IT'S PERSONAL

PRESERVING WEALTH FOR PEOPLE AND PRIVATE COMPANIES

Tax Shelters: What Is Next For The Buyer/Participant?

By David W. Chodikoff, Miller Thomson LLP

In 2006, the Supreme Court of Canada (the "SCC") finally closed the door on the tax shelter known simply as the "Art Flip" cases. More formally referred to as the *Klotz* case and the *Nash*, *Tolley* and *Quinn* trilogy of tax cases, the SCC denied the leave applications in both sets of appeals. Both Klotz and the group of taxpayers known as *Nash, Tolley* and *Quinn* represented thousands of other taxpayers that participated in a buy low – donate high charitable gifting program. In the "Art Flip" cases, a taxpayer would typically purchase art prints in bulk at a cost of $300.00 per unit. The taxpayer would then donate the prints to an institution. In turn, the institution would issue a charitable receipt based upon the value of $1,000.00 per print. The key issue for the Tax Court was whether the taxpayer was entitled to claim a tax credit for a charitable gift based on the appraised value of each print. In *Klotz*, the Court found that the tax credit for the charitable gift should be based on the value at which the prints were acquired (the lower amount – i.e. $300.00). Clearly, the taxpayer lost his appeal. In *Nash, Tolley* and *Quinn*, however, the Tax Court judge found in favour of the taxpayers. Both cases separately went to the Federal Court of Appeal (the "FCA"). The taxpayer was the appellant in *Klotz* and the Crown was the appellant in *Nash, Tolley* and *Quinn*. At the FCA, the Court upheld the findings of the former Chief Justice of the Tax Court in *Klotz*. However, in *Nash, Tolley* and *Quinn*, Mr. Justice Rothstein, speaking for the Court, said that the Tax Court judge made two palpable and overriding errors. The first mistake was to accept the expert's valuation evidence based on the retail market for individual prints when there was a normal market for the groups of prints, the specific property the expert was required to value. The second error was to find the fair market value of the property to be roughly three times the amount paid for the property with no credible explanation for the three-fold increase. Thus, by the conclusion of the two separate Federal Court cases, all of the donors had lost and were reassessed accordingly. (Leave to appeal to the SCC was denied in both cases.)

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In the last two years, tax shelters continue to remain under the intense scrutiny of the Canada Revenue Agency ("CRA"). Leveraged donation programs and limited partnership tax shelters have slowly made their way through the court system. One example is the case of *Tolhoek*. Here, the taxpayer acquired units in a limited partnership that was registered as a tax shelter. The investment provided for an accelerated Capital Cost Allowance deduction in respect of certain computer software. The computer software was supposed to assist in futures trading. The acquisition cost of the software was paid in part by cash and the balance by the assumption of a promissory note. The vendor of the software guaranteed that the software was capable of making enough money to, at a bare minimum, cover the principal owed on the promissory note. The Minister of National Revenue (the "Minister") alleged that the promissory note was a Limited Recourse amount in accordance with subsection 243.2(7) of the *Income Tax Act* ("ITA") because there were no *bona fide* arrangements for the repayment of the note. The Tax Court of Canada found that the arrangement was less than *bona fide* because of the revenue guarantee and circular flow of funds. In April 2008, the FCA dismissed the taxpayer's appeal and endorsed the findings of the Tax Court judge.

In its ever increasing zeal to close down what it views as abusive tax shelters, the CRA has sought to expand its investigative powers. One of the most important decisions of the summer months was the *Redeemer Foundation* case. The SCC rendered its decision on July 31, 2008. In a four-three decision, the Court dismissed the appeal by *Redeemer Foundation* ("*Redeemer*"). The case focused upon the CRA's right to ask for information about unnamed persons from third party record holders without first obtaining judicial authorization.

Redeemer carried on a forgivable loan program for the students of Redeemer University College ("RUC"). From the government's perspective, the contributions to the program were not valid charitable donations because many of the donations were made by the parents of the students attending RUC. The CRA was looking for additional information of the names of the donors and students whose loans were forgiven. Obviously, the CRA had every intent to reassess those people. During the audit, the CRA made requests for donor lists. Initially, Redeemer complied and as a coincidence, or should I say consequence, notices of reassessment were sent to some of the donors. When the CRA came back a second time to ask for additional donor lists for other tax years, RUC refused. RUC relied on subsection 231.2(2) of the ITA. This subsection provides that the CRA must first obtain authorization from a judge to request information relating to one or more unnamed persons. RUC brought an application for judicial review before the Federal Court to determine the validity of the CRA request. The Federal Court concurred with *Redeemer*'s position. The Crown appealed this decision. On appeal, the FCA agreed with the Crown. Finally, *Redeemer* sought leave to the SCC.

