Heavy Case Load

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Baxter: Tax Shelters – Down for the Count?

Baxter[1], a Federal Court of Appeal verdict, could be a lesson that trusting the conventional wisdom of King-and-Bay tax types can sometimes be dangerous[2]. Along with some other recent cases in the tax shelter area, if may also spell a kayo for already-punch-drunk promoters who have gone too many rounds with the CRA.

Let me explain. In essence, there have been two major elements to determining whether the "tax shelter rules" apply. First there is a mathematical test - do the deductions[3] in the first four years equal or exceed the cost of the property in question, net of "prescribed benefits" (basically potential financial assistance to limit losses[4])? Because lots of things could trip over the math – buying computer software, to give just one example - tax practitioners have taken a lot of stock in the "representation" test – i.e., these benefits must be "represented" to potential investors[5]. Otherwise, King-and-Bayers would ask, "where does it end?"

When the rules first came out, conventional wisdom in that neck of the woods - belt and suspenders being belt and suspenders - was to register anything that looked like it could be a tax shelter with the CRA - to guard against the loss of all write offs, if an unregistered property turned out to be a tax shelter. Not surprisingly, King and Bayers quickly found out that that this was playing into the CRA's hands – and soon found a team of tax auditors waiting outside their oak paneled offices.

So enter Plan B: the "no reps" angle: in a nutshell, the shelter may ultimately trip over the math, but we never "represented" this. I remember some commentary going so far to say that representation means legal representation – like “representations and warranties” in a contract. Oh, and here’s our 50 page tax opinion which – by the way – does not constitute a representation.

This angle has finally found its day in court and, not surprisingly, a frosty reception by judges. In fact, there have recently been three key unfavourable verdicts in respect of tax shelters: *Maege*[6], *Tolhoek*[7], and most significantly, *Baxter*. In that case, the Court of Appeal appears to ascribe a non-technical meaning to the representation concept[8]. “Representations” (which are made by the promoter[9]) need only to be “communicated” or “announced” (presumably, including verbally) to “prospective purchasers” – and not necessarily to the particular taxpayer[10]. So if the acquisition of a property meets the mathematical test, watch out. Along the way, the Court trashed the defence of isolating the representations into discrete documents (e.g., separation of appraisals from the tax opinion)[11], as well as the argument (which succeeded at the Tax Court of Canada level) that CCA was not an “amount incurred” as required under the tax shelter rules. All told, this was a frontal assault on conventional wisdom of the King and Bay set. Trouble is, with the representation test in tatters, we may be back to “Where does it end?” when it comes to what constitutes a tax shelter[12].

Pecore – Joint Accounts Unsnarled (or Snarled)?

Segue - from the towers of King and Bay to the hinterlands, where estate planning is often based on articles in the paper, or chats with bank managers and stock brokers. In this *milieu* the joint tenancy snafu has been one of the biggest traps in personal financial planning. Because the asset passes outside of the estate, putting an asset in joint tenancy is often recommended to reduce probate fees[13], particularly in high-probate-fee provinces such as Ontario and B.C. Trouble is, joint tenancies can have some bad side effects, perhaps the most nasty being that, if this is done between generations (e.g., parent puts an asset in joint tenancy with his or her child), there is a deemed sale of the joint interest – if a two- person joint tenancy is created, this would be 50% of the particular asset, with capital gains tax based on the value of the asset at the time. Tax drones call this a "deemed disposition". Those of us who are particularly cruel like to spring this on unwitting financial advisors, along the following lines: "aha, you ignorant so and so, you missed the deemed disposition".

All too often, the taxpayer finds out about this trap after the joint account is set up. In fact, it looks like this is what happened in the *Pecore*[14]case, where father created joint accounts with his daughter.[15] To make things worse, after father passed away, the daughter became involved in a wrangle with her former husband over her father's estate. If the joint accounts held up as gifts to the daughter, she got the accounts; if the gifts were invalid, the accounts went to father's estate, out of which the former husband stood to benefit because he was in his father-in-law's will.

As many readers will be aware, the case went all the way to the Supreme Court of Canada, where the court made a remarkable verdict. There were no gifts of the accounts during father's lifetime – beneficial ownership remained with the father and the would-be lifetime gift of the joint account was overridden by the "presumption of resulting trust" that applies to most gifts (more on this later). But the court held that the *inter vivos* transfer of the right of survivorship was effective (the presumption of resulting trust in this case overridden by the evidence of the father's intention to make the gift of the right of survivorship), with the result that the joint accounts in question passed to the daughter on father's death.[16]

When it comes to the probate fee strategy, the result is a classic case of have-your-cake-and-eat it. Probate fees are reduced, with none of that deemed disposition stuff - the top court going so far as to say that even though the right of survivorship passed during father's lifetime, there would be no deemed disposition of this right when the account was set up[17]. So the aforementioned financial advisor can tell the client he or she was right all along – and the tax drone to shove it.

