CCH Tax Notes - March

Close Encounters with the CRA

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I would like to talk about three interesting developments that have cropped up in recent weeks. All three have to do with the actions of the CRA and two of them are examples of what seem to be an increasingly aggressive attitude toward tax collection on the part of CanRev**[1]**.

Self-assess – OR ELSE!

As readers will be aware, Canada relies on the "self-assessment" system of taxation. By the looks of things, the CRA has decided to give thousands of taxpayers a shove: self-assess or be audited.

A CRA release dated February 4th deals with a "self review letter initiative", indicating that the CRA will be conducting a letter-writing campaign "in an effort to provide Canadians with the information they need to understand their tax obligations".

It's sort of like "Close Encounters of the Third Kind" – only with CanRev, not aliens. But recipients of CRA letters may end up wishing that CRA followed the Prime Directive. The release indicates that two types of letters will be sent to "thousands of Canadians":

- *Close Encounters of the First Kind*: Some taxpayers will receive a letter providing information about eligibility criteria for certain deductions they have claimed in their recent income tax returns.
- *Close Encounters of the Second Kind*: Other taxpayers will receive a similar type of letter and will be advised of the possibility that their income tax returns may be selected for audit. Of course, that would be *Close Encounters of the Third Kind*.**[2]**

A sample letter we obtained pertains to motor vehicle expenses claimed for 2008, reminding the addressee that: "if we audit your tax records, our audit may not be restricted to the items identified in this letter. When you file your 2009 income tax return and all future returns, please consider the information we have provided. This will help reduce the need for us to contact you again in this regard."

The letter goes on to remind taxpayers that they are subject to penalties for making a false statement or omission. Always eager to be helpful, the letter includes an appendix with the basics of automobile expenses, including a suggestion to record the particulars of each business-related trip and a friendly reminder that the CRA considers the use of a motor vehicle to travel between home and work as a personal use.

Asset Purchases – Another Close Encounter

A member of our tax department drew my attention to a tax file where the purchaser of a business, having complied with bulk sales legislation, has been reassessed for the vendor's unremitted source deductions. In case you're curious, the basis of this assertion is that the source deductions constitute a deemed trust for Her Majesty, courtesy of subsections 227(4) and (4.1) – so that the assets belong to Her Majesty and not the purchaser. A similar situation came before the Supreme Court of Canada in The Queen v. First Vancouver Finance and Great West Transport Ltd.**[3]** In that case, the CRA was unsuccessful in collecting a vendor's unremitted source deductions from a purchaser of assets. Apparently, however, at least one CRA official is of the view that the case is limited to the purchase of assets in the ordinary course of business (in the First Vancouver case, the purchase of receivables by a factor)**[4]**.

At the moment, I am not aware of any other files where the CRA has assessed on this basis. If any readers are aware of a similar file, I would appreciate it if you could notify me at the e-mail address below, as this approach would be quite problematic for asset purchasers and their counsel**[5]**.

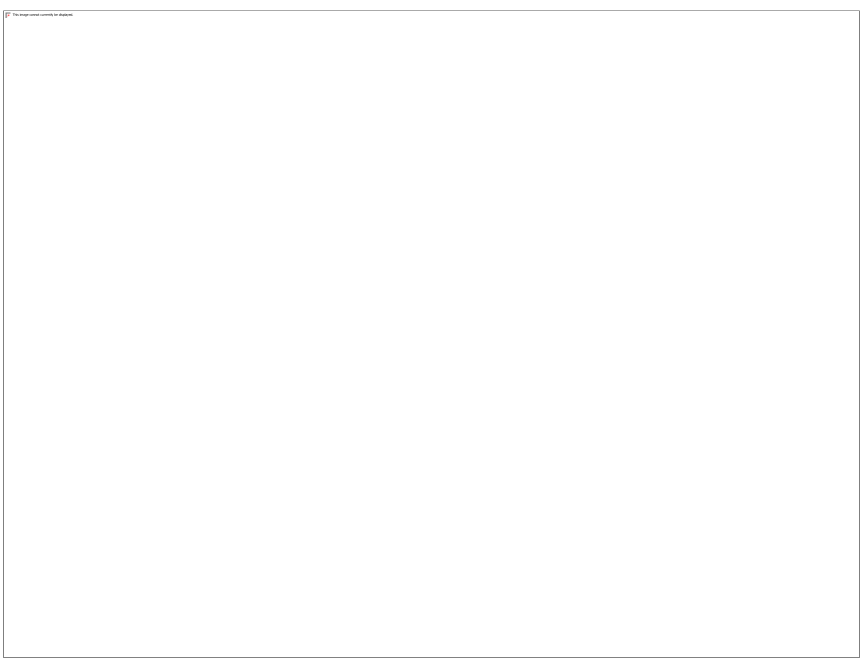
"Ownership" by Trustees/Executors

Ignorance is bliss; particularly when it comes to troublesome tax interpretations.

At issue are two fairly recent CRA "Technicals" - which we came across when we were writing Tax and Family Business Succession Planning - that attribute "ownership" of shares held by a trust to its trustees**[6]**. The concept of ownership of shares by trustees can be particularly problematic when it comes to the so-called "cross-ownership" provisions in the association rules. In very simple terms, these come into play where a person (or a related group of persons) controls one corporation and is related to a person (or a related group of persons) that controls a second corporation. If, in addition to the control position, either person (or any member of either of the groups) has "cross-ownership" – i.e., "owns" at least 25% of the shares of any class – of the other corporation**[7]**, the two corporations will be associated.