In rendering its decision on the appeal, the majority of the SCC held that *Redeemer* was required to collect the information as part of its record keeping obligations and

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the CRA had the right to request this type of information because of its auditing powers. The SCC rejected the argument that the real purpose of the request was to reassess donors.

The *Redeemer* decision greatly expands the CRA's power to investigate and obtain information. It also renders the provision requiring prior judicial authorization virtually meaningless.

The *Tolhoek* and *Redeemer* cases illustrate some of the issues and problems that an individual can face if he/she participates in a tax shelter. In a sentence, YOU, the tax shelter participant, could be reassessed. Before you or your client get involved in a tax shelter always remember to do your due diligence. And if you are currently in a tax shelter that has been reassessed, you should talk to a tax professional for advice but, in the meantime, pay your tax bill and stop the interest clock from running! ■

Canada Revenue Agency's Broad Audit Power Upheld

By Robert McMechan (LL.B., LL.M., co-author *Tax Court Practice*), www.TaxAssistance.ca

The Supreme Court of Canada has released a majority decision in *Redeemer Foundation v. Minister of National Revenue* 2008 SCC 46 that has far-reaching implications for taxpayers in terms of how the Canada Revenue Agency gathers information about them for the purpose of auditing their returns.

When auditing a registered charity, the Agency requested its donor lists. Although the charity had released a list of donors to the Agency on an earlier occasion, it refused on this occasion on the basis that as the information related to unnamed third parties, the Minister was required to obtain judicial authorization for the request, in accordance with ss. 231.2(2) and 231.2(3) of the *Income Tax Act*.

The SCC majority decision stated that as the charity was obliged to maintain records under s. 230 of the *Act*, to enable the Minister to determine whether any grounds existed for revocation of its registration, and since the Minister led unchallenged evidence to the effect that the information it sought identifying the donors was necessary to enable the Minister to make this determination, the request could be made under the general audit power in s. 231.1(1) of the *Act*, without first obtaining a judicial determination.

In response to the charity's argument that the existence of ss. 231.2(2) and 231.2(3) in the *Act* means judicial authorizations should be obtained wherever requests for information relate to unnamed third party information, the majority responded that so long as the Minister had a valid purpose in making the request, which in this case was the audit of the charity, the reassessment of its donors "is just a logical consequence." The majority added that there is a very low expectation of privacy vis-à-vis business records, and that persons who donate to charities can reasonably expect that their donations will be examined, thus always raising the possibility that they will be audited and ultimately reassessed.

Concerning an argument that the Agency can abuse its general audit power in s. 231.1(1) by auditing a taxpayer who is not personally suspected of non-compliance, in order to investigate other unnamed taxpayers, the majority held that "the risk seems minimal". This latter point does not seem to have been addressed in the evidence, and represents a view that informed persons could certainly disagree about.

In a strong dissent for the majority, Justice Rothstein noted that the majority approach would entirely eliminate the need for judicial authorizations to obtain information about unnamed persons when the Agency is auditing taxpayers. Nothing in the *Income Tax Act* suggests such a restricted application for the judicial authorization provisions. Because the authority of the Agency under the *Income Tax Act* is so broad, it should be obliged to rigorously follow the procedures set out regarding unnamed persons.

The Supreme Court's decision was released on the 31st of July. The Agency began releasing proposal letters, on the basis of information obtained without judicial authorization, within the next few days. ■

It's Personal . . . Recent CRA Views

In **Views document 2008-0270421C6**, dated June 11, 2008, the CRA responded to a question posed at the Conference for Advanced Life Underwriting (CALU) 2008 Annual Meeting asking whether a trust settled with the proceeds of a jointly owned last-to-die life insurance policy could qualify as a "testamentary trust" (as defined in subsection 108(1) of the *Act*), assuming that the trust was designated by the spouses jointly and the surviving spouse makes no change to the designation. The CRA responded that a trust created from the receipt of the proceeds of such an insurance policy will not lose its testamentary trust status solely by reason of the receipt of the proceeds of that policy, provided that the policy is owned by the individual who survives the other immediately before his or her death, the policy qualifies as a testamentary instrument of that person at that time, and that the only amount that is payable to the trust under the policy is paid on the death of the last of the two persons insured under the policy. This is consistent with the CRA's previous interpretations that a trust created pursuant to an individual's will or other testamentary instrument will not lose its testamentary trust status solely by reason of the receipt of the proceeds of an insurance policy on the life of that individual (who was the policyholder), where the trust is the designated beneficiary under the policy and the trust was not created or settled before the death of the individual (see *Views document 9605575*).

