Canadian Tax Highlights

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Volume 27, Number 4, April 2019

Rectification Allowed

Crean (2019 BCSC 146) is the latest case on the doctrine of rectification in the wake of the SCC companion decisions in *Jean Coutu* (2016 SCC 55) and *Fairmont Hotels* (2016 SCC 56). Rectification was allowed in *Crean*.

The facts in *Crean* were simple. Two brothers each owned one-half of the shares of a funeral services company (Opco) and wished to consolidate all the shares in one brother's hands. They entered into an agreement in principle (AIP), which specified that the transaction would give rise to a capital gain in the transferor brother's hands, and took the following steps: (1) the transferee brother rolled his Opco shares into a newly incorporated company (Holdco) and (2) the transferor sold his Opco shares to Holdco under a purchase and sale agreement (PSA). Holdco, which was wholly owned by the transferee, thus became the sole shareholder of Opco—the intended result. However, because the transferor and Holdco did not deal at arm's length, and Holdco and Opco were connected after the transaction, subsection 84.1(1) deemed a dividend to be paid from Holdco to the transferor.

When they discovered this unintended tax consequence, the brothers applied to rectify the PSA and the related promissory note to instead provide for a direct sale of the Opco shares from the transferor to the transferee—a transaction that avoided a deemed dividend—and a subsequent sale of Opco shares from the transferee to Holdco. The petitioners' submission was simple: the PSA did not reflect their true agreement, which was evidenced by the direct sale contemplated by the AIP. The brothers said this misrepresentation should be attributed to their tax adviser; the Crown submitted that the only error was the brothers' failure to consider subsection 84.1(1).

The court opened its decision with an overview of the law of rectification. The court reiterated that a "common, continuing intention" to achieve a particular tax outcome, without more, was no longer sufficient in the wake of *Jean Coutu* and *Fairmont Hotels*. Now, a petitioner must clearly and cogently have evidence of a prior agreement with "definite and ascertainable" terms in order to access rectification.

Notably, the court also reviewed the SCC decision in *AES* (2013 SCC 65), which was advanced by the petitioners for the proposition that if an error in a legal instrument was attributable to a taxpayer's professional adviser and the planned transaction is otherwise determinable, a court must remedy the error in accordance with the parties' intentions. Even though *AES* was decided prior to *Jean Coutu* and *Fairmont Hotels*, the court found that *AES* was still good law and in the court's view was consistent with *Jean Coutu*, which held that the reformulated doctrine of rectification was not limited to clerical errors and could also bridge gaps between a legal instrument and the parties' true intentions by interposing certain steps. Both *AES* and *Jean Coutu* were decided under the Quebec Civil Code, but the court accepted them as persuasive authorities and cited the SCC pronouncement in *Jean Coutu* and *Fairmont* that principles and outcomes for rectification converged in both common-law and civil-law provinces.

The court next examined whether the petitioners' application satisfied the four conditions precedent for rectification. First, it reviewed whether there was a "definite and ascertainable" prior agreement. The petitioners submitted that the AIP was their prior agreement and clearly evidenced their intention to execute a direct sale. An indirect sale was ultimately carried out, but the petitioners explained this discrepancy by reference to their tax adviser, who testified that he misrepresented the parties' true intentions in the PSA. The Crown discounted this evidence as self-serving and said that there was simply no evidence of a prior agreement contemplating a direct sale, emphasizing that the AIP made no explicit reference to this intention. Faced with an ambiguity, the court applied a contextual and purposive analysis to the AIP and concluded that it assumed a sequence of definite and ascertainable steps contemplating a direct sale.

Second, the court considered whether the AIP was in effect at the time the PSA was executed, in order to determine whether the petitioners had a common, continuing intention. Because the court previously held that the AIP contemplated a direct sale, it had to ascertain why the PSA failed to give effect to this intention. Both sides attributed this discrepancy to an error by the petitioners' tax adviser but disagreed as to the nature of the error. Whereas the petitioners characterized the error as a mix-up of names (that is, Holdco and not the transferee brother was named in the PSA by mistake), the Crown maintained that the real error was the tax adviser's failure to appreciate the consequences flowing from an indirect sale.

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Once again the court sided with the petitioners and its decision was governed by the evidentiary record before it. The petitioners had provided evidence of the nature of their true agreement and mistake through affidavits and also through their tax adviser's testimony—evidence that was left partly unchallenged by the Crown.

Third, the court evaluated whether the PSA was inconsistent with the AIP and relied on the evidence of the petitioners' tax adviser, who admitted that he erred in misrepresenting the AIP. The fact that the petitioners almost immediately notified the CRA of the error was, in the court's view, additional support that reinforced its finding that the AIP and the PSA were inconsistent.

Fourth, the court concluded that the PSA could be modified—by replacing the name of Holdco with that of the transferee brother—to carry out the transaction in accordance with the AIP.

As a result, the court granted the petitioners' application and rectified the PSA to effect a direct sale of the Opco shares from the transferor to the transferee. The court also added the subsequent sale of Opco shares from the transferee to Holdco in order to give effect to the petitioners' full agreement, which was for Holdco to ultimately own all of the Opco shares. The court confirmed that its decision was consistent with the policy considerations underlying rectification, as well as the anti-avoidance purpose of subsection 84.1(1).

Crean is welcome news to taxpayers who might have otherwise considered *Jean Coutu* and *Fairmont Hotels* to have narrowed the doctrine of rectification into oblivion. Most importantly, *Crean* highlights that it is possible for the doctrine of rectification to remedy more than just clerical errors. *Jean Coutu* and *AES* left this possibility open, but *Crean* is the first reported common-law decision to apply rectification in such a case and to interpose an additional step in the transaction to accord with the transacting parties' true agreement.

