KPMG Law

Case Law Update Fall 2022

Presentation to CPTS

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Agenda

- Recission: *Canada v Collins Family Trust* (2022 SCC 26)
- Subsection 84(2): *Robillard (Succession de) c. R.* (2022 TCC 13)
- Capital Dividends: *3295940 Canada Inc. c. R.* (2022 TCC 68)
- Improperly Paid Dividends: *Kufsky v. R.* (2022 FCA 66)
- Financial Accounting: *Thinaddictives inc. c. ARQ* (2022 QCCQ 3029)
- Earnouts: *4432002 Canada c. R.* (2022 TCC 101)
- SRED: *Airzone One Ltd. v. R.* (2022 TCC 29)
- Source of Income: *Duhamel c. R.* (2022 TCC 66)

This presentation contains a discussion or analysis of decided tax cases. Any discussion or description of the facts of the case or the positions argued by the parties is based solely on publicly available information. For greater certainty no confidential client or taxpayer information is disclosed.

Recission: *Canada (A.G.) v Collins Family Trust*

- **Taxpayers sought to protect corporate assets from creditors without incurring income tax liability.**
- **Taxpayers incorporated a holding company ("Holdco") and a family trust ("Trust") the beneficiary of which was Holdco. Holdco loaned money to Trust, which in turn purchased shares of Operating Company ("Opco").**
- **Opco pays dividends to Trust. Under old interpretation of subsection 75(2), dividends are attributed to Holdco.**
- **New interpretation: Subsection 75(2) does not apply where property in question was sold.**
- **CRA reassesses Trust's 2008 taxation year to include the dividends.**
- **B.C. Supreme Court granted rescission.**
  - B.C. Court of Appeal affirmed, relying on U.K. Supreme Court decision in *Pitt v Holt*
- **Supreme Court of Canada granted leave to appeal**

Recission: *Canada (A.G.) v Collins Family Trust*

- **Recall that the Supreme Court of Canada held rectification was not available where sought to achieve retroactive tax planning.**
- **Issue in *Collins Family Trust* was whether other equitable relief (such as recission) also was not available.**
- **Majority (Justice Brown) held other equitable relief was not available.**
  - A court of equity may grant relief where it would be "unconscionable" or "unfair" to allow the common law to operate in favour of the party seeking enforcement.
  - Nothing "unconscionable" or "unfair" in the ordinary operation of tax statutes to transactions freely agreed upon.
  - Regarding tax law, taxpayers are to be taxed based on what they actually agreed to do, not what they could have done. Absent a sham, the taxpayer's legal relationships must be respected.
- **Majority also says *Pitt v Holt* was not applicable.**
  - Minister is required to apply the Act to the transactions.

Recission: *Canada (A.G.) v Collins Family Trust*

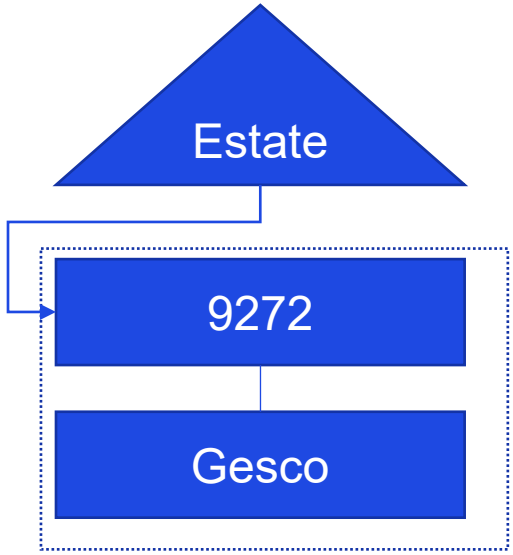
- **Justice Côté dissents**
  - If taxpayers meet the test for equitable remedy, the court may grant it, even if doing so would effectively relieve the taxpayer from payment of unexpected taxes.
  - Rescission based on mistakes relating solely to tax consequences should be granted only in rare circumstances – agreeing with *Pitt v. Holt.*
- **Ultimate Conclusion: Appeal Allowed**
  - The prohibition against retroactive tax planning should be understood broadly, precluding any equitable remedy by which it might be achieved, including recission.

Subsection 84(2): *Robillard (Succession de) c. R.*

- The deceased ("Deceased") owned shares of "Gesco", a holding company.
- Deceased passed away on June 18, 2012. His estate has three beneficiaries.
- At time of death, Deceased realized a capital gain of $1,912,567 on the deemed disposition of the Gesco shares.
- Estate implemented a post-mortem pipeline in the fall of 2012.

