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New Offshore Trust Case is Relevant to Tax Preparers

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Over a year after it was originally heard, the Tax Court of Canada released a long-awaited case, Labow et al v. The Queen**[1]**, in which the CRA successfully attacked deductions claimed for contributions to an "offshore health and welfare trust". But in addition, the case, along with a number of other recent cases (discussed below), continues the trend of the CRA's successes in being able to reassess beyond the normal reassessment period.

The offshore structure - and the CRA dispute that resulted in the case itself – has become well known to many tax practitioners, especially around Ontario: as the case says, the taxpayers are among 75 files involving these trusts implemented by one Ottawa lawyer alone. Actually, the Labow case involved three of the lawyer's clients. But I will largely confine my comments to one of them, especially since the fact situations are fairly similar.

Dr. Labow, an Ottawa-area physician, started an offshore trust for his wife - essentially a part-time employee making $20,000 a year. The plan involved disability and health benefits, but as the latter was funded on a pay-as-you-go basis, it is the disability benefits that ostensibly enabled large contributions. The plan specified that a participating employee (i.e., Mrs. Labow exclusively) who is unable to work because of sickness or accidental injury is entitled to income replacement benefits equal to 75% of weekly earnings to age 70.**[2]** Generally for these plans, the contributions were payable in two annual installments; the actuarial calculations were made on the assumption that the participating employee would be totally disabled at the end of the second year of the plan and would remain so until age 70. Needless to say, these assumptions would generate very large contribution limits. In fact, nearly $400,000 was contributed to the trust over the two-year period.**[3]**

The CRA attacked the contributions as non-deductible expenses on a number of alternative grounds, including that the plan was a "sham" and the contributions were not made for the purpose of gaining or producing income.**[4]**

The court ended up holding that, although the plan was not a sham, the contributions to the trust were not made for the purposes of gaining or producing income, so as to deny the deduction under paragraph 18(1)(a) of the Act (in view of this, the court declined to deal with the other grounds advanced by the CRA). The court's rationale is routed in common sense: notably, there was no commercial reason for Dr. Labow to spend $400,000 for such a plan (especially since Mrs. Labow already had a disability plan), nor did he attempt to compare the cost of the plan with the cost of purchasing similar coverage from an insurance company.

The court also held that the income from the trust was taxable under the reversionary trust rules in subsection 75(2) because the particular plan provided that the residual amounts in the plan reverted to the employer.**[5]**

Limitation Period Breached

But the more interesting part of the case is the fact that the court upheld the CRA's attempt to reassess beyond the normal reassessment limitation period.

Generally, in order to do this, there must be a "misrepresentation" that is attributable to neglect, carelessness, willful default, or fraud.**[6]** In the case of Dr. Labow's contributions to the trust, the misrepresentation was that the deductions for the contributions were buried in salary expense on the financial statements**[7]**.

In addition, the normal reassessment period can be extended (for three years) if the reassessment is made as a consequence of a transaction involving the taxpayer and a non-arm's-length non-resident person. The court held that, because the trust gave the employer the power to replace the trustee, Dr. Labow had "control" of the trust with the result that "he and the trust were clearly not operating at arm's-length."**[8]**

Not Just Unreported Income

As I said earlier, Labow is just the latest in a growing number of cases in which the CRA has successfully breached the limitation period. Not just in respect of unreported income, other recent cases have shown that the normal reassessment period can be abrogated in respect of "technical issues" as well, where the taxpayer has not exercised reasonable care – basically, that of a "wise and prudent person". In one recent case**[9]**, the assessment limitation period was breached because the taxpayer, part of an associated group of corporations, did not pay or report federal capital tax (which would have also reduced the company's small business deduction).**[10]** Another recent case**[11]** involved claiming the capital gains exemption where a corporation lost its CCPC status because of a merger. These cases are discussed in a recent article by my tax partner at Minden Gross, Joan Jung**[12]**. This is not to say that a technical mistake, per se, will allow the CRA to open up the assessment limitation period. In the well-known recent case involving Toronto Sun cartoonist Andy Donato**[13]**, the court held that the taxpayer's mistaken belief that the capital gains on donations of his cartoons were subject to the "personal-use property" rules did not constitute neglect, carelessness or willful default**[14]**.

Another recent case**[15]** in which the CRA successfully breached the assessment limitation period and imposed the 50% gross negligence penalty (under subsection 163(2)) involved taxpayers who tried to redo corporate resolutions in order to fix a situation where Part IV tax would otherwise apply. The CRA refused to admit the validity of the resolutions, characterizing them as retroactive tax planning that were never intended to be part of the original corporate reorganization plan in question.