Crean also highlights the importance of properly documenting taxpayers' intentions prior to and independent of a transacting instrument: absent the AIP, the *Crean* petitioners would have had no recourse to rectification of their tax adviser's mistake. Notably, *Crean* is not an authority for the proposition that parties may, in a prior agreement, specify an intention to carry out a transaction on a tax-neutral basis to insulate themselves from adverse tax consequences. Both *AES* and *Jean Coutu* clarify that such an intention is too broad to invoke a court's equitable jurisdiction to grant rectification. To reiterate, the common intention identified in *Crean* was for a direct sale; the fact that the AIP stated that one brother was to realize a capital gain only informed the court's perspective that a direct transfer was intended.

Ultimately, *Crean* is instructive because it identifies the type of behaviour that a court may interpret as evidence that the taxpayers' prior agreement was their true agreement. Unlike in *Jean Coutu* or *Fairmont Hotels*, the petitioners in *Crean* did not wait for an audit to identify certain adverse tax consequences before they petitioned a court; rather, they applied for rectification and informed the CRA as soon as they discovered the mistake.

Despite the foregoing, the takeaways from *Crean* are preliminary at best. Since the reasoning for some of the court's conclusions is quite sparse, *Crean* does not set out a clear and cogent blueprint for applying the legal principles underlying rectification. This ambiguity is largely attributable to the court's reliance on the evidentiary record for its decision; the fact that this evidence was not comprehensively canvassed makes it difficult to gauge the precedential value of the decision. Although *Crean* confirms that rectification is still a viable solution for adverse tax consequences attributable to inadvertent transactional steps, its value and significance to taxpayers at large remain to be determined.

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CRA: Surplus After Foreign Tax Adjustment

A recent advance tax ruling (2017-0729431R3, 2018) confirms that the exempt surplus balance of a controlled foreign affiliate (CFA) increases only by the amount of tax overpaid as a result of a foreign tax authority's notional downward transfer-pricing adjustment. The CRA confirms that if the foreign adjustment does not involve any actual payments by the CFA, then its lower exempt earnings (owing to the decrease in taxable income under foreign tax laws) are offset by an increase in exempt earnings of the same amount retained by the CFA. Therefore, the CFA's exempt earnings increase only by the amount of its overpaid prior-year taxes; its earnings are not otherwise affected. The ruling summarizes how foreign transfer-pricing adjustments interact with surplus computation.

The ruling considers a taxable Canadian corporation (Parentco) that owns 100 percent of the shares of both a CFA and a Canadian subsidiary (Canco). The CFA is resident in country A and earns service fees from arm's-length and non-arm's-length parties; its fees earned are considered "income from an active business" carried on in country A. Canco also earns service fees from arm's-length and non-arm's-length parties.

Canco and the CFA submitted a bilateral advance pricing agreement (APA) request to establish an appropriate transfer-pricing methodology for the intercompany transactions; both companies were accepted into the APA program.

The CRA reassessed Canco for certain tax years on the basis that a portion of the service fees earned by the CFA should have been earned by Canco; Canco's fees were therefore too low from a transfer-pricing perspective. Canco objected to the reassessments and also sought double-taxation relief from the competent authorities under the mutual agreement procedure (MAP).

As a result of both the APA adjustments and the MAP settlement, Canco's taxable income was increased to reflect certain transfer-pricing adjustments, and the CFA's taxable income was reduced in country A. Previously, the CFA had paid tax to country A on this income. Country A's tax authorities will refund to the CFA the tax overpaid as a result of its reduced income.

Under both the MAP settlement and the APA, the CFA is not required to, and does not, pay Canco for the transfer-pricing adjustments. The CFA is proposing a transaction to declare and pay a dividend to Canco in order to pay out all or substantially all of the CFA's retained earnings, as required by the corporate group's dividend policy.

Generally, under the tax rules, exempt earnings include earnings for the year from an active business carried on by a foreign affiliate (FA) in a designated treaty country (subparagraph (d)(i) of the definition of "exempt earnings" in regulation 5907(1)). An FA's earnings include the income or profit from an active business for the year, computed in accordance with the income tax law of the country in which the affiliate is resident, if the FA is required to compute its taxable income in that jurisdiction (subparagraph (a)(i) of the definition of "earnings" in regulation 5907(1)). Regulation 5907(2)(f) generally requires an FA's surplus accounts to reflect any actual revenue, income, or profit not recognized under the tax laws of the foreign jurisdiction.

According to the CRA, when the transfer-pricing adjustment reduces the CFA's taxable income in country A, that adjustment results in a corresponding reduction in the CFA's earnings (using the definition in regulation 5907(1)(a)(i)). The CRA also ruled that if an amount of the transfer-pricing adjustment is retained by the CFA but not reflected in its taxable income in country A (that is, the downward transfer-pricing adjustment that has no corresponding cash payment), that amount is added back to the CFA's earnings. The amount represents money realized and retained by the CFA that is excluded from income for foreign tax purposes (regulation 5907(2)(f)). In addition, the CRA ruled that the CFA's prior-year taxes that were overpaid, owing to the transfer-pricing adjustment, increase its "earnings" (regulation 5907(1)(a)). As a result, the only net change in the CFA's exempt surplus arising from the adjustment is an increase equal to the overpaid taxes that country A refunds to CFA.

On the basis of the CRA ruling, the following hypothetical example summarizes the exempt surplus changes as a result of the APA adjustments and the MAP settlement: if the CFA's exempt surplus before the APA adjustments and the MAP settlement is $10,000, and if country A's tax authority issued a reassessment that decreased the CFA's taxable income by $2,000 and its income tax payable by $500 (reflecting the APA adjustments and the MAP settlement), its exempt surplus increased by $500 (to $10,500) as a result of the APA adjustments and the MAP settlement. This increase is equal to the refund of overpaid taxes.