Subsection 84(2): *Robillard (Succession de) c. R.*

1. **Estate incorporated a new corporation (“9272”).**
2. **Estate transfers Gesco shares for a note equal to FMV.**
3. **Gesco is wound up into 9272 one day later.**
4. **Note is repaid by 9272 three weeks after winding-up.**

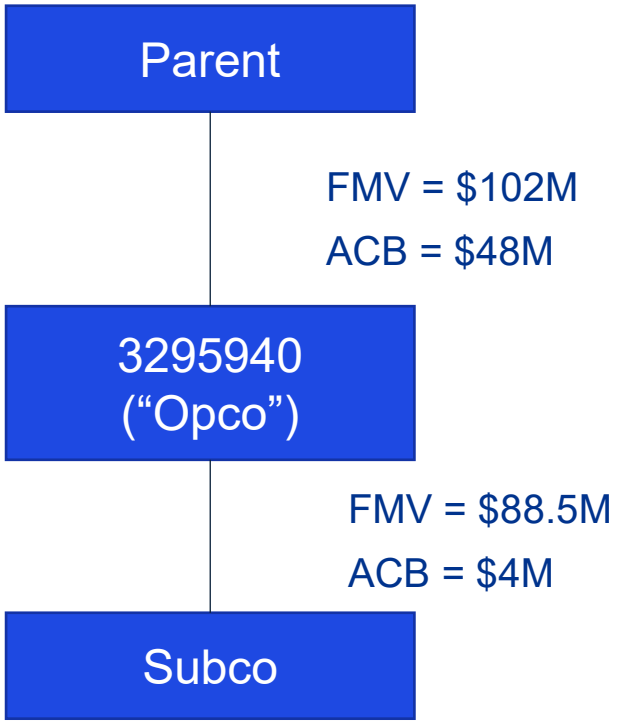


Subsection 84(2): *Robillard (Succession de) c. R.*

- **CRA reassessed on basis that Estate received a deemed dividend under subsection 84(2).**
- **Tax Court of Canada (Justice Hogan) agreed with CRA due to principles set out in Federal Court of Appeal's decision in *MacDonald v. R.* (2013 FCA 110).**
- **However…Justice Hogan also stated he disagreed with the Federal Court of Appeal's decision in *MacDonald.***
  - Decision causes uncertainty regarding how long to wait to undertake a pipeline transaction – 12 months? 24 months? 36 months?
  - *MacDonald* in effect gives the CRA a discretionary power regarding subsection 84(2).
  - *MacDonald* also ignores the wording in subsection 84(2), specifically the phrase "at the particular time".
- **Estate's appeal was allowed because half of the deemed dividend was deductible under subsection 104(6), as income was distributed to the beneficiaries.**
- **No appeal filed.**

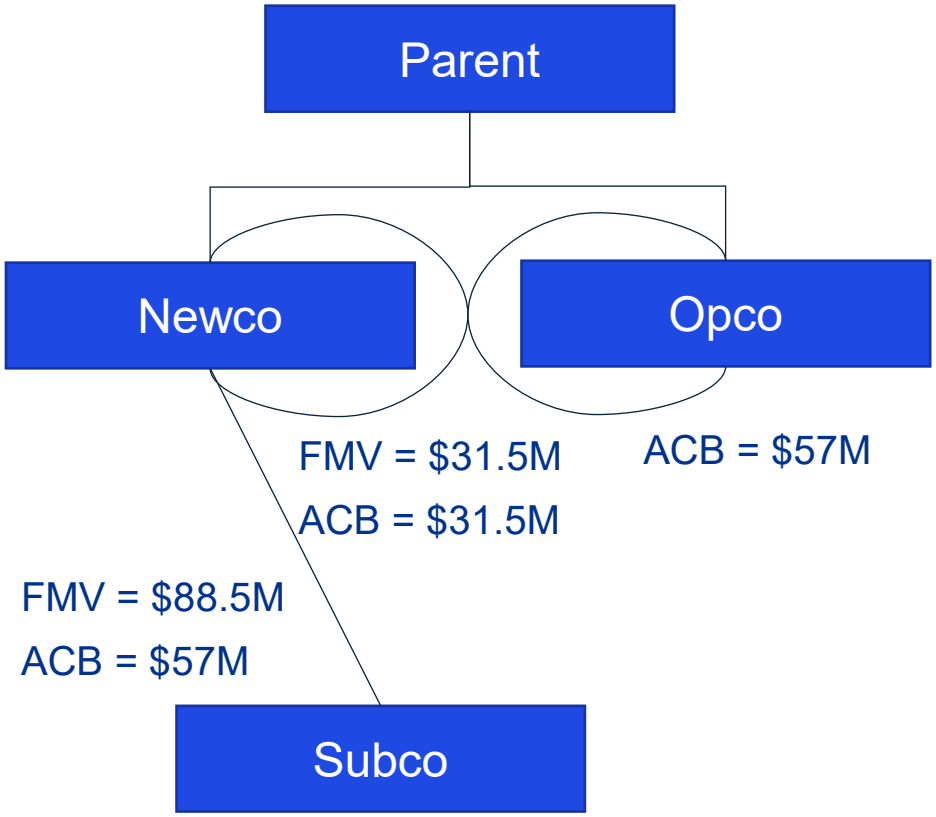
Capital Dividends: *3295940 Canada Inc. c. R.*

