its analysis in the TI, the CRA concludes that Spouse B does not meet the reasonable return exception in the definition of "excluded amount," since it does not consider the funds contributed to Opco from the joint bank account to be a direct or indirect contribution from that spouse. The CRA also advises that Spouse B does not qualify for the "excluded business" exception, since he or she was not actively engaged in the business of Opco. As a result, the CRA confirms that taxable dividends designated to Spouse B by the trust are subject to TOSI.

The CRA notes that the facts in this TI—including the legal form of Spouse A's subscription for Opco common shares and the subsequent loan to Opco—strongly imply that Spouse B has not made a contribution to Opco. As a result, the CRA says that it would not consider these transactions to be contributions of property made by Spouse B to Opco, even though the contributions were made from a joint bank account held by both Spouse A and Spouse B. The CRA further states that such a broad interpretation of an "indirect financial contribution" in the context of the reasonable return exception frustrates the tax policy that underlies the TOSI rules.

The CRA also confirms that Spouse B's taxable dividends do not meet the "excluded business" exception and are subject to TOSI. The CRA advises that although Spouse A has always been actively engaged in the business of Opco on a regular, continuous, and substantial basis, Spouse B has never been involved in Opco's business, and therefore is not eligible for this exception.

Dino Infanti
KPMG LLP, Toronto

The Complexity of Residential Complexes

Residential real estate transactions have become a particular target of CRA audits over the last few years. Many of the audits start with GST/HST, and then proceed to income tax. This trend does not appear to be dissipating: the 2019 federal budget proposed to further support real estate compliance action by providing $50 million over five years to create a Real Estate Task Force focusing initially on the Greater Toronto and Greater Vancouver areas. According to the CRA, since 2015 it

has "identified over $1 billion in additional gross taxes related to the real estate sector. During this same period, CRA auditors reviewed over 41,700 files in Ontario and British Columbia, resulting in over $100 million in assessed penalties." (Canada Revenue Agency, "The Government of Canada Identifies More Than a Billion Dollars in Additional Taxes in British Columbia and Ontario Real Estate Markets over the Last Four Years," May 30, 2019.) However, the numbers quoted are misleading. Numerous (re)assessments are overturned on appeal, and for good reason. Auditors are often taught to apply a checklist approach to auditing real estate transactions, which is problematic since the law requires an extensive analysis of the complicated factual matrix surrounding each transaction. This article will explore some of the issues that often arise during GST/HST real estate audits.

Overview of Relevant Statutory Provisions

Most residential real estate audits centre around a few provisions in the Excise Tax Act (ETA). The key provisions are the definition of "builder" in subsection 123(1) and section 191. Under these provisions, builders are required to self-assess GST/HST at either the time that construction is substantially complete or the time that the first residential occupant moves in (whichever is later). If the builder sells the new complex before the first occupant moves in, the builder does not need to self-assess. Instead, that sale is taxable. In nearly all GST/HST residential real estate audits during recent years, at issue is whether the vendor was a builder and should have either self-assessed or collected tax upon sale. Needless to say, the audits arise because the vendor has done neither.

Who Is a Builder?

The issue at the core of nearly all these GST/HST audits is whether the vendor was a "builder." The term is defined in subsection 123(1) of the ETA, but the definition is lengthy. At a high level, it captures anyone who builds or substantially renovates a residential complex, or who engages someone to do so. It also captures those who acquire an interest in a residential complex while it is being built. In most of the audits, it is obvious that there was construction activity. The contentious point centres around paragraph (f) of the definition. This paragraph excludes individuals who construct or substantially renovate a residential complex "otherwise than in the course of a business or an adventure or concern in the nature of trade" or engage someone to do so.

Typically, a CRA auditor focuses on the fact that the residence was sold after a relatively short period of inhabitation and, in effect, places the onus on the owner to rebut the presumption of speculative intent.

By and large, however, paragraph (f) requires an examination of the vendor's intention at the time of acquiring and constructing the property. Although courts have applied the factors from an income tax case, *Happy Valley Farms Ltd. v. The Queen* (86 DTC 6421 (FCTD)), in both the income tax and GST/HST contexts, the most important factor is the person's motive. (See *Canada Safeway Limited v. Canada*, 2008 FCA 24.) The secondary factors—(1) nature of the property, (2) period of ownership, (3) number of similar transactions and knowledge of the industry, (4) work done on the property, (5) circumstances responsible for the sale of the property, and (6) financing—are typically given less weight.

The secondary factors are not truly stand-alone factors in determining whether a person is a builder. Rather, they are part of the analysis of the vendor's intention. In the author's view, when it comes to residential real estate purchases and sales, some of the factors that should be given more weight are (1) the reasons for the purchase; (2) the extent of design and materials customization and personalization; and (3) the reasons for selling, including whether there was a change in personal circumstances that precipitated the sale.

The reasons for purchase and sale are important considerations. An individual should have some personal reason for choosing a specific lot or house if the property was truly intended to be a personal-use home. Likewise, if the individual's plans for the home were frustrated by events beyond his or her reasonable control, this supports the position that the property was intended for personal use. Divorce, breakup, loss of employment, shoddy workmanship, neighbourhood tensions, and unexpected relocation of family members are all examples of unexpected events that would support a vendor's assertion that the acquisition, construction, and sale were without a business motive.