Besides the ability to "separate" the right of survivorship from the interest in the joint account during the transferor's lifetime, the *Pecore* case held that the presumption of resulting trust (i.e., a presumption that a gift is not intended), rather than the presumption of advancement (i.e., a presumption that it is) should generally apply to intergenerational transfers. So that the onus is generally on the transferee to demonstrate that a gift was intended. This applies to gratuitous transfers from a parent to an adult child, even if dependent[18]. However, the presumption of advancement applies to the transfer to a child who is a minor.[19] In *Pecore*, the presumption of resulting trust with respect to the right of survivorship was overridden by the evidence. But In a companion case, *Madsen Estate*[20]*,* the evidence was insufficient to rebut the presumption of resulting trust re the right of survivorship.

Of course, the applicability of the foregoing result depends on the facts. In *Pecore*, the court found the evidence was consistent with the father having intended to gift rights of survivorship when the accounts were established.[21] It is, of course, important to be clear about whether the beneficial interest in a joint tenancy is being granted, and also to be clear about whether the right of survivorship is being granted. Based on *Pecore*, it is possible to grant the latter without granting the former. Given the court's holding that the presumption of resulting trust applies to a gift from a parent to an adult child, the court will presume that no gift was intended unless the presumption can be overcome. In other words, a joint account between parent and adult child with a right of survivorship does not pass any beneficial interest to the funds in the account on death unless it can be established that there was an intention to do so.[22]

However, if an individual can fit within the case, the benefits of joint tenancies can be enjoyed without those nasty side effects that tax advisors drone on about. So has the

Supreme Court verdict resulted in joint tenancies as an estate planning panacea for the masses? I don't think so. Unfortunately, I fear that, in the aforementioned hinterlands, the case will be short-formed into the notion that joint tenancies will reduce probate fees without income tax issues. This, of course will be particularly dangerous in view of the case's complex presumptions and onuses, evidentiary weightings[23] and the like. But where it will really hit the fan is where the results of survivorship are disputed by testamentary beneficiaries.

For further discussion of *Pecore* and *Madsen Estate*, see "Joint Accounts at Death", Robert Spenceley, *The Estate Planner*, No. 149, June 2007.

More Remarkable Cases

Lipson[24] was the GAAR first case decided by the Federal Court of Appeal after the Supreme Court's landmark *Canada Trustco* and *Kaulius* decisions. Naively, one might ask, why all the fuss? *Lipson* involves on old mortgage interest deductibility flip: a spouse borrowing money to buy unlevered shares of a family company from her husband. But the case seems to have broadened the test for determining when a series of transactions will be considered to be abusive by having regard to the purpose of the series taken as a whole. This has been perceived as coming perilously close to an approach that looks at substance or "economic reality" of the transactions to override legal relationships. Translation? It throws all sorts of interest deductibility strategies into jeopardy, including certain strategies which mean big bucks to their proponents. Small wonder that leave to appeal to the Supreme Court of Canada was quickly sought.[25]

Strother[26] held that a tax lawyer who failed to disclose a tax strategy to revive film tax shelters (thought to be plugged by tax changes) was in breach of his fiduciary duty to a client, in view of the fact that he had personally profited in a venture with another client to whom the strategy was disclosed. Strother and his firm had formerly been on a retainer arrangement to the first client which prohibited them from acting for other clients in relation to shelter schemes (which had been replaced with a more limited retainer when the transgressions occurred). The Supreme Court decreed that Strother had to cough up monies received until he resigned from his firm in 1999. As I expect that this case will be the subject of extensive commentary in coming months, I will not discuss it in detail.

MIL Investments is a pro-taxpayer GAAR verdict of the Tax Court of Canada which was recently affirmed by the Federal Court of Appeal[27]. While the judgment is brief, it pours cold water on the CRA's position that treaty shopping is GAARable[28].

2530-1284 Québec Inc.[29] This case, which has yet to be translated into English, may revive the doctrines of sham/ineffective transactions. The case involves a strategy to create capital dividends using stock dividends. I am told that a key element of the case was that certain transactions were not legally effective under Quebec law. The case is important because it may reopen a second broad line of attack - besides GAAR, that is – that has been dormant for years.

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[1] 2007 FCA 172 (2007 DTC 5199); reversing 2006 DTC 2642 (TCC).

[2] For the record, my office is at King and York – a block away from King and Bay - but a symbolically significant block.

[3] Amounts represented to be deductible.