- **3295940 (“Opco”) is a Canadian-controlled private corporation.**
- **Subco carries on a pharmaceutical business.**
- **In 2005, Purchaser wanted to buy pharmaceutical business, but only wanted to buy Subco shares.**
- **Opco had a capital dividend account (“CDA”) balance of $5.8M.**
- **Paid-up capital is nominal for all shares.**



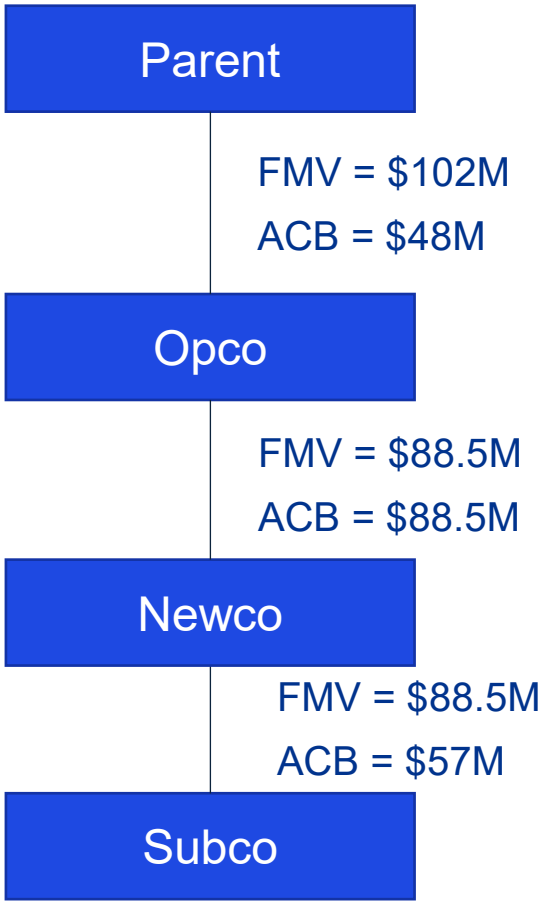
Capital Dividends: *3295940 Canada Inc. c. R.*

1. **Parent transferred its shares of Opco to Opco for preferred shares ("Opco Prefs") with an ACB to Parent and FMV of $31.5M and common shares with the remaining ACB and FMV.**
2. **Newco is incorporated and issues shares to Parent. Parent transfers Opco Prefs to Newco.**
3. **Opco transfers Subco shares to Newco in exchange for Newco preferred shares and Newco common shares. Parties elect to have subsection 85(1) apply, with an elected amount of $57M, all of which is allocated to Newco preferred shares.**
4. **Opco realizes a $53M capital gain and increases CDA account to $32.3M.**



Capital Dividends: *3295940 Canada Inc. c. R.*

5. **Opco redeems preferred shares owned by Newco for a $31.5M note. Redemption is deemed a dividend under subsection 84(3).**
6. **Opco elects to treat this as a capital dividend.**
7. **Newco then redeems all Newco shares owned by Opco in exchange for $31.5M note. Redemption is deemed a dividend under subsection 84(3).**
8. **Notes are set-off and cancelled**
9. **Parent transfers Newco preferred shares to Opco in exchange for Opco shares. Parties elect to have subsection 85(1) apply with an elected amount of $31.5M.**
10. **Opco sold Newco shares for $88.5M and reported no capital gain.**



Capital Dividends: *3295940 Canada Inc. c. R.*

- **CRA reassessed Opco's 2005 taxation year on the basis that GAAR applied, and included a $31.5M capital gain (being the difference between $88.5M and the reported $53M capital gain).**
- **CRA argues the series of transactions results in a misuse or abuse of subsections 55(2), 83(2) and definition of capital dividend in subsection 89(1).**
  - Used the CDA rules to reduce the capital gain by $31.5M that Opco would have otherwise realized on the disposition of Subco shares.
- **Opco argues that no provision was abused – in particular using the CDA rules did not abuse subsection 55(2).**
  - Subsection 55(2) applies only to taxable dividends.
  - Additional argument that double taxation would result.