The extent of design and materials customization and personalization is also a consideration that could support the claim that the property was acquired and constructed for personal use. Presumably, if a person were really designing and building a home for personal use, individual or family members' needs and preferences would be considered and incorporated into the home. Some examples include houses without interior doors for family members with disabilities, carpetless rooms for individuals with dust allergies, and sound-proofed walls for individuals who are musicians or who require peace and quiet because of insomnia. That said, the lack of extensive customization or personalization does not automatically point to a business intent. Building a highly customized home is relatively expensive. For vendors who are not particularly wealthy, this factor should be given limited weight out of recognition that there may have been restrictions on the extent of customization the vendor could financially bear.

It should be noted that the factors discussed above are just that—factors. Determining a person's intention is naturally a fact-intensive inquiry. Since each person's story will differ, one

cannot simply apply a checklist when auditing these types of transactions. As with any fact-intensive exercise, a checklist can only serve as a starting point—it cannot be the extent of the inquiry.

CRA Audit Practice

Although determining the vendor's intentions should be the dominant driver in most GST/HST real estate audits, in the author's experience the CRA has typically placed more emphasis on (1) length of ownership after construction is completed, (2) length of time between completion of construction and first listing date, and (3) knowledge of the industry.

With respect, such factors should be given limited weight. Length of ownership after construction is completed is relevant only to the extent that it raises flags about the vendor's intent at the time of acquisition and construction. If there are compelling reasons for the sale, the length of ownership does not matter, no matter how short the duration. The same reasoning applies to the second factor. The vendor's knowledge of and expertise in the industry is likewise of limited evidentiary value. Developers and other individuals with real estate-related expertise can buy, build, and sell property outside the course of their business. If there are compelling non-business reasons for the purchase and sale of the residence, extensive development experience should not push auditors to determine that the vendor is a builder under the ETA.

The Out for Builders?

Subsection 191(5) of the ETA is often glossed over during audits. It operates to relieve a builder of the liability to self-assess tax in circumstances where

1) the builder is an individual;
2) at any time after completion of construction, the residential complex is used primarily as a place of residence for the builder or a family member;
3) the complex is not used for any other purpose between the completion of construction and when the builder or family member moves in; and
4) the builder has not claimed input tax credits in respect of the acquisition of or improvement to the complex.

On a plain reading of subsection 191(5), one would think that a builder who is an individual and who lives in his or her home for a year and then sells it would not be subject to GST/HST. In practice, the CRA rarely allows the exception, despite accepting that the builder or a family member lived in the property for a period of time after construction was complete. The CRA often argues that requirement 2 is not met because the complex was not *used* primarily as a place of residence; rather, it argues that the builder used the complex by holding it as inventory. For similar reasons, the CRA often asserts that requirement 3 is not met. This interpretation is problematic because it not only fails to accord with the plain wording of the provision, but is also contextually unsound.

The exception does not apply if the home is used for another purpose between substantial completion and residential occupation. Throughout the ETA, however, Parliament has distinguished between the acquisition of property for the purposes of consumption, use, or supply. These terms have distinct meanings when applied in the context of subsection 191(5). The CRA is confusing *use* with *supply*. A builder occupying a home may have speculative intent, and if so she or he is holding the home for the purpose of *supply* but is nevertheless *using* the home as a place of residence.

Likewise, in context, subsection 191(5) is an exception to the self-assessment rules in subsections (1) to (4). When subsection 191(5) is applied, it is already assumed that the vendor is a builder, and hence it is also assumed that the vendor acquired and constructed the residential complex with speculative intent. Therefore, it has already been determined that the vendor will hold the complex as inventory. To then say that a builder can be afforded relief from liability under subsection 191(5) only if he or she does *not* hold the property as inventory is absurd. If the vendor did not treat the property as inventory, he or she would not be a builder in the first place.

The CRA's position on subsection 191(5) is not without support from the case law. As the saying goes, bad facts make bad law. This was the case in *Lacina v. Canada* (1997 CanLII 5361). In *Lacina*, the FCA dealt with a builder who had constructed and sold three houses over three years, living in each house for a few months. The court held that the exception in subsection 191(5) did not apply to exempt the builder from GST liability, because that individual did not use the house "primarily as a place of residence." The court interpreted "primarily as a place of residence" to mean a personal intention to live there permanently. Notably, the court did not address how this interpretation could be read in harmony with paragraph (f) of the definition of "builder." In fact, the court did not analyze paragraph (f) at all. In this sense, the analysis in *Lacina* is incomplete.

In contrast to *Lacina*, the TCC in *Coates v. The Queen* (2011 TCC 74, informal procedure) tackled subsection 191(5) and paragraph (f) of the definition of "builder" head on. There, the fallacy in the CRA's reasoning was succinctly stated by the court.

> By definition, an individual is a builder only if the property was built in the course of a business or an adventure in the nature of trade. If the home was constructed by the individual purely for personal reasons, the "self-supply" rule does not apply in the first instance. The exception only comes into play after an individual has been found to be a builder. Therefore, the exception cannot be interpreted as requiring that the property

> have been built only for purely personal reasons. This means that an individual can benefit from the exception even if he has the secondary intention, at the time of its construction, of reselling the property, provided he actually uses it as a place of residence after the construction is completed.
>
> I recognize that this may lead to an incongruous result, with tax being avoided simply because an individual actually uses a residential construction or home as a place of residence and then, for example, decides to sell it at a later date. The enactment of a change of use rule requiring the payment of GST/HST after the home no longer serves as the builder's place of residence would counter this type of tax planning or behaviour. Only Parliament can attend to that.

As noted by the TCC, although the CRA may perceive that allowing builders to avoid GST/HST simply by living in the new building for a period of time is unfair, the solution to this "unfairness" is not to read down subsection 191(5) into nothing. If Parliament deems this to be a problem, the solution is to either remove subsection 191(5) or introduce a new provision to render the property taxable again once the home no longer serves as the builder's (or a family member's) place of residence.