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Proposed US Reg: GILTI Reduced on Canadian Operations

A regulation proposed recently (Treas. reg. section 1.962-1(b)(1)(i)(B)(3); REG-104464-18) should eliminate, until 2026, any material US tax on undistributed profits (via immediate attribution) of a US person who carries on an active business in Canada through a Canadian or other non-US corporation. The US tax should be substantially reduced after that time for some US persons and eliminated, under current law, for the balance.

The 2017 US Tax Cuts and Jobs Act (TCJA) adopted a rule that levies taxes on a US person's share of a non-US corporation's profit in excess of 10 percent of the undepreciated cost of tangible property used in the business. That excess (the taxable amount) is global intangible low-taxed income (GILTI) under Code section 245A, but the term is misleading because it applies to all businesses, not just those that develop and exploit intangibles. The misleading term is not inconsistent: GILTI as introduced negated the US government's claim that the TCJA imported territoriality into the US tax system. (See "US Territoriality: A Promise Not Kept," *Canadian Tax Highlights*, May 2018.)

GILTI applies only if the corporation is a controlled foreign corporation (CFC) of a US shareholder: a non-US corporation is a CFC vis-à-vis any US person where that person owns at least 10 percent of the shares and where 50 percent or more of the shares are owned, collectively, by US persons.

However, the interrelation of (1) GILTI, (2) a Code section 962 election, and (3) Canadian corporate tax rates on the CFC that is a Canco carrying on business in Canada prevents US net tax if the shareholder is (1) a US corporation, (2) a US citizen not resident in Canada, or (3) a US citizen resident in Canada (in which case the CFC becomes a Canadian-controlled private corporation [CCPC]) and the CCPC is not qualified for the Act's section 125 small business deduction (SBD).

If the shareholder is a US citizen resident in Canada and the CCPC is eligible for the SBD, GILTI tax would arise but for the March 4, 2019 proposed regulation, which should totally or substantially eliminate tax until at least 2026.

Assume that Canco, owned by a US corporation, earns $100 of GILTI and pays 27 percent tax in Canada; the US corporation pays no US GILTI tax: it includes $100 in US income but gets a 50 percent deduction under Code section 250 (reduced to 37.5 percent in 2026) and has GILTI tax of $10.50: 21% × ($100 − $50) net of a $21.50 credit (of up to 80% × $27). There is no net US tax and there should also be no US tax on the subsequent $73 distribution to a US corporation (but the Canadian treaty-reduced withholding tax rate of 5 percent probably is unused).

If the shareholder of Canco is a US individual, the rules are different, although a Code section 962 election brings the results closer. Assume that Canco is owned by a resident of Florida (which has no personal state income tax) in the highest federal US personal bracket. US tax is $27 ([$100 − $27] × 37%) (there may also be US health-care tax of 3.8 percent); the US tax does not increase on distribution, but there is Canadian (treaty-reduced) withholding of 15 percent. A Code section 962 election allows the individual to calculate US tax by using US corporate rules, except for the 50 percent Code section 250 deduction. US tax is nil: 21% × $100 net of a credit of up to 80% × $27. But if that $73 of after-tax income is distributed to the individual shareholders, US tax of 20 percent applies (plus US health-care tax of 3.8 percent) as though a US corporate shareholder paid after-tax income in the base case above to a US individual shareholder. Presumably the 15 percent Canadian withholding tax is fully creditable.

If Canco is owned by a US citizen resident in Canada (Canco is a CCPC but is not entitled to the SBD), the results without a section 962 election are the same as in the preceding paragraph: $27 of US tax. But there is a bigger issue resulting from an eventual dividend, especially if the individual emigrates from Canada before the distribution. But if the individual does elect under section 962, he or she will owe the same tax as a US individual: there is no upfront tax, but on an eventual dividend there is a much higher overall tax that can be aggravated by a pre-distribution emigration from Canada.

There are also four situations to consider if a US citizen shareholder is resident in Canada and the Canco/CCPC is entitled to the SBD. Assume a small business tax rate of 12 percent:

1) If the individual does not make a section 962 election, the US tax is $32.60: ($100 − $12) × 37% (plus US health-care tax); however, if an amount is paid subsequently as a dividend there is no US tax on it, but there is Canadian withholding tax that is presumably fully creditable.
2) If the individual does make an election, then under the current law, immediate US tax is $11.40: ($100 × 21%) net of a $9.60 credit (80% × $12). The US tax reduces the taxable amount of $88 on a subsequent distribution to $76.60.
3) If a section 962 election is made and the proposed regulation is promulgated, then section 250 allows a 50 percent deduction until 2026, and the current US tax is substantially eliminated: 21% × ($100 − $50) net of a $9.60 credit (80% × $12). The net tax is $0.90, but the distribution tax factors discussed above apply. After 2025, the section 250 deduction is reduced to 37.5 percent and the US tax increases from $0.90 to $3.53: 21% × ($100 − $37.50) net of a $9.60 credit (80% × $12).

The bottom line is that, until 2026, the proposed regulation, if promulgated, should insulate any US shareholder of a Canadian operating company from substantially all US federal GILTI tax—whether or not the Canco is a CCPC entitled to the SBD. After 2025, the proposed regulation still provides a very material reduction of US tax for a US shareholder vulnerable under the current law—that is, a US citizen who is resident in Canada and whose CCPC is entitled to the SBD.

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Stewart: CRA Audit Project Gone Awry

The TCC's recent *Stewart* (2019 TCC 22) decision has hopefully put an end to an 18-year ordeal for two taxpayers dealing with a CRA project audit.

In 2000, an investment opportunity was presented to Alan and Cindy Stewart, husband and wife, which involved the development of a trailer park on a plot near Edmonton. Participation required the acquisition of a mortgage interest on the land—an "eligible investment" for a self-directed RRSP.