As pointed out in Joan's article, the CRA's Audit Manual suggests that tax auditors should look to the number of transactions for which income has been understated, or a single improperly recorded or omitted transaction involving a material amount of income**[16]**.

In view of the emerging cases, heeding these (perhaps "inelegant") guidelines may be prudent. In addition to the ability to breach the assessment limitation period, one should also be aware of the 50% gross negligence penalty mentioned earlier which, although perhaps requiring somewhat more egregious conduct, nonetheless may often go hand-in-hand with extending the assessment limitation period.

What bothers me about the CRA's policy is that, in the real world, due diligence on a tax filing item can be a sliding scale ranging from a completely innocent mistake all the way to "taking a shot" at a dubious tax filing position in the hopes that it isn't caught. As the tax involved gets bigger, do we move closer to serious consequences for nothing much more than a simple mistake? This is a chilling thought for tax preparers who don't have the luxury of an in-house tax practitioner.

The Labow case raises a number of other interesting issues which, though beyond the scope of this article**[17]**, will no doubt be dealt with at greater length by other commentators.

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[1] 2010 TCC 408.

[2] See paragraph 21.

[3] In a sense, this arrangement is the antithesis of what I would regard as a normal disability plan, whereby the risks of large personal expenditures are shared amongst a number of participants; here, there is only one participant and the worst case scenario is assumed. Per paragraph 28 of the case, the contribution recommended by the actuary was almost double the amount that would have been required to provide disability payments at the maximum level provided for in the plan.

[4] The other grounds were as follows:

- the contributions were payments on account of capital;
- the amounts of the contributions to the trusts were unreasonable;
- the amounts were contributions to employee benefit plans, the deduction of which is prohibited by paragraph 18(1)(a) of the Act;
- if the contributions were in fact contributions to genuine employee group sickness or accident plans, they were consideration for insurance in respect of years after the years they were paid, so as not to be deductible by virtue of the rules pertaining to prepaid expenses (subparagraph 18(9)(a)(iii) of the Act).

[5] The trust was not subject to an exemption from subsection 75(2) pertaining to employment (see paragraphs 75(3)(b) and (a.1) of the definition of "trust" in subsection 108(1)): the benefits were not provided to Dr. Labow's spouse because of her office or employment, but because she was married to Dr. Labow.

[6] See subparagraph 152(4)(a)(i).

[7] At paragraph 41, the court indicated:

> There is nothing in either return that would reveal to the reader that these amounts described as salary expense include contributions to a trust to fund a plan for his wife, the purpose of which had nothing to do with gaining or producing income. That is a misrepresentation, as it represents a contribution made to the trust fund for purely personal reasons as being a business expense.

In the case of income from the offshore trust, the court indicated that, having found that Dr. Labow was aware that the purpose of the fund was personal and not for the benefit of his medical practice, it "follows that he should have been aware that he was required to report that income each year." See paragraph 48.

[8] See paragraph 46. As indicated, the case follows *Robson Leather Co. Ltd.* v. *M.N.R.* 77 DTC 5105 (FCA).

[9] *College Park Motor Products Ltd.* (also cited as *College Park Motors Ltd.*), 2009 TCC 409.

[10] Questions in the T2 Tax Return were incorrectly answered, and this was held to be a misrepresentation.

[11] *Dalphond,* 2009 FCA 121.

[12] "Neglect Is Not Just Unreported Income", *Tax Planning For The Owner-Manager*, April 2010, Canadian Tax Foundation.

[13] *Donato* v. *The Queen*, 2009 DTC 1384, TCC.

[14] Paragraph 67. See also *O'Dea*, 2009 DTC 1172, TCC, in which individuals were held to have acted in a reasonable and prudent manner in their reliance on the tax opinion and partnership statements of deductible losses received in respect of a limited partnership structure having complex tax issues.

[15] *Gestion Forêt-Dale Inc.* v. *The Queen*, 2009 DTC 1254 (TCC).

[16] See section 11.3.7 of the CRA Audit Manual.

[17] The *Labow* case makes an interesting comparison to the recent *Faraggi* case (2008 DTC 3245, TCC; 2009 DTC 5023, FCA) another successful CRA attack on aggressive tax planning. Among other things, the Federal Court of Appeal held that capital dividend elections were "shams" because they "misrepresented" the underlying transactions as on capital account because no capital gains had been validly created in the first place (paragraphs 77 and 79).