Zheting Su
Thorsteinssons LLP, Vancouver

"Unified Approach" May Go Beyond the Arm's-Length Principle, But It's Still Transfer Pricing

On October 9, the OECD released a public consultation document outlining the Secretariat's proposal for a "unified approach" to address the tax challenges of the digitalization of the economy. This latest release highlights two important realities. First, this topic is clearly top of mind for the G20. The OECD has intensified its work on the digitalization of the economy since introducing the issue in 2013 as the first of a 15-part BEPS action plan. This year alone, the OECD has released four documents on this topic.

Second, the latest paper (like many others issued under the BEPS project) reinforced the idea that the future of international tax planning, as uncertain as it may seem, will increasingly hinge on transfer pricing. Although this paper may have intended to simplify the issue, it may have instead inadvertently complicated it. Nonetheless, the stakes are indeed very high, and the world of international tax is in dire need of clarity to diffuse the rising skepticism from practitioners, taxpayers, and the public, if nothing else.

The central issue in the debate around the digitalization of the economy has always focused on the mismatch between economic presence and taxable profits. The modern digitalized economy is viewed as exacerbating this mismatch because highly digitalized businesses participate remotely in domestic economies—a reality that the current international tax framework is not designed to address at the local jurisdictional level.

Three main proposals were previously described by the OECD to address these challenges: "user participation," "marketing intangibles," and "significant economic presence." These proposals form the basis for the unified approach, which seeks to reduce the number of options under consideration, bridge the gap between them, and provide a consensus approach for adoption by the G20 in 2020.

Although the unified approach does, on the surface, achieve the objective of reducing the number of options under consideration, it might not provide a consensus approach. In some ways, the unified approach reflects a significant expansion in the scope of coverage (applying to all consumer-facing businesses—not just highly digitalized ones), but in other ways it reflects a contraction (taxing profits from marketing intangibles—not all profits). Also, under the unified approach, taxable nexus would arise in a market jurisdiction regardless of a company's level of physical presence.

The mechanics of the approach are straightforward in certain respects, though they are still uncertain at this stage. Under the proposed rules, multinationals will be taxed in a given country on the basis of an aggregate amount of profits, calculated using a three-tiered process: amounts A, B, and C.

Amount A is calculated on the basis of the country's portion of group-wide or business-line-wide "deemed residual profit" attributed to marketing intangibles and activities. For example, 40 percent of a group's profits may be deemed to be non-routine (that is, residual) profits. Of these, a portion (say, 50 percent) may be attributed to marketing intangibles and activities. To be clear, this is not supposed to include profits attributable to trade intangibles and other inputs, such as capital and risk. A given country could have a tax claim on that market-related residual portion based on its proportionate share of the group's total sales derived within that jurisdiction (say, 20 percent), regardless of physical presence.

Amount B is calculated from a different angle. It begins with an agreed-upon profit margin as a fixed percentage (say, 6 percent) to compensate for "baseline marketing and distribution activities" in the country through its physical presence. Presumably, this requires segmented costing of these baseline activities, which will form the base on which the 6 percent profit margin (in this example) would apply.

Amount C is much less clear at this stage. Conceptually, it represents "the profit in excess of the fixed return contemplated under Amount B" for the other business activities beyond baseline marketing and distribution and/or other activities unrelated to marketing and distribution. Amount C will be established in accordance with the arm's-length principle, but it cannot duplicate the profit under amount A to

avoid the argument that a portion of amount A is covered in amount C.

Under the unified approach, the modern computation of taxable profits attributable to a market jurisdiction for a multinational will be the sum of amounts A, B, and C—an outcome that will certainly differ from that of the historical approach to tax calculation. This will not displace the traditional approach relating to allocations based on the exercise of DEMPE (development, enhancement, maintenance, protection, and exploitation) functions, assets, and risks; however, amount A would be extracted from the tax bases of the jurisdictions where those elements are located. Unfortunately, this is far from a simple computation, since many decision points in this process remain the subject of much debate and discussion.

The interplay between the unified approach and the arm's-length principle is particularly interesting and, as with many areas of technical expertise, the devil is in the details. The OECD is firm in its claim that the unified approach goes "beyond the arm's length principle." Ironically, it firmly rejected global formulary apportionment in support of "maintaining the arm's length principle as the international consensus" almost two years ago, which is ancient history given today's legislative pace.

Many details are still to be worked out, as evidenced by the many caveats in the paper. It remains to be seen whether and how the countries in the Inclusive Framework will agree on the allocation formulas, fixed profit percentages, and effective dispute resolution mechanisms required for these rules to be based on more than mere theory.

The OECD has called for "simultaneous implementation by all jurisdictions to ensure a level playing field," while recognizing the potential political fallout that could follow. This will undoubtedly lead to a frenzy of analyses behind the scenes by countries in order to evaluate the winners and losers from this proposal, which will most likely affect the consensus to be reached by the already ambitious target of 2020. Will the members of the Inclusive Framework be able to agree on the fixed returns? Could sales revenue become the new standard for profit apportionment? And would jurisdictions accept the sharing of losses where no physical presence exists?

There may indeed be "a widespread recognition that the arm's length principle is becoming an increasing source of complexity," and there certainly is a growing need for guidance and clarity in this respect. However, rules should never come at the cost of principles or consistency; otherwise, current OECD skeptics will never turn into believers.