The Stewarts owned and operated a small campsite and restaurant catering to construction workers. Alan was a welder with experience in the oil patch. The Stewarts were well aware of oil and gas development in the area of the proposed trailer park, and they believed it to be a sound business opportunity based on realistic financial projections. After consulting a lawyer who confirmed the investment's eligibility for an RRSP, the couple decided to participate and opened self-directed RRSPs; their combined RRSPs loaned $79,500 to a company controlled by the promoters and the loan was secured by mortgage interests on the land.

In total, the promoters raised about $7 million from 119 investors, including the Stewarts. The promoters had purchased the land (for $5,000) and properly registered $7 million in mortgages to the investors. The promoters did not develop the trailer park, but instead absconded with the money and transferred it overseas. The Stewarts and the other investors lost all monies invested; a class proceeding against the promoters was abandoned because recovery was unlikely.

Adding to the Stewarts' woes, the CRA said that the amounts stolen were included in their personal income. A 2004 reassessment of the Stewarts ensued and gross negligence penalties were imposed on them; the Stewarts objected. Some six years later, in 2010, the CRA confirmed the assessments. The Stewarts then appealed to the TCC and were put in abeyance until they came to trial in 2018.

The CRA offered three alternative grounds for including stolen RRSP amounts in Stewarts' income:

1) the Stewarts participated in a scheme to gain tax-free access to their RRSP funds through a collateral arrangement and thus received the funds as a taxable benefit (subsection 146(8));
2) the Stewarts' RRSPs acquired property for a consideration greater than FMV, so the difference was included in income (subsection 146(9)); or
3) the rights registered on title did not truly constitute mortgages and thus were not qualified investments, and consequently, the mortgages' FMV was included in income (subsection 146(10), predecessor of subsection 207.04(1)).

Concerning the primary ground, the CRA simply assumed that the Stewarts acted in concert with the promoters and had a collateral arrangement with them to obtain their RRSP funds back, but the CRA did not produce any evidence of such activity or arrangement. The court accepted the Stewarts' uncontradicted testimony that "[t]hey were innocent victims in what was in effect a con."

The court also rejected the other two CRA arguments, noting that the plot of land was duly acquired, mortgages on the land were properly registered, and, for an admittedly brief period, the developer had sufficient funds to pay back the loans secured by the mortgages: in sum, the mortgages were acquired for FMV. The fact that the funds were stolen rather than applied to their expected purpose of developing a trailer park did not change the nature of the mortgage interests or retroactively diminish their FMV on acquisition.

The Stewarts were arguably fortunate that the con artists who stole their RRSP savings were diligent in ensuring that all the fraud's legal formalities were properly implemented. Otherwise, one or both of the alternative grounds may have been upheld. In contrast, in *St. Arnaud* (2013 FCA 88), which also involved taxpayers scammed out of their RRSP savings, the taxpayers were found not liable for tax on the stolen amounts because the fraudsters *neglected* to perform the legal formalities to issue shares and thus undermined the CRA's assessing position, which was based exclusively on subsection 146(9). *Stewart* and *St. Arnaud* together invite discussion of whether it is appropriate from a fiscal policy standpoint to rest a taxpayer's tax liability on the defrauding parties' attention to detail.

A bigger question is why the case was litigated to judgment. The CRA assumed that the Stewarts knowingly participated in an RRSP strip—a scheme to access their RRSP funds tax-free—solely because the promoters had marketed RRSP strips to other taxpayers. There was no actual evidence of their intention to participate in an RRSP strip or that any RRSP strip actually occurred. Yet the CRA imposed tax and gross negligence penalties on the Stewarts, even though the CRA bore the burden of proof of the penalties.

The reason for the ultimate litigation may rest, in part, on the fact that the CRA spent the early 2000s in an audit project to combat RRSP and RRIF strip schemes. Many of these schemes involved purported investments in non-existent businesses or acquisitions of property at inflated prices, and they included collateral agreements to return some money. The audit project eventually resulted in reassessments of large numbers of disparate taxpayers. Appeals were stayed before the TCC—apparently including the Stewarts' case—to allow an orderly resolution through the use of lead cases. The CRA seemed unwilling or unable to treat the Stewarts' case as unique.

Audit projects play a valid role in ensuring taxpayers' consistent treatment, but they seem to risk missing the forest for the trees. The Stewarts' experience—having their retirement savings stolen and then spending almost two decades fighting reassessed taxes and gross negligence penalties—was not fair to them. One can only hope that *Stewart* promotes further CRA reflection on the management of audit projects and related litigation.

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CRA on a PHSP "All or Substantially All" Test

A recent technical interpretation (TI) (2016-0651291E5, January 24, 2019) says that a self-insured health plan qualifies as a private health services plan (PHSP) if all or substantially all (at least 90 percent) of benefits paid by the plan in the calendar year qualify for the medical expense tax credit (METC). Before the "all or substantially all" test became applicable on January 1, 2015, *all* medical expenses covered under a plan had to be METC-eligible for a plan to qualify as a PHSP.

The TI also looks at how this test applies to a self-insured plan that consists of three health-care spending accounts (HCSAs) for three employees: the "all or substantially all" threshold may apply to the HCSAs either in aggregate or employee by employee, depending on the facts and circumstances.

A PHSP is defined in subsection 248(1); it is a contract or plan of insurance that generally covers costs incurred by employees for health and medical expenses that qualify for the METC. A PHSP can be either an insured plan (administered via a third-party insurance contract) or a self-insured plan (administered by the employer itself).