In **Views document 2007-0234381E5** dated July 21, 2008, the CRA maintained its current administrative position that a T3 Trust Income Tax and Information Return ("T3 Return") is required to be filed where all of the income of a trust is attributed to the settlor under subsection 75(2) of the *Act*. The CRA stated that a trust is required to file a T3 Return unless it is a trust that is ignored for the purposes of the *Act* (e.g., a bare trust) or it meets the administrative exceptions set out in the T3 Guide. A trust under which the income is attributed to the settlor under 75(2) is not eligible for the administrative exception. Therefore, in a situation such as that described in the letter where the property was bequeathed to the beneficiaries and they subsequently transferred the property to a trust to be held on their behalf, it is the CRA's position that subsection 75(2) would apply and a T3 Return would be required for each year in which the trust is in existence.

It's Personal . . . Cases of Note

Redeemer Foundation v. Minister of National Revenue, 2008 CarswellNat 2550, 2008 CarswellNat 2551, 2008 D.T.C. 6484 (Fr.), 2008 D.T.C. 6474 (Eng.), 2008 SCC 46 (S.C.C.) – 08/07/31 - Binnie J., Charron J., Deschamps J., Fish J., LeBel J., McLachlin C.J.C., Rothstein J. - The taxpayer was a foundation which operated a forgivable loan program ("FLP") for students of a college. Prior to 2003, parents, friends and relatives contributed to the foundation. In 2003, Canada Customs and Revenue Agency ("CCRA") conducted an audit and, after an oral request by the auditor, the taxpayer provided the CCRA with a list of all the donors who contributed to the FLP for the 2001 and 2002 taxation years. The CCRA reassessed some of the donors, disallowing their charitable contributions.

The taxpayer's application for judicial review of the minister's determination to request third party information was granted. The trial judge found that the operation of s. 231.2 of the *Income Tax Act* cannot be limited to requests in writing. The trial judge found that the CCRA acted wrongly in requesting the information in question and the minister acted wrongly in using it.

The minister's appeal was allowed, the taxpayer's cross-appeal was dismissed. The appellate court found that the minister was entitled to use the donor list as the basis for reassessments of certain donors. The appellate court found that the trial judge erred in evaluating the scope of s. 231.2(2) of the *Act*. The appellate court found that the minister was not required to obtain judicial authorization to obtain the list of donors, and that the minister's power to conduct audits and investigations under s. 231 of the *Act* was sufficient to legitimately request the information. The taxpayer, as a charity, was required by law to maintain books and records. As the auditor was entitled to create a list of donors from examining the taxpayer's receipts, a court order was not required before asking for the taxpayer's assistance. The fact that s. 231.2(2) of the *Act* makes specific reference to unnamed persons does not prevent

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the operation of ss. 231 and 231.1. The privacy expectations of the taxpayer were not adversely affected.

The taxpayer appealed and the appeal was dismissed.

Per McLachlin C.J.C. and LeBel J. (Fish, Charron JJ. concurring): The minister was entitled to use the donor list as the basis for the assessments. The minister is entitled to examine records which have been kept, or should have been kept, under s. 231.1(1) of the *Act*. Section 231.1 does not exclude third party information. The minister sought the information for a legitimate purpose, that of investigating the activities of the taxpayer. The information was necessary in order to determine whether the receipts the taxpayer had issued were proper. The reassessment of the donors was not the intent of the request for information, rather it was the logical outgrowth of observing the records obtained. The list of donors was clearly information that the taxpayer, as a charity, was required to keep under s. 230(2) of the *Act*.

Requiring judicial authorization whenever an audit of a charity entails the possibility that donors would be investigated and reassessed would be unworkable. Allowing the minister to audit the records of charities does not place undue power in the hands of the minister. Those who donate to charities have the reasonable expectation that the charity's records may be examined.

Per Rothstein J. (Binnie, Deschamps JJ. concurring) (dissenting): The appeal should be allowed. Where the CCRA seeks information or documents for a purpose other than compliance by the taxpayer with the Act that may be determined through an audit, it is acting outside s. 230 and s. 231.1 of the *Act*. If what the CCRA seeks pertains to unnamed persons, judicial authorization is required. A verbal or informal request is not sufficient. The donors' expectation of privacy was not determinative of the issue.

The CCRA is required to obtain judicial authorization regardless of whether the documents were obtained for the sole purpose of obtaining information regarding unnamed purposes, or for the dual purpose of also auditing the taxpayer itself.

Requiring judicial approval merely due to the possibility that third party information might be disclosed would be impractical, but this was not the situation in the case at bar. The information needed to reassess the compliance of the donors was not entirely within the records of the taxpayer. Obtaining authorization would not be unduly burdensome.

There was no evidence that the forms the minister requested to be kept by the taxpayer were proper records that the taxpayer was required to keep under s. 230(2) of the *Act*. The situation was not one where information was used to verify compliance by the taxpayer with record keeping responsibilities.