Waël Tfaily
Ernst & Young LLP, Montreal

Tax Treatment for Crowdfunding Contributions

In a recent technical interpretation (TI 2018-0779191E5, August 23, 2019), the CRA states that taxpayers who receive a crowdfunding contribution from their employer in their capacity as individuals (rather than as employees) would not include this contribution in their income as a taxable benefit. In addition, the CRA notes that the employer could not deduct such a contribution for tax purposes. However, the CRA advises that the tax treatment of contributions would be different where they are received by taxpayers in their capacity as employees.

The CRA notes that this position depends on individual facts and circumstances, since a crowdfunding contribution could represent a loan, a capital contribution, a gift, income, or a combination thereof. The CRA says that it evaluates each situation on a case-by-case basis before determining the income tax consequences.

Generally, the TI considers a situation in which a taxpayer, Ms. X, establishes a donation-based crowdfunding campaign to provide her child with additional therapies and support to mitigate a certain health condition. As part of the campaign contributions collected, Ms. X's employer, Canco, makes a significant one-time contribution. The CRA was asked whether Canco's crowdfunding contribution should be included in Ms. X's income as a taxable benefit.

The CRA says that, in this case, Canco's crowdfunding campaign contribution would not be included in Ms. X's income under subsection 5(1) or paragraph 6(1)(a), since she is considered to have received the amount in her capacity as an individual, not as an employee.

The CRA notes that a person who deals at arm's length with an employer may be considered to receive an amount in his or her capacity as an individual where the amount is (1) provided for humanitarian or philanthropic reasons; (2) provided voluntarily; (3) not based on employment factors, such as performance, position, or years of service; and (4) not provided in exchange for employment services. The CRA also reviewed additional factors that it may consider when making this determination, including whether the individual was affected by extenuating circumstances or a non-work event that was beyond his or her control.

However, the CRA indicates that if Canco's crowdfunding contribution represented a form of disguised remuneration, it would consider the contribution to be employment income (for example, if the contribution were given in lieu of extra wages or benefits, the value of the contribution would be considered to be a taxable employment benefit). In addition, the CRA cautions that its determination of whether an amount is received by an individual in his or her personal capacity, or in his or her capacity as an employee, is always a question of fact.

The CRA also confirms that, because Canco's contribution is not an outlay or expense incurred for the purpose of gaining or producing income, Canco cannot deduct it as a business expense under paragraph 18(1)(a).

Marlene Cepparo
KPMG LLP, Toronto

Corporate Residence

In June, a UK case on corporate residence was decided. The case may have significance in Canada. In *Development Securities PLC and Ors v. HM Revenue and Customs* ([2019] UKUT 169 (TCC)), the Upper Tribunal of the Tax and Chancery Chamber reversed the decision of the First-Tier Tribunal holding that certain corporations were resident in the United Kingdom and not in Jersey, as contended by the appellant taxpayers. The decision is important for the determination of the residence of offshore subsidiaries or special purpose vehicles (SPVs).

In *Development Securities*, the UK corporations had unrealized losses on certain assets. They wanted to realize the losses without losing the benefit of an indexation allowance so as to maximize the offset of losses against realized gains. A plan was devised. The UK corporations sold the assets with latent capital losses to the Jersey-incorporated subsidiaries at their original cost rather than at their lower FMV. The purchase by the subsidiaries was financed by capital contributions to them from the parent corporations.

For the plan to work, the residence of the subsidiaries in Jersey was a sine qua non. The majority of the boards of directors of the subsidiaries were therefore Jersey residents. Shortly after the purchase of the assets, the Jersey-resident directors were replaced by UK residents with a view to making the subsidiaries resident in the United Kingdom. The subsidiaries then sold the assets at a loss without losing the benefit of the indexation allowance.

The question before the tribunal was whether the Jersey-incorporated subsidiaries were resident in Jersey, and not in the United Kingdom, when they purchased the assets.

According to the Upper Tribunal, the fact that the Jersey-incorporated subsidiaries were incorporated in Jersey and required Jersey-resident directors for the purpose of implementing a tax-avoidance scheme was "irrelevant" to the question whether the Jersey-incorporated subsidiaries were resident in Jersey. Therefore, it left that fact "out of the count," citing Lord Neuberger in *HM Revenue and Customs v. Secret Hotels2 Limited (Rev 1)* ([2014] UKSC 16) at paragraph 57:

> [O]ne must be careful before stigmatising the contractual documentation as being "artificial," bearing in mind that EU law, like English law, treats parties as free to arrange and structure their relationship so as to maximise its commercial attraction, including the incidence of taxation.

The Upper Tribunal acknowledged the now trite principle that a corporation is resident in the country where its central management and control (CMC) is exercised, which derives from the speech of Lord Loreburn LC in *De Beers Consolidated Mines v. Howe (Surveyor of Taxes)* ([1906] AC 455). The tribunal also referred to the decision of Park J, affirmed by the Court of Appeal, in *Wood v. Holden* ([2005] EWHC 547 (Ch.), aff'd [2006] EWCA Civ. 26), which it considered to be of particular significance because it concerned the residence of SPVs owned entirely by a parent company. In *Wood v. Holden*, Park J stated at paragraph 25:

> [I]t is possible (and is common in modern international finance and commerce) for a company to be established which may have *limited functions* to perform, sometimes being functions which *do not require the company to remain in existence for long.* Such companies are sometimes referred to as vehicle companies or SPVs (*special purpose vehicles*). "Vehicle" has a belittling sound to it, but such companies exist. They can and do *fulfil important functions* within international groups, and they are principals, not mere nominees or agents, in whatever roles they are established to undertake. They usually have board meetings in the jurisdictions in which they are believed to be resident, but *the meetings may not be frequent or lengthy*. The reason why not is that in many cases the things which such companies do, though important, *tend not to involve much positive outward activity*. So the companies do not need frequent and lengthy board meetings [emphasis added].