Generally, a PHSP has a variety of tax advantages for both employers and employees. An employer can generally deduct from its taxable income a contribution to a PHSP as well as administrative fees. An employer PHSP contribution is not a taxable benefit for an employee (it is excluded from employment income under subparagraph 6(1)(a)(i)). A benefit received from the plan is also not taxable to the employee, and an employee contribution to a PHSP generally qualifies as a medical expense for the METC.

The TI considers three health insurance plans in regard to only the "all or substantially all" test on the assumption that each plan meets all other conditions for qualifying as a PHSP. The first plan considered is an insured plan. Under this plan, the CRA says that 92 percent of the employer's premium paid and 88 percent of the employees' benefit claims relate to expenses that are METC-eligible. According to the TI, the insured plan is a PHSP because at least 90 percent of the employer's premium relates to expenses that are METC-eligible. The CRA also adds that the percentage of the benefits paid out to employees is irrelevant because this is an insured plan.

The second plan considered is a self-insured plan under which 93 percent of the benefits paid out to employees during the calendar year are METC-eligible. The TI says that this plan is also a PHSP because at least 90 percent of the benefits paid to employees during the year are METC-eligible. This plan differs from the insured plan, because the benefits are paid by the employer (rather than the third-party insurer).

The third plan is also a self-insured plan that is said to consist of three HCSAs for three employees (the HCSA plan). The benefits paid in the calendar year for each HCSA are described as follows: for employee A, 95 percent of the $4,200 in total benefits is METC-eligible ($4,000); for employee B, 83 percent of the $3,900 in total benefits is METC-eligible ($3,250); and for employee C, 96 percent of the $4,425 in total benefits is METC-eligible ($4,250). In total, 92 percent of the $12,525 in benefits is METC-eligible ($11,500). The TI says that whether the HCSA plan is a single PHSP is a question of fact, because it is unclear whether the three HCSAs make up one plan, or each HCSA is a plan on its own. If the three HCSAs form one plan, then according to the CRA the plan under consideration is a PHSP because at least 90 percent of the benefits paid to the employees in a calendar year are METC-eligible ($11,500/$12,525 = 92%). However, if each HCSA is a separate plan, then only two of the three are PHSPs (for employees A and C) because only these two plans paid out 90 percent or more of their benefits on qualifying expenses.

According to the CRA, the allocation of the benefit ceilings is irrelevant for the PHSP test.

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Tenant's Change in Use: GST Implications for Landlord?

In general, property owners look to their own activities to determine the taxable status of the property's use under the Excise Tax Act (ETA). Landlords who lease their property for commercial purposes are typically considered to make taxable supplies and thus charge GST/HST on rent, pay GST/HST on purchases in connection with the supply, and claim input tax credits (ITCs). In some cases, however, the characterization of the landlord's use of the property may depend on the tenant's use.

Recently, *Prima Properties (92) Ltd.* (2019 TCC 4) dealt with a landlord who was reassessed, not because the landlord changed the property's use, but because a tenant's change in its use was attributed to the landlord. Luckily for the landlord, the reassessment was made beyond the normal four-year limitation period; pursuant to ETA subsection 298(4), the burden was thus on the minister to show that the landlord made a misrepresentation attributable to its "neglect, carelessness or wilful default" in its return for the reporting period.

The TCC held that the minister did not show sufficient evidence that there was a change in use by the tenant; thus, the court was not satisfied that there had been a misrepresentation. The TCC said that even if there had been a misrepresentation, it was not attributable to negligence or carelessness on the part of the taxpayer landlord. However, the outcome for the taxpayer may have been different if the minister had reassessed it within the normal reassessment period. *Prima* therefore serves as a warning for commercial landlords to be aware of their tenants' activities and the GST/HST consequences that may result from a change in the tenant's use.

Prima was a commercial landlord that purchased and leased a building to a company that operated the property as a hotel. Prima later entered into a lease with a new tenant, PHS, a non-profit organization that operated housing projects and support programs for the homeless; PHS indicated to Prima that it would use the property to provide housing therefor. Prima charged and reported GST/HST on the rent paid by PHS and claimed ITCs in respect of the lease.

The PHS lease began on May 1, 2010. On June 10, 2016, the minister reassessed Prima on the basis that when the prior lease ended and the PHS lease began, the property was converted from commercial use to residential use. The minister therefore claimed that at that time, there was a deemed self-supply of the property and a requirement to have collected GST on the sale (ETA subsection 206(4)). (The minister had initially said that there was a self-supply under subsection 190(1), but subsequently amended his pleadings on the basis that subsection 206(4) was the appropriate provision. The minister also disallowed ITCs claimed after the start of the PHS lease, which the landlord ultimately decided not to challenge. Therefore, the only issue before the TCC was the GST reassessment on the deemed self-supply under subsection 206(4).)

The minister took the position that there was a change in use and alleged that PHS was making exempt supplies under subsection 6(a) of part I of ETA schedule V. This provision indicates that a supply is exempt if it is a supply "of a residential complex or a residential unit in a residential complex by way of lease, licence or similar arrangement for the purpose of its occupancy as a place of residence or lodging by an individual, where the period throughout which continuous occupancy of the complex or unit is given to the same individual under the arrangement is at least one month." The minister argued that the leases, licences, or other similar arrangements under which PHS gave possession of the units to the homeless individuals was for periods of more than one month, as its operations management plan indicated. This document also referred to the operation of the property as a "supportive long-term housing project."

Pursuant to the head lease exemption in section 6.11 of part I of ETA schedule V, the supply of a residential complex (or part of a residential complex) by way of lease, licence, or similar arrangement to a person who uses, or intends to use, the property to make exempt supplies is itself exempt. The minister's position was that by leasing the property to PHS, which made exempt supplies of the property's use, Prima's supplies under that lease were also exempt under section 6.11.