So if a trustee or executor is considered to own shares held by a trust, this can potentially have an impact on the choice of trustees or executors.

Suppose, for example, that I appoint my wife and her brother, Sam, who has his own company, as my executors. I die and the shares of my company pass to my estate. So my company is controlled by my wife and her brother Sam.



If Sam, as executor of my estate, "owns" shares of my company, then the two companies will be associated when I pass away.**[8]**

As I said previously, the CRA has weighed-in with two Technicals on the subject. The first suggests that each executor owns 100% of the shares held by the estate. The second (2008 APFF Question 10) may suggest that the share ownership could be pro rata, so that in my example, Sam would own 50% of the shares. Even so, this would still be problematic because it exceeds the 25% cross-ownership threshold.

As shown by this simple example, there are obvious issues raised in terms of choice of trustees (and executors). These and other examples are discussed in the third edition of the book**[9]**.

But apart from 100% ownership or pro rata ownership, there is a third possibility – that of "collective ownership" – i.e., where the trustees are treated as a single owner, so that no single trustee owns the shares**[10]**. In my example, if my wife and her brother collectively own shares of Opco, the two corporations would not be associated; generally the choice of executors would appear to be much less problematic. This possibility is pointed out in the third edition of the book**[11]**. But at the time of publication, the concept of collective ownership had not been endorsed by the CRA.

A few weeks after the book went to press, a colleague forwarded the 2009 APFF Round Table. While the actual proceedings are released only in French, my handy-dandy Google translation suggested that the CRA was going to a notion of collective ownership. Some days ago, the CRA released an English version of the question**[12]**, which appears to confirm this**[13]**, stating that the reference to the trust as owner of the shares in question "would normally refer to all of the trustees as a group".**[14]**

In the absence of this interpretation, the selection of executors would have been problematic where shares of a closely-held CCPC are involved, perhaps necessitating an analysis of the association rules. So this would be a welcome development.

This is not to say that the choice of an executor or trustee can never have untoward tax consequences in respect of associated corporations. For example, if a single executor is appointed, and that executor controls his or her own corporation – i.e., other than as an executor – the two corporations will be associated; however, this result is by virtue of common control and long-standing case law.**[15]** Also, the choice of executor can have repercussions with respect to CCPC, related person status, etc.**[16]**

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[1] Other examples pertain to the increased scrutiny on *inter vivos* trusts, including the "Golden Horseshoe" initiative involving the review of family trusts in that region and elsewhere, as well as the Alberta Trust questionnaire in the spring of 2009. For further discussion, see "The Trouble with Trusts", by the author, in the January edition of *Tax Notes*.

[2] The release indicates that the CRA wishes to "provide taxpayers the opportunity to amend their income tax returns by completing an adjustment request and/or by making a voluntary disclosure in cases where the taxpayer may have claimed deductions in error or provided inaccurate information."

[3] 2002 DTC 6998.

[4] While it may be open for the CRA to take this position, my personal feeling is that the underlying reasoning for the Supreme Court's holding may well support the contention that a purchaser of assets outside of the ordinary course of business would not be subject to the deemed trust. The Court indicated that the deemed trust operates in a manner similar to a floating charge whereby the proceeds of a sale replace the assets sold and that there is no basis upon which to allow the Minister's interest in the tax debtor's property to continue once such property has been sold to third parties [paragraphs 40-43]. However, the case holds that the deemed

trust does not operate over assets which a tax debtor has sold "in the ordinary course" to third party purchasers [paragraph 46].

[5] Corporate-commercial lawyers who read this article will be troubled because, in the absence of the development of special CRA procedures, it is difficult to take steps to protect an asset purchaser, notwithstanding compliance with bulk sales legislation. For what they're worth, representations and indemnities can be obtained, although a vendor's lawyer might be resistant to providing these. Ultimately, it may be the case that a detailed accounting review by the purchaser would be required.

[6] Doc. No. 2005-0111731E5, May 2nd, 2006, and 2008-0285021C6, October 10th, 2008.

[7] Excluding shares of a specified class, per subsection 256(1.1).

[8] I.e., in addition to the share ownership by Sam, a related group – Wife and Sam control Opco.

[9] See paragraphs ¶319 and ¶810b.

[10] This possibility was first pointed out to me by my tax partner, Joan Jung.

[11] See footnote 61 to chapter 3, and footnote 30 to chapter 8.

[12] Doc. No. 2009 – 0330271C6. 2009 APFF Round Table Question 30 (formerly Question 26).

[13] Although the translation is somewhat unclear.

[14] If you have managed to read this far, you may be asking why a trustee would be considered by the CRA to be an owner of shares held by a trust. Actually, the answer, which was fairly explicit in Doc. No. 2008-0285021C6, is rooted in subsection 104(1) of the Act, which indicates that a reference to a trust or an estate shall, unless the context otherwise requires, be read to include a reference to a trustee, executor (etc.) having *ownership* or control of trust property. In other words, subsection 104(1) presupposes that a trustee or executor is the *owner* of trust property.

[15] See, in particular, *H.A. Fawcett & Son Limited* v. *The Queen*, 80 DTC 6195 (FCA).

[16] For further discussion, reference should be made to ¶810d of *Tax and Family Business Succession Planning*.

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