The Upper Tribunal held that the "mere fact that a 100% owned subsidiary carries out the purpose for which it was set up, in accordance with the intentions, desires and even instructions of its parent does *not* mean that central management and control vests in the parent [emphasis in original]." According to the Upper Tribunal, this meant that in the case of SPVs, the CMC test must be approached with particular care to distinguish between *influence over* the subsidiary and *control of* the subsidiary. Where a parent merely influences the subsidiary, it held, CMC remains with the board of the subsidiary. Only where the parent company controls the subsidiary, in the sense that it takes the decisions that should properly be taken by the subsidiary's board of directors, does CMC vest in the parent.

The Upper Tribunal stated that, in general, the principle almost always followed is that a company is resident in the jurisdiction where its board of directors meets, but that principle will not hold where there has been a usurpation of the subsidiary's board by the parent or where the subsidiary is a sham. Nor does the principle hold where the directors of the subsidiary abdicate responsibility for management and control by "not bring[ing] their mind to bear on the questions that they ought to consider if properly exercising management and control," or, as the CRA put it, "where the directors of the subsidiary who ought to have exercised control stood aside from

their directorial duties." (See "Residency of a Corporation," CRA website.) (This statement derives from Lord Radcliffe's speech in *Bullock (HM Inspector of Taxes v. The Unit Construction Co. Ltd.*, [1959] 38 TC 712, at 736 and 741.) This is behaving as a rubber stamp.

The Upper Tribunal pointed to the difference "between a *board doing what it is told* (which does not affect its residence) and the *parent controlling the board* in the conduct of its business (which will affect its residence). In both cases *a significant factor is whether the directors would have declined to do something improper or inadvisable; if they would, then this would point towards the conclusion that there was no control by the parent* [emphasis added]."

The Upper Tribunal elaborated on the meaning of abdicating responsibility for CMC:

> One indicator of an abdication of responsibility or of acting as a "rubber stamp" is *where the person who ought to have CMC disregards or breaches the duties imposed on that person to ensure the proper governance of the corporation*. Where, for example, the board of a corporation is obliged to act in the best interests of the corporation and—on the instruction of the parent—does an act that is contrary to the corporation's best interests, then this is cogent evidence that CMC resides not with the board, but with the parent. . . .
>
> Another indicator of an abdication of responsibility is where the board knowingly takes decisions without having sufficient information properly to make that decision. [But] the mere fact that the board makes ill-informed or ill-advised decision is not inconsistent with CMC vesting in the board [emphasis added].

The Upper Tribunal considered that the First-Tier Tribunal held the Jersey subsidiaries to be resident in the United Kingdom for two reasons, one primary and the other subsidiary. The primary reason was that the directors of the Jersey subsidiaries knew from the outset that they were—as an integral part of the specific task entrusted to them—to cause the Jersey subsidiaries to act in a manner contrary to their commercial interests; that is, they purchased all of the assets at an "overvalue" and the only possible inference that could be drawn from their agreement to serve on this basis was that they would go through with it without question and without exercising their judgment as directors.

In short, the First-Tier Tribunal's inference that CMC vested in the parent corporations was based on the Jersey directors' willingness to accept appointment knowing that it involved causing the Jersey companies to enter into transactions that could be explained only by an abdication of responsibility of the directors to exercise CMC. The subsidiary reason was that the directors of the Jersey subsidiaries had a specific task entrusted to them by their parent, after completing which they would resign, as they did.

The Upper Tribunal acknowledged that the scheme was "artificial" and that it had no commercial purpose other than producing the tax benefits flowing from the realization of losses. However, it held that the directors of the Jersey subsidiaries acted in the best interests of the subsidiaries because the Jersey directors ought to have been, and were in fact, concerned chiefly with what was in the best interests of each parent corporation qua shareholder. The subsidiaries had no employees and the transactions they entered into did not prejudice creditors or shareholders. The Upper Tribunal held that it would have taken a factor of some significance, such as a material risk that the scheme was unlawful, for the Jersey directors properly to be in a position to refuse to enter into the transactions required by the scheme.

The essential error committed by the First-Tier Tribunal, according to the Upper Tribunal, was to focus on the "uncommerciality" of the transactions to the individual Jersey subsidiaries (the assets having been purchased at an amount exceeding their FMV) without having regard to the actual duties the directors owed to those corporations. These duties, in the view of the Upper Tribunal, principally involved consideration of the shareholders' interests. The fact that the assets were purchased at an amount exceeding their FMV was considered to be of no importance because the parent corporations financed the purchases.

The Upper Tribunal held that the problem with the First-Tier Tribunal's approach was that it confused an instruction from a parent corporation (which would be a matter the Jersey directors should have taken into account, but not been ruled by) with the authorization or ratification of a course of conduct by the shareholders of the company that might be in breach of the duty of the directors.

As for the subsidiary reason, the Upper Tribunal held that the mere fact that the directors had a specific task entrusted to them by their parent, after which they were to resign, says nothing about where CMC vested. As Park J noted in *Wood v. Holden*, SPVs are often brought into being for specific, short-term purposes, on the achievement of which they are wound down. Although the Jersey subsidiaries were not wound down, they did replace the Jersey-resident directors with UK residents with a view to changing their place of residence. The Upper Tribunal held that this factor shed no light on the question of who was exercising CMC, and that the short-term nature of the scheme had no impact on where CMC lay. The directors of the subsidiaries discharged their duties because the transactions were in the best interests of the shareholders. The fact that the directors sought clarification from tax advisers on the stamp duty aspect of transactions and some of the documentation showed that they were performing the duties they owed to the subsidiaries and were not simply abdicating their responsibility to exercise CMC.