The making of exempt supplies is excluded from the definition of "commercial activity" (ETA subsection 123(1)). Therefore, the change from the prior use of the property as a hotel to one of the making of exempt supplies was a change in use that triggers the self-supply provision in ETA subsection 206(4). Subsection 206(4) applies when a registrant that last acquired property for use in commercial activities then begins to use the property exclusively for other purposes: the registrant is deemed to have sold and reacquired the property at the time and collected GST on the sale.

The alleged change in use occurred in 2010; the CRA reassessment was made in 2016, beyond the normal four-year time limit (ETA subsection 298(1)). Thus, the minister had to show that the misrepresentation was attributable to neglect, carelessness, or wilful default (subsection 298(4)).

The TCC held that there was no misrepresentation because the minister failed to meet the burden of showing a change in use. The minster provided insufficient evidence that the non-profit was intending to rent the units on a long-term basis (for periods exceeding one month, as required under subsection 6(a)) and not as short-term transitory housing until the homeless individuals found something more permanent.

The TCC also held that even if there was a misrepresentation and Prima was required to report a deemed self-supply, the evidence did not support the conclusion that Prima's representative, in acting for the company, was careless or negligent in making the misrepresentation. The TCC found it to be significant that Prima did not change the use of the property—it was still entering into a commercial lease of the whole property and had no further involvement in the day-to-day operations of the tenant. It was reasonable to believe that Prima's representative saw no difference between the two leases. Also, the fact that PHS's intended use of the property would trigger GST consequences is not something that a lay person was reasonably expected to know: the relevant provisions of the ETA are highly technical, complex, and challenging to understand even for lawyers and accountants, let alone for someone without a professional legal or accounting background. The minister therefore did not meet his burden to show that a reasonable person would have known to make inquiries about the issue of self-supply or change in use. (Arguably, Prima's accountant was careless or negligent in making the misrepresentation, but to reopen a statute-barred return there must be carelessness or negligence on the part of the taxpayer itself.)

In this case, the taxpayer was fortunate that the minister's reassessment was beyond the normal time limit; otherwise, the burden would not have shifted to the minister to show the existence of a misrepresentation and the minister may then have prevailed. The clear takeaway is that commercial landlords should get advice on how GST/HST applies to their rents. Here, a lookthrough provision apparently applied that can create a change in use even if the landlord itself has not changed its use of the property. (And arguably the proper analysis is even more complicated and was not even touched on in the TCC's judgment.)

If the lookthrough rules properly apply, they can lead to counterintuitive results that may catch commercial landlords unawares—and leave them on the hook for a significant GST/HST assessment.

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The 2019 Federal Budget: Transfer Pricing

The 2019 federal budget confirmed Canada's commitment to active participation in the OECD/G20's base erosion and profit shifting (BEPS) initiative, to work with its international partners to improve and update the international tax system, and to ensure a coherent and consistent response to cross-border tax avoidance. However, no major transfer-pricing measures relating to BEPS were implemented or proposed in the 2019 budget, apart from the minimum measures introduced in 2016 to implement country-by-country reporting and actions to move Canada closer to ratification of the multilateral instrument (MLI).

Finance continues to view the current transfer-pricing rules in part XVI.1 as BEPS-compliant; many Canadian tax practitioners and taxpayers view that position as questionable. Many countries have adopted the OECD transfer-pricing guidelines and BEPS in their legislation; however, there have been no proposals by Finance to codify the OECD guidelines into the Canadian legislation. These guidelines include the simplified low-value-services approach, master/local file requirements, and changes to the transfer-pricing guidelines resulting from BEPS actions 8 to 10. However, the 2019 budget did propose two measures that concerned the transfer-pricing rules in part XVI.1, relative to other provisions of the Income Tax Act, as outlined below.

Order of Application

According to Finance, questions have arisen as to whether adjustments under the transfer-pricing rules are made first, for example, if both the transfer-pricing rules and another provision of the Income Tax Act may apply to the same amount relevant to the computation of part I tax. To address these questions, the 2019 budget proposes to add new subsection 247(1.1), which is intended to clarify that the part XVI.1 transfer-pricing rules in section 247 apply before other provisions in the Act. Subsection 247(1.1) is proposed as follows:

> For the purpose of applying the provisions of this Act, the adjustments under Part XVI.1 shall be made before any other provision of the Act is applied.

Section 247 thus applies before other provisions in the Act (particularly in part I). Subsection 247(8) is repealed at the same time. (That subsection gave section 247 priority over specified provisions in part I, such as sections 67, 68, and 69.) Newly proposed subsection 247(1.1) gives section 247 priority over all of part I and thus subsection 247(8) is made redundant. Current exceptions to the transfer-pricing rules in subsections 247(7) and 247(7.1) continue to apply to situations in which a Canadian-resident corporation has an amount owing by a controlled foreign affiliate or extends a guarantee in respect thereof.

The 2019 budget document submits that, without the ordering rule, transactions may have various unintended results, including penalties. For instance, if the CRA uses section 247 to disallow a cross-border charge, the penalty under subsection 247(3) may apply if the reasonable-efforts requirement is not met. Without proposed subsection 247(1.1) (assuming, for example, that paragraph 18(1)(a) might also apply to the same transaction), it was arguable that the penalty under subsection 247(3) did not apply, because it applies only if an adjustment was made under section 247.

Another example involves an existing cross-border non-interest-bearing loan. Subsections 17(1) and 247(2) both require or adjust an interest income inclusion; without the ordering provision in subsection 247(1.1), it is unclear whether the penalty under subsection 247(3) applies to the full amount of interest inclusion or to the difference between the amount assessed under subsection 17(1) and the arm's-length amount assessed under section 247. New subsection 247(1.1) clarifies that Finance intends the former.

Even though Finance stated that this new measure is intended to clarify its existing position, it appears contrary to the CRA's administrative position outlined in *Information Circular* IC 87-2R at paragraph 21. In the IC, the CRA takes the position that the Act's specific provisions usually apply before a more general provision, such as section 247.