Capital Dividends: *3295940 Canada Inc. c. R.*

- **Tax Court agrees with CRA – dismisses appeal.**
  - Circular use of the capital dividends frustrates the object, spirit and purpose of subsection 55(2) and the CDA rules.
  - Holds that Opco circulated its CDA balance to intentionally avoid recharacterizing a taxable dividends as capital gains.
  - Purpose of subsection 55(2) is to prevent paying a tax-free dividend where the gain on the shares is attributable to appreciation of the dividend payor's underlying assets.
  - Purpose of the CDA rules is to track a corporation's non-taxable portion of capital gains and ensure that "flows up" tax-free.
  - Does not result in double taxation.
  - Parent selling Opco shares was not a comparable alternative transaction.
- **Under appeal to the Federal Court of Appeal.**

Improperly Paid Dividends: *Kufsky v. R.*

- **Taxpayer is the sole shareholder of a corporation ("Corporation").**
- **Corporation had an unpaid tax liability.**
- **Corporation paid personal expenses of the Taxpayer.**
- **Accountants for the Taxpayer (who also were accountants for the Corporation) filed T1 adjustment requests to include dividends paid by the Corporation.**
  - T5s were issued by the Corporation at the same time.
  - Taxpayer did not sign any documents declaring a dividend.
- **CRA assessed consistent with the T1 adjustment request.**
- **CRA then assessed Taxpayer as jointly and severally liable for Corporation's tax debt under section 160.**

Improperly Paid Dividends: *Kufsky v. R.*

- **At Tax Court, Taxpayer raised the following arguments:**
  - Consideration was paid for the dividends.
  - Amounts were not dividends because the Corporation did not comply with relevant corporate law – no declaration was made, and the payment of the dividend violated the insolvency test.
  - Portion of dividends were loan repayments.
- **Tax Court rejected all arguments, dismissed Taxpayer's appeal.**
  - In particular: amounts were still dividends even though there was no evidence of a declaration.
- **Justice Webb writing for the majority of the Federal Court of Appeal:**
  - Tax Court was incorrect to conclude that a reported dividend, even if not in compliance with corporate law, remains "valid" for tax purposes.
  - Nevertheless, Taxpayer cannot now contest whether or not the amounts were dividends because she did not contest them in her personal return.

Improperly Paid Dividends: *Kufsky v. R.*

- **In concurring reasons, Justice Monaghan expressed disagreement with the argument that a dividend could not be declared and paid in breach of the solvency test under applicable corporate law.**
  - Consequences of breaching the corporate law exists under the corporate law, not tax law.
- **Justice Monaghan does question whether it is open to challenge whether the amounts are dividends.**
  - Just because an amount is assessed as a dividend does not mean it is true: see subsection 152(8).
  - "Assessments may be wrong, even if they are binding".
  - Nevertheless, the Taxpayer did not demolish the Minister's assumption that dividends were paid.
- **Takeaways:**
  - Breaching corporate law does not change tax consequences.
  - If you disagree with an assessment, strongly consider filing an objection.

Financial Accounting: *Thinaddictives Inc. c. ARQ*

- **Canco – a corporation that pays tax in Quebec – received $19M from Canco's U.S. parent ("USCo") for the purpose of buying assets.**
- **$10M was in exchange for an interest-bearing promissory note.**
- **$9M was an equity contribution.**
- **Canco mistakenly recorded the $9M equity contribution as a non-interest-bearing loan.**
- **If $9M actually was debt, then Canco's debt-to-equity ratio would exceed 1.5:1 under the thin capitalization rules.**
- **Canco deducted interest paid to USCo.**

Financial Accounting: *Thinaddictives inc. c. ARQ*

- **Error was discovered during Revenu Quebec's audit.**
- **Canco revised its financial statements, recorded the $9M in contributed surplus and prepared amended income tax returns.**
- **Revenu Quebec did not process the amendments, and denied the interest deductions on subsequent assessment. Canco appealed, arguing the equity contribution was not debt.**
- **Cour du Quebec agreed with Canco – permitted to classify the amount as equity because it was a genuine error.**
  - Internal emails and draft resolution clearly reflected the amount as equity.
  - Court commented that the financial statements didn't reflect reality.
- **Takeaways: Financial statements do not create legal relationships.**