The case seems to support the proposition that the formation by a Canadian-resident parent corporation of a subsidiary corporation outside Canada with non-resident directors for tax purposes does not by itself result in the vesting of CMC of the subsidiaries in the Canadian parent. As long as the directors actually perform their duties under the corporate law governing the subsidiaries, they do not abdicate their responsibility to the parent or suffer usurpation of CMC by the parent. The fact that the directors do exactly what they are expected to do under a tax plan is insufficient to vest CMC in the parent. So, too, is the fact that the parent sets up the subsidiary as an SPV with an ephemeral existence and a limited purpose.

David Nathanson
DLA Piper LLP, Toronto

Immunity or Legal Right: High Court of Australia on Solicitor-Client Privilege

The High Court of Australia issued a disconcerting decision on the scope of solicitor-client privilege in *Glencore International AG v. Commissioner of Taxation* ([2019] HCA 26). The court held that solicitor-client privilege was not sufficient to grant the plaintiffs an injunction restraining the defendants (the commissioner of taxation) from making any use of Glencore's documents, or any information contained in or that may be derived from those documents.

The documents in question were created for the sole or dominant purpose of the provision by Appleby (Bermuda) Limited, an incorporated law practice in Bermuda, of legal advice to the plaintiffs with respect to the corporate restructuring of Australian entities within the Glencore group. The documents were among the "Paradise papers" stolen from Appleby's electronic file management systems and provided to the International Consortium of Investigative Journalists. The court held that solicitor-client privilege was not a legal right sufficient to sustain a cause of action to restrain the commissioner from adducing the documents as evidence at trial.

The High Court agreed that the documents were subject to privilege and exempt from production by court process or statutory compulsion. However, the court held that the documents were in the public domain, were already in the commissioner's possession, and could be used in connection with the exercise of his statutory powers unless the plaintiffs were able to identify a juridical basis on which the High Court could restrain that use. The court ruled that the plaintiffs had not met the requirements for equity to restrain the breach of confidential information subject to privilege.

The plaintiffs argued that privilege is a fundamental common-law right, and that the recognition of an actionable right to restrain the use of and recover the documents would advance the furtherance of the administration of justice. The plaintiffs argued further that an injunction would reinforce the recognition at law of the importance of protecting privileged communications obtained by impropriety.

The High Court, however, upheld the defendants' demurrer. The court decided that the plaintiffs' arguments rested on an incorrect premise—namely, that privilege is a legal right that is capable of being enforced. The court restricted the scope of privilege significantly, holding that privilege is "only an immunity from the exercise of powers which would otherwise compel the disclosure of privileged communications."

From its review of the common law, the court did not discern a "right" in connection with privilege that could serve as an actionable right. Instead, the court limited the scope of privilege to "a right to resist the compulsory disclosure of information" or "the right to decline to disclose or to allow to be disclosed the confidential communication or document in question." The court characterized privilege as an immunity provided by the common law, rather than a legal right. The court held that the justification for privilege is not to be found in the enforcement of a private right but rather in the public interest.

In reaching its decision, the High Court had to resolve a conflict between two competing public interests: (1) the client's interest in preventing the compulsory disclosure of information and (2) the requirement for a fair trial that all relevant documentary evidence be available. The court characterized privilege as a client's "personal interest in preventing the use which might be made by others of the client's communications if they obtained them." The court held that the policy of the law is that the public interest in the administration of justice is sufficiently secured by the grant of an immunity from disclosure, and it refused to extend privilege to found a cause of action to restrain the defendants' use of documents already in the public domain. The court's ruling contrasts with Canadian jurisprudence, which has established that privilege is the client's alone to waive and that privilege protects information and documents unless and until privilege is waived.

It is likely that Canadian courts would rule differently under similar circumstances, as evidenced by the development of Canadian jurisprudence on privilege. For example, in *Descôteaux et al. v. Mierzwinski* ([1982] 1 SCR 860), the SCC affirmed that privilege is a substantive rule of law. Moreover, Binnie J has stated that the protection afforded by a class privilege is decided not by the content of the particular communication, but by the relationship between the sender and recipient (*R v. National Post*, 2010 SCC 16). The sedulous protection of the solicitor-client relationship distinguishes SCC rulings on privilege from the Australian High Court's decision in *Glencore*.

Privilege is further buttressed by the Canadian Charter of Rights and Freedoms. Most recently, the SCC affirmed in

Canada (Attorney General) v. Chambre des notaires du Québec (2016 SCC 20) that solicitor-client privilege is a fundamental principle of justice within the meaning of section 7 of the Charter, and that "professional secrecy should not be interfered with unless absolutely necessary given that it must remain as close to absolute as possible."

Nevertheless, the wording of the definition of "solicitor-client privilege" in the Act should be examined in light of the High Court's ruling. For the purposes of the Act, subsection 232(1) defines "solicitor-client privilege" as "the right . . . *to refuse to disclose* an oral or documentary communication [emphasis added]." The language appears to restrict privilege to an immunity from disclosure. An attempt to adduce as evidence at trial privileged communications already in the public domain, such as the documents at issue in *Glencore*, may lead to further jurisprudence on the scope of privilege in the Act. In light of Canadian jurisprudence and the Charter, a court should maintain the near-absolute status of solicitor-client privilege and should not follow the example of the High Court of Australia in such matters.