In the end, this new ordering provision could result in larger transfer-pricing penalty assessments. With respect to cross-border intercompany debt, it may also result in more attention to debt-capacity analysis. A debt-capacity analysis determines whether the borrower has sufficient funds, assets, equity-financing capacity, and revenue-generating capacity to cover interest and debt services payments when they come due. In light of the proposed ordering provision, a debt-capacity analysis should be performed before looking at whether the interest deductibility or the thin capitalization rules apply.

Applicable Reassessment Period

The 2019 budget proposes to expand the applicability of the extended reassessment period for transfer-pricing adjustments. The transfer-pricing rules include an expanded definition of "transaction" in subsection 247(1), which includes an "arrangement or event." This existing definition allows the transfer-pricing rules to apply to a broad range of situations that may arise in a multinational enterprise's operations.

Clause 152(4)(b)(iii)(A) provides an extended three-year reassessment period where the reassessment is made as a consequence of a transaction involving a taxpayer and a non-arm's-length non-resident. However, the expanded definition of "transaction" in the transfer-pricing rules does not apply for the purposes of the rule establishing this extended part I reassessment period. This approach was taken by the TCC in *Blackburn Radio Inc.* (2009 TCC 155); the court held that the term "transaction" in subparagraph 152(4)(b)(iii) did not include an arrangement or event.

As a result, the 2019 budget proposes to apply the definition of "transaction" for the transfer-pricing rules for the purposes of the extended reassessment period relating to transactions involving a taxpayer and a non-arm's-length non-resident. This measure applies to taxation years for which the normal reassessment period ends on or after budget day 2019.

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Potential Uncertainty When Capital Gains Are Subject to TOSI

The new tax on split income (TOSI) legislation may not apply as the federal Department of Finance intended if a taxpayer's split income includes a capital gain realized during the year. Since Finance initially proposed changes to the TOSI legislation, it has maintained the following position:

> Paragraph 20(1)(ww) provides for the deduction, in computing a taxpayer's income for a taxation year, of an amount equal to the taxpayer's split income for the year. Paragraph 20(1)(ww) ensures that income that is taxed as split income is not also taxed as regular income.

But paragraph 20(1)(ww) must be viewed in the broader context of the rules for computing income from a business or property in division B, subdivision b—specifically section 9. A taxpayer must have a source of income from a business or property in order to claim deductions under subsection 20(1).

The SCC established in *Stewart* (2002 SCC 46) that the relationship between the amount determined under subsection 20(1) and its related source of income from a business or property must be examined to determine the amount's deductibility in computing income or loss from that source. *Cassan* (2017 TCC 174, currently under appeal to the FCA) expanded on the *Stewart* jurisprudence to say that, since a capital gain is not income from a business or property, it cannot be derived from a source of income from a business or property.

Contrary to Finance's position above, any portion of an amount included in paragraph 20(1)(ww) that is solely attributable to a taxable capital gain will not be deductible in computing a taxpayer's income or loss from a business or property.

Assume, for example, that a business owner (Mr. L) and his son (M), both resident in Canada, own all the issued and outstanding common shares of LMR, a Canadian-controlled private corporation. Mr. L is over 40 years old and owns 91 percent of LMR's common shares; M is 17 years old and owns the remaining 9 percent. The common shares of LMR are held as capital property by both Mr. L and M.

M sells his LMR common shares to an arm's-length investor and recognizes a $100,000 capital gain on the sale. M has no other sources of income for the year.

Based on Finance's position, as stated above, the federal tax consequences of M's sale should be as shown in the table below:

Source of income (loss)	Amount
Taxable capital gain (paragraph 3(b))	$ 50,000
Loss from a property under subsection 9(2) (paragraph 20(1)(ww) deduction)	$(50,000)
Net income for tax purposes	nil
Split income for tax purposes	$ 50,000
Federal part I tax payable	$ 16,500

The $50,000 taxable capital gain is included in M's split income pursuant to paragraph (e) of the split income definition in subsection 120.4(1) and is subject to TOSI (no defined exclusions apply).

Notwithstanding that paragraph 20(1)(ww) is supposed to allow for a deduction equal to a specified individual's split income for the year, a deduction under that paragraph can only be claimed—according to the preamble of subsection 20(1)—"in computing a taxpayer's income for a taxation year from a business or property." M's ability to claim a deduction under paragraph 20(1)(ww) is inextricably linked to the basic rules for computing income from a business or property in sections 9 to 11.

Under section 9, a deduction under subsection 20(1) must be attributable to a source of income from a business or property in order to be deductible in computing income or loss from that source. *Stewart* provides the currently accepted methodology for determining a source of income from a business or property, and whether an expense or a deduction in subsection 20(1) can be attributed to such a source. *Stewart* states that the nature of an expense does not shape the characterization of its related source. Consequently, an amount included under paragraph 20(1)(ww) that is derived from a taxable capital gain cannot recharacterize its related source as a source of income from a business or property.

Subsection 9(2) determines how a taxpayer computes a loss from a particular business or property for the year. The particular business or property for which the loss is to be determined is its source and, without that source, M does not have a loss from a business or property. M's deduction under paragraph 20(1)(ww) is directly attributable to a capital gain, and therefore the deduction does not relate to a source of income from a business or property. Subsection 9(3) specifically excludes a capital gain from being income from a property when it results from the disposition of that property—an exclusion that is consistent with the scheme of the Act and the Act's segregation of income and capital.

This position was recently well summarized in *Cassan*:

> In *Stewart*, the Court states that a capital gain is not income from a source described in section 9 of the ITA, which can only

> mean that a capital gain is not income from a business or property. . . . [T]his proposition is self-evident and can be further justified by a detailed review of the relevant provisions of the ITA and the history of the taxation of capital gains under the ITA.