The Federal Court does not have jurisdiction to vacate tax assessments. Any issues regarding the admissibility of evidence in respect of assessments were to be resolved at the Tax Court.

Reid v. R., 2008 CarswellNat 2598, 2008 TCC 421 (T.C.C. [Informal Procedure]) – 08/07/30 – Boyle J – The taxpayer collected Canada Pension Plan benefits as of his 60th birthday. He also had self-employment income in the taxation year in which he turned 60, which he earned only after he began receiving benefits. The Minister assessed the taxpayer for the year in which he turned 60, imposing contributions on a portion of the self-employment earnings. The taxpayer appealed. The appeal was allowed in part. The relevant portion of the *Income Tax Act* requires that self-employment income earned in the year that the taxpayer turns 60 is apportioned evenly throughout year, with tax payable on the same portion as months prior to 60th birthday. The fact that the taxpayer earned all of the income after turning 60 did not defeat operation of *Act*. The fact that Human Resources Canada advised the taxpayer that he would not be required to make contributions for amounts earned after he turned 60 did not alter the assessment. The contributory earnings were four-twelfths of the self-employment income, rather than five-twelfths as assessed. The taxpayer was awarded costs due to contradictory messages from government agencies.

White v. R., 2008 CarswellNat 2543, 2008 TCC 414 (T.C.C. [Informal Procedure]) – 08/07/24 – Mogan J.– The taxpayer acquired a life insurance policy in September 1983 when he was 48 years old. The policy had a "return of premium" benefit for which the taxpayer paid a separate premium. The policy terminated in September 2005 when he was 70 years old. Because the taxpayer survived the termination of the policy, he received a cheque in 2005 from the insurer for $24,909 which represented his "return of premium" benefit. The taxpayer filed his 2005 income tax return reporting total income of approximately $21,200 derived primarily from old age security, Canada Pension Plan, and pension arising from employment. By Notice of Reassessment, the Minister of National Revenue added $24,909 to reported income for 2005 which in effect, taxed the taxpayer's return of premiums. The taxpayer appealed. The appeal was allowed in part. The appeal was allowed only for purpose of reducing the amount to be included in 2005 income from $24,909 to $23,888, which was taxable pursuant to s. 148(1) of *Income Tax Act*. While the words "proceeds of disposition" and "adjusted cost basis" are similar to

words used in Act to define capital gain as set out in s. 40(1)(a)(i), with respect to life insurance policy, any gain on disposition of interest therein flows directly into policyholder's income because of the opening words of s. 148(1) and the specific words of s. 56(1)(j). The maturity of the taxpayer's policy in September 2005 was "disposition" of his interest in the policy. The "proceeds of disposition" of his interest in policy was amount ($24,909) which he was entitled to receive in September 2005 when the term of the policy expired and his interest therein dissolved. The taxpayer's adjusted cost basis of his interest in the policy was the total of all amounts paid as premiums for pure life insurance plus all amounts paid as premiums for return of premium benefit ("ROP); minus net cost of pure insurance ("NCPI") as defined by regulation 308 and determined by insurer. When the taxpayer disposed of his interest in the policy in September 2005, he was required to include in computing his 2005 income the amount by which his proceeds of disposition ($24,909) exceeded his adjusted cost basis ($1,021.20). Therefore, the amount to be included in 2005 income under s. 148(1) was $23,888. The taxpayer's frustration was understandable as he paid $24,909 in premiums, which was not deductible in computing his income. The taxpayer naturally thought of the ROP benefit ($24,909) as the return of non-taxable dollars. But according to Canada Revenue Agency, a greater portion ($23,888) of ROP benefit was share of income earned by insurer over the 22 year term. That share of income was going to be taxed in the hands of either the insurer or the taxpayer as the insured. Because the taxpayer received that share, he must pay tax.

Tiedemann v. Tiedemann, (2008), 2008 CarswellOnt 2418, 39 E.T.R. (3d) 213 (Ont. S.C.J.) – 08/04/14 - Belch J. - The deceased and his sister held a joint account. The son of the deceased, and sole beneficiary of estate, brought an action to determine who is entitled to funds on deposit with bank. The action was allowed. The sister presented no evidence that the deceased had intended to gift her balance of funds in the joint account. The court was satisfied that the deceased chose a joint account because the authority to pay bills owing could be exercised by the surviving account holder; a power of attorney would not permit this. In other words, the deceased was interested in financial management, rather than gifting account balances. After weighing all of the evidence, the court found that on a balance of probabilities the presumption of resulting trust has not been rebutted and the intention of deceased was to have sister assist with management of financial affairs if he was incapable of so doing; accordingly funds are to be paid to estate.