[4] As well as "limited recourse amounts", per Regulation 231(6.1).

[5] I.e., there must be "statements or representations made or proposed to be made in connection with the property" that "represent" that the numerical test will be met.

[6] 2006 TCC 117, TCC, affirmed, 2007 FCA 125. This case indicated that one could make representations to oneself. For a discussion reconciling this concept with the concept of representation to a "prospective purchaser" in *Baxter*, see "Tax Shelters – Presumed Cognizant?" Francois Giroux, *Tax Topics* No. 1837, May 24, 2007.

[7] 2006 TCC 681, TCC. In *Tolhoek,* Campbell, J. suggested that because the case involved aspects of the tax shelter provisions (the applicability of the limited recourse indebtedness rules in section 143.2) the test of *bona fide* arrangements for repayment should be interpreted more stringently than similar provisions relating to shareholder loans. Query whether the Federal Court of Appeal implicitly took a similar approach to the meaning of "representation" in *Baxter.*

[8] For another discussion of *Baxter*, see "Get a Tax Shelter Number: Baxter", John Jakolev and Graham Turner*, Canadian Tax Highlights,* Volume 15, Number 6, June 2007. The authors state the following about the meaning of representation: "the conventional wisdom of many tax advisers was that the preamble test of 'statements and representations' having been made required a direct linkage between the information in the representation and the ability to rely thereon by the taxpayer. This belief was based on the fact that the term 'representation' has a distinct legal meaning—a 'statement of fact made to induce another to enter into a contract'."

[9] As defined in section 237.1; see paragraph 44.

[10] Thus, in *Maege*, the Federal Court of Appeal indicated that, once the tax consequences had been "announced", the fact that the appellant did not make statements to herself is irrelevant. Query, however, why the Federal Court of Appeal felt that "what is relevant is that she knew that beneficial tax consequences would arise as a result of her investment" (see paragraph 5). If a representation is a communication to a prospective purchaser rather than the particular taxpayer, per *Baxter*, what difference does Maege's knowledge of the beneficial tax consequences make?

[11] Paragraph 34.

[12] What may be left is a situation where a taxpayer who, on his own, or through consultations with his own advisors, decides to purchase property which meets the math test. Arguably this situation would not be subject to the tax shelter rules, unless a third party (promoter) is also involved. See "Tax Shelters – Presumed Cognizant?", *op. cit.*

[13] A joint tenancy may also simplify estate administration because of the "survivorship" feature.

[14] *Pecore* v. *Pecore*, 2007 SCC 17.

[15] Father's financial advisor told him that by placing his assets in joint ownership, he could avoid the payment of probate fees and generally make after-death dispositions less expensive and less cumbersome. Three years later, father's accountant advised him that for tax purposes, transfers to his daughter could trigger a capital gain. Father then wrote letters to the various financial institutions to the effect that he was the "100% owner of the assets". (See paragraph 10.)

[16] While the case did not deal with spousal gifts, the court observed that the presumption of advancement has also been applied for transfers from a husband to a wife. See paragraph 28.

[17] See paragraph 70.

[18] However, evidence as to the degree of dependency of an adult transferee child on the transferor parent may provide strong evidence to rebut the presumption of a resulting trust.

[19] The court indicated that the foregoing applies whether the transfer is from the mother or father of the child. See paragraph 23.

[20] *Madsen Estate* v. *Saylor*, 2007 SCC 18.

[21] Query the effect of *Pecore* on the property law concepts underlying joint tenancies, particularly the requirement of the "four unities" (interest, title, possession, time).

[22] Thanks to James Baird and William Cooper of Boughton Law Corporation, Vancouver for comments on *Pecore*.

[23] For example, Rothstein, J. stated that: "banking documents in modern times may be detailed enough that they provide strong evidence of the intentions of the transferor … Therefore, if there is anything in the bank documents that specifically suggests the transferor's intent regarding the beneficial interest in the account, I do not think that courts should be barred from considering it. Indeed, the clearer the evidence in the bank documents in question, the more weight that evidence should carry." Really? Are people who follow this type of strategy likely to read and understand the documents?

[24] *Lipson* v. *The Queen*, 2007 FCA 113

[25] See "Lipson (FCA): All-Purpose Logic?", Olivier Fournier and Michael N. Kandev, in last month's edition of *Tax Notes*.

[26] *Strother* v. *3464920 Canada Inc.*, 2007 SCC 24.

[27] 2007 FCA 236, affirming 2006 DTC 2784.

[28] See paragraphs 5-8. Paragraph 4 of the judgment indicates it is "unlikely that the Tax Court judge's conclusion was the result of a palpable and overriding error".

[29] Dossier: 96-1457(IT)G