Josiah Edwards Davis
Miller Thomson LLP, Toronto

Challenging the Minister's Exercise of a Discretionary Power

There are circumstances under which a taxpayer that has delayed filing a tax return may not be able to access tax refunds. Under subsection 164(1), a taxpayer is required to file its tax return within three years of the taxation year in respect of which a tax refund might be applicable. However, the Act contains certain relief provisions to assist taxpayers; in particular, the minister has discretion to relieve the taxpayer of certain penalties and limitation periods otherwise provided for in the Act. Section 221.2, for example, allows the minister to reallocate amounts paid in respect of one account to a second account. Also, subsection 220(3) allows the minister to grant an extension to a filing period. Both of these provisions are available to assist a taxpayer that misses a limitation period for filing a return, especially when, if the return had been filed on time, the taxpayer would have been entitled to a refund.

Although the wording in subsection 164(1) is clear, subsection 221.2(1), which allows the minister to reapply amounts from one taxpayer account to another, *may* be interpreted as giving the minister discretionary authority to allow the taxpayer to use credits that are otherwise statute-barred under subsection 164(1). Similarly, subsection 220(3) allows for broad relief in cases of late filing of tax returns. In this article, we examine how the minister's discretionary powers have been challenged under the relief provisions in the Act, and their impact on taxpayers.

Taxpayers are not always successful when they request relief measures. Failure to obtain taxpayer relief can have serious consequences, such as the risk of not achieving tax integration. *1057513 Ontario Inc. v. The Queen* (2014 TCC 272) addressed a situation where dividends were paid to shareholders in taxation years 1997 to 2004. A personal Holdco, which was a shareholder in 1057513, failed to file its tax returns within the three-year limitation period. Upon late filing, the minister denied a dividend refund to 1057513 and imposed part IV tax on Holdco. The court ruled that subsection 129(1) was unambiguous in its language with respect to a three-year filing limitation and denied the taxpayer's claim for discretionary relief.

Such a ruling results in an obvious loss of cash flow to the corporation if it is unable to access any tax refunds, and prevents the corporation from achieving tax integration. The dividend tax credit reflects the tax that the corporation has already paid, and the principle behind the recovery of the dividend tax credit is to enable tax integration.

While the onus is on the taxpayer to file on time, subsection 220(3) allows the minister discretion to override strict filing requirements. It remains unclear how the courts would have ruled had subsection 220(3) been argued. In *1057513*, the result was double taxation and a denial of the integration principle.

In contrast to the outcome in *1057513*, in *Bonnybrook Park Industrial Development Co. Ltd. v. Canada (National Revenue)* (2018 FCA 136), the taxpayer successfully appealed for relief under subsection 220(3) and was able to obtain the dividend refunds pursuant to subsection 129(1). In this case, the FCA allowed the appeal on the basis that subsection 220(3) was a broad provision, and if Parliament had wanted to provide an exception for subsection 129(1), it would have done so explicitly. Although it is not explicit in the court ruling, an underlying assumption of this ruling is that both the courts and Parliament want to protect the tax integration principle and taxpayers' right to access the corporate refunds due to them.

Another important concept associated with tax integration is the notional accounts: eligible refundable dividend tax on hand (ERDTOH) and non-eligible refundable dividend tax on hand (NERDTOH), as defined in subsection 129(4). Both accounts prevent corporate tax deferrals on investment income earned, while enabling tax integration. Prior to the 2018 federal budget, there was a single notional account, refundable dividend tax on hand (RDTOH) (based on the same tax concept), and there have been situations where the CRA reduced the RDTOH amount whenever a dividend tax refund was denied as a result of late filing (see CRA document no. 2012-0436181E5). This clearly prevents the corporation from achieving tax integration.

In this context, two TCC decisions, *Presidential MSH Corporation v. The Queen* (2015 TCC 61) and *Nanica Holdings Limited*

v. The Queen (2015 TCC 85), allowed the corporations to not have their RDTOH accounts reduced after the dividend refund tax credits were denied because the corporations filed their returns after the statutory three-year filing period. Overall, the court found that the CRA's decision to reduce an RDTOH account will interfere with the corporation's ability to achieve tax integration, which is not the intent of the Act. This is notwithstanding the fact that the loss of a dividend tax refund for the corporation already results in double taxation.

Following the rulings, the CRA, in a roundup meeting (2015-0610691C6, November 24, 2015), responded that it would follow the court rulings with respect to the computation of a corporation's RDTOH. Specifically, the CRA stated, "the court's objective was to achieve a balance between fostering compliance in the context of Canada's self-assessment system (the denial of the dividend refund) and continuing respect of the integration principle (the non-reduction of the RDTOH balance)."

It would be interesting to see how the courts would have ruled in *1057513* had subsection 220(3) been applied, as in *Bonnybrook*. In such a scenario, an impact on the RDTOH account would have been redundant; in *Bonnybrook*, the court stated that subsection 220(3) is broad enough to address the stringent timelines for dividend refunds.

Since the *Bonnybrook* ruling, the courts have been reluctant to act as a substitute for the minister's discretion to provide taxpayer relief. For example, the court rulings on two recent cases, *Forbes Painting and Decorating Ltd. v. Canada (Attorney General)* (2019 FC 160) and *Paradise Interior Ltd. v. Canada* (2019, docket T-1657-17), make the point that the Act gives the minister discretionary powers, and it is not the court's prerogative to substitute its judgment for the minister's discretionary power.