Earnouts: *4432002 Canada c. R.*

- **In 2009, a purchaser ("Purchaser") purchased software rights from the taxpayer ("Holdco") in exchange for lump-sum payments and certain payments, the amounts equaling a percentage of Purchaser's software sales over three years.**
  - Maximum combined amount of the payments could not exceed $8M.
  - Holdco includes 50% of lump-sum payments in income under former paragraph 14(1)(b) regarding eligible capital property.
- **In 2010, the parties renegotiated the agreement and cancelled the remaining lump-sum payments. Instead, Purchaser prepaid $1.6M, which was a prepayment of the remaining payments. Holdco was not required to refund the payments if targets are not met. Purchaser also paid $345,000 in 2012 based on sales.**
  - Holdco includes 50% of these payments in income under former paragraph 14(1)(b).
- **CRA reassessed 2010 and 2012 taxation years on basis that 100% of the 2010 and 2012 payments were included in income under paragraph 12(1)(g)**

Earnouts: *4432002 Canada c. R.*

- **TCC agreed with the CRA and dismissed Holdco's appeal.**
  - Purchaser's additional payments depended on software sales.
  - Amended agreement did not require reimbursement if certain targets are not met.
- **TCC rejected Holdco's argument that the earnout was a "reverse earnout"**
  - Reverse earnout is an obligation to pay back if certain targets are not met. Fact that there was a maximum payment amount was irrelevant.
- **Holdco also argued paragraph 14(1)(b) should apply before paragraph 12(1)(g)**
  - TCC rejected Holdco's argument – paragraph 12(1)(g) comes first.
  - Paragraph 14(1)(b) applies to the initial sale, but not the additional payments.

SRED: *Airzone One Ltd. v. R.*

- **Taxpayer carried out six projects monitoring low-concentration compounds in the air.**
- **Deducted expenses as scientific research and experimental development ("SRED") expenditures and claimed investment tax credits.**
- **CRA denied those expenditures and credits on basis that the projects were not SRED.**

SRED: *Airzone One Ltd. v. R.*

- **Five factors apply when considering if a project is SRED:**
  1. Was there a technological risk or uncertainty which could not be removed by routine engineering or standard procedure?
  2. Did the person claiming to be doing SRED formulate hypotheses specifically aimed at reducing or eliminating that technological uncertainty?
  3. Did the procedure adopted accord with the total discipline of the scientific method including the formulation testing and modification of hypotheses?
  4. Did the process result in a technological advancement?
  5. Was a detailed record of the hypotheses tested, and results kept as the work progressed?
- **Tax Court calls factors 1 and 4 the "why" factors.**
- **Factors 2, 3 and 5 are the "how" factors.**

SRED: *Airzone One Ltd. v. R.*

- **On the first project, CRA argued that Taxpayer used standard methods and procedures to establish extraction and identification protocol for 52 compounds the Taxpayer was interested in measuring.**
- **Court disagreed – using the same equipment that Taxpayer used for normal samples did not mean "standard methods" were used.**
- **Court mentioned also that Taxpayer created new protocols to identify those 52 compounds.**
- **Ultimately, 4 projects out of 6 were SRED.**
  - First project for reasons described above.
  - Three other projects resulted in technological advancements, though small.
  - Two remaining projects denied due to using standard methods and techniques.

Source of Income: *Duhamel c. R.*

- **Taxpayer earned $5.4M from poker tournaments between 2010 and 2012 (mainly connected with winning the World Series of Poker). Taxpayer did not include his winnings in his personal income.**
- **Separately, a corporation owned by the Taxpayer ("Canco") received $1M for the Taxpayer to act as a spokesperson for a third-party poker company.**
- **CRA assessed the 2010 to 2012 taxation years on the basis that Taxpayer as carrying on a poker gambling business.**
- **Tax Court of Canada held Taxpayer did not carry on his poker activities in a sufficiently commercial manner. Therefore, the Taxpayer did not have a source of business income.**
  - Did not act as a "serious" business person as he couldn't consistently generate profits.
  - Did not maintain records of his winnings and losings until the CRA audited.
  - Did not practice any risk management.
  - Net earnings related largely to two tournaments.
  - Chance is an important element of poker – "risk of ruin" is theoretically higher than winning.
  - Sponsorship was not relevant – Canco is a separate person.

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