This current trend of the minister's denials of taxpayer relief measures, and the courts' refusal to be a substitute for the minister's decision-making powers, can be a challenge to the taxpayer. Both *Forbes* and *Paradise Interior* were related to section 221.2, which was added in the early 1990s, following the decision in *Ginette Chalifoux v. MNR* (91 DTC 946 (TCC)). Initially, the CRA took a generous view of the section and granted relief in circumstances such as those in the cases discussed above. Today, the CRA requires the taxpayer to demonstrate "extraordinary" circumstances (see form RC431) before it will exercise its discretion under section 221.2 to reallocate credits that are otherwise statute-barred by the taxpayer's failure to file a return on a timely basis. In the CRA's view, "extraordinary" circumstances are circumstances beyond the taxpayer's control. This approach is questionable, especially when a taxpayer is otherwise fully compliant.

The CRA's position has been criticized as not giving effect to the policy underlying section 221.2. See, for example, David Sherman's notes to the section in *Practitioner's Income Tax Act*, 54th ed. (Toronto: Thomson Reuters, 2018). The courts have also noted this issue, especially where the taxpayer is otherwise fully compliant: see *Cybernius Medical Ltd. v. Canada (Attorney General)* (2017 FC 226).

What recourse does the taxpayer have when appealing the denial of a relief measure? It is likely that the taxpayer must rely on the standard held by the court, which is a test for reasonableness. The court decisions make it clear that the minister must act reasonably in the exercise of discretionary powers. Generally, this requires the minister to take into account all the circumstances of the taxpayer's case. In particular, the minister must not fetter her discretion by limiting the review to specific factors that may have been previously published as the factors to be considered.

Absent extraordinary circumstances, the court will be unlikely to substitute its decision for that of the minister. Instead, it will refer the matter back to the minister for redetermination by a different representative. The CRA has stated that it will reconsider its policy regarding the relief provisions. However, as recent court cases have shown, there has been little observable change in the CRA's approach to broad relief measures.

The lesson here is that, although there are provisions giving the minister the authority to provide relief after a taxpayer fails to comply with some of the strict filing provisions in the Act, as those provisions are currently administered it is unclear when a taxpayer can expect to rely on them.

Balaji Katlai
MNP LLP, Montreal

Refresher on US Estate Tax Filing for Canadians

As most practitioners are aware, the United States imposes gift and estate taxes on its citizens and residents on the transfer of their worldwide assets during lifetime and at death. The US gift and estate tax exemption for 2019 for US taxpayers is $11.4 million per person. (All amounts in this article refer to US dollars.)

Non-resident non-citizens of the United States (NRAs), including Canadians, are also subject to US gift and estate tax, but the rules differ and the exemptions are lower. NRAs are subject to US gift tax on the transfer of certain types of US-situs assets, mainly US real property and tangible personal property. (The US gift tax does not apply to NRAs on the transfer of intangible assets, such as US stocks).

Canadians and other NRAs are subject to US estate tax on a broader category of US-situs assets, which include US real property, tangible personal property (that is physically located in the United States), US stocks, debts of US companies or persons, and, arguably, partnership interests or LLC interests

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that own US-situs assets. The maximum estate tax rate for both US citizens and residents and NRAs is 40 percent.

Accordingly, Canadians who own US-situs property when they die will in most cases have, at the very least, a US tax-filing obligation. The estate tax exemption under the Internal Revenue Code ("the Code") is only $60,000 for an NRA, so the executors for a Canadian who owns US-situs property, US stocks, or US real property at the time of death will be required to file a US non-resident estate tax return (form 706-NA) within nine months of death (which can be extended for six months) if the decedent's US assets are worth at least the $60,000 minimum threshold.

Under the US-Canada tax treaty, a Canadian-resident NRA decedent is entitled to a prorated amount of the US estate tax exemption equal to the ratio of the decedent's US assets, divided by his or her worldwide assets, multiplied by the current US exemption. For example, a Canadian decedent who owned US real property worth $1 million and had a $10 million net worth would receive a prorated treaty credit equal to 10 percent of the current US exemption—approximately $1.14 million of exemption—to apply against any applicable US estate tax. Note that in order to claim the prorated treaty credit, all of the decedent's worldwide assets must be disclosed and valued.

In addition, the treaty provides an additional marital credit, equal to the prorated credit, for qualifying transfers to a surviving spouse. The marital credit approximately doubles the prorated exemption, but the assets must pass to the surviving spouse outright or in a qualifying spousal trust. In addition, there is a maximum time limit to claim the marital credit if the return is filed late.

Accordingly, if a Canadian's worldwide net worth is below the current US exemption, no estate tax will be owing on the non-resident estate tax return. However, a filing is required to claim the prorated treaty credit. A common misconception is that a US return is not required if no US estate tax is owing, or if the decedent's worldwide estate is worth less than the US exemption. To the contrary, a filing is required for an NRA in all circumstances where the value of the US property exceeds $60,000.

On the death of a first spouse of a Canadian couple, confusion can arise in regard to their joint ownership of US property. There is a common misconception that if a US property is jointly owned, only one-half of the value is includible in the estate of the first spouse to die. Although that is the general rule for US-citizen spouses, if NRAs jointly own US property, the default rule under the Code is that the entire value of the joint asset will be included in the estate of the first joint owner to die. This presumption can be rebutted by proof that the surviving spouse contributed to the purchase of the property.

Another often-overlooked issue is the ownership of US stocks. The ownership of a condominium in Florida is often recognized immediately by the decedent's family and advisers (along with the need for a US filing), but a thorough review of the decedent's stock portfolio often reveals additional US-situs assets that must be included on the US return.

In summary, Canadian residents with even modest estates that are far below the current US estate tax exemption often still have US filing requirements on death, even if no US tax is owing. In addition, care must be taken to thoroughly review the decedent's assets to discern if there are any US stocks (or other intangible US-situs assets) that also require a US filing.

Kevin K. Gluc
Hodgson Russ LLP, Buffalo

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