The CRA also acknowledged the following view when asked for its position on the use of the word "source" in the preamble to subsection 20(1):

> The CRA's position is that this view requires that expenses that otherwise qualify for one of the many paragraphs of s. 20(1) be prorated between the taxpayer's sources of income to which the expenses relate and the taxpayer's activities, if any, that do not constitute a source.

Given the precedents in *Cassan* and *Stewart*, and the CRA's confirmation that deductions under subsection 20(1) must be allocable to related sources, it is difficult to take the position that M can claim a loss that results from a deduction under paragraph 20(1)(ww). Under the TOSI legislation, M is taxed on his $50,000 capital gain at both the high rate and graduated rates. This is not the result intended by Finance.

Prior to the recent amendments to the TOSI rules in section 120.4, taxable capital gains were not explicitly included in the definition of split income. When revised draft legislation was released by Finance, the CRA issued guidance (including several examples) on the application of TOSI. No example contemplated TOSI that arose because of the sale of shares. Later, a submission was made to Finance by the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada that highlighted various concerns, but this issue was not discussed. It is also worth noting that the explanatory notes accompanying the TOSI legislation did not include any examples in which TOSI applied to a capital gain.

The CRA might not reassess a taxpayer who claims a paragraph 20(1)(ww) deduction in respect of a capital gain included in the taxpayer's split income, especially given Finance's comments on how paragraph 20(1)(ww) should apply in this context. However, other issues and inconsistencies can result from applying the TOSI legislation in this manner.

For example, a taxpayer can realize a taxable capital gain subject to TOSI and realize an allowable capital loss in the same year. In this case, the taxpayer's paragraph 20(1)(ww) deduction effectively allows for the conversion of the capital loss into a loss from a property.

A taxpayer's allowable capital loss and taxable capital gain are offset under paragraph 3(b). If a taxpayer obtains a paragraph 20(1)(ww) deduction that results in a loss from a property under subsection 9(2) (included in calculating the taxpayer's net income for the year under paragraph 3(d)), the taxpayer could use this loss to offset income from other sources in the year. A loss that cannot be used in the year is included in the definition of non-capital loss in subsection 111(8) by virtue of element E of that definition.

Appropriate consideration and a careful review of the rules are therefore warranted when there is a transaction that involves a capital gain subject to TOSI. It seems necessary for Finance to review the current TOSI legislation with respect to taxable capital gains to ensure that the law applies as intended and is consistent with the existing framework of the Act. It may be practical to place the rules allowing for a deduction to offset taxable capital gains subject to TOSI in division B, subdivision c rather than in paragraph 20(1)(ww).

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Tax Court Update

This article summarizes two TCC initiatives of interest to practitioners: the preliminary ruling docket (PRD) pilot project, which will soon be formalized as a practice direction, and new Practice Note no. 22, dealing with an experts' panel.

PRD Pilot Project

The PRD pilot project responds to concerns expressed by practitioners regarding litigation costs for tax appeals involving smaller disputed amounts. Although "smaller" may be in the eye of the beholder, the PRD project responds to disputed amounts of $25,000 to $300,000 per taxation year. Practitioners will appreciate that $25,000 (of aggregate income tax amounts per year under appeal) is the threshold below which a matter may be heard under the informal procedure (other than, for example, an income tax loss determination of $50,000 or less, an appeal concerned only with interest, or a GST/HST appeal involving less than $50,000). PRD eligibility is thus limited to matters to be tried under the general procedure. A PRD hearing's outcome is a non-binding preliminary TCC ruling to which the parties may agree, as described below.

To engage the PRD pilot project, parties must apply jointly to be added to a list within 90 days of the close of pleadings: addition to the list is at the TCC's discretion (on the basis of factors not yet enumerated). The PRD process is streamlined—for example, the maximum duration of a hearing is two days; experts are rarely allowed; the rules of evidence for informal procedures apply; and no list of documents and no discovery or document production is provided for in connection with the hearing. Thirty days before a hearing, the parties must each file a pre-hearing brief not to exceed 20 pages, which sets out the facts, issues, law, and analysis. A PRD hearing's primary goal appears to be establishing facts and applicable law, and not resolving pure questions of law; thus, the TCC's intent is not to substitute the PRD process for rule 58 motions or matters brought under section 174 of the Act.

As noted above, a PRD hearing results in a non-binding preliminary TCC ruling, which must be made orally or in writing within 60 days after the hearing. Following the TCC's preliminary ruling, the parties may agree to be bound by it, and must respond to the TCC in writing within 30 days of the ruling. If the parties agree to the ruling, it becomes a consent judgment without costs; if they do not agree, costs may be awarded in relation to the PRD hearing and the matter then proceeds as a regular litigation. Further, if a preliminary ruling is not agreed on and the matter proceeds to trial, the preliminary ruling may be considered as a factor in awarding substantial indemnity costs, and it will be treated by the trial judge as a written settlement offer. After a preliminary hearing, the file and its materials are sealed and not made available to anyone without a court order; moreover, the hearing judge cannot participate in the appeal in any capacity.

Although no discovery or document production is required, it appears that no party can rely on documents at a hearing unless they were produced to the other side at least 30 days before the hearing (unless the court otherwise directs). This means that the production of lists of documents in accordance with the rules is not a requirement, but in order to facilitate an orderly hearing, documents to be relied on at the hearing should be produced in advance.

In principle, the PRD pilot project looks like an interesting hybrid of a settlement conference and a trial. Rightly or wrongly, some counsel may have adopted the view that settlement conferences are not always a helpful exercise. However, because both parties must request a PRD hearing together, both parties are presumably equally invested in the outcome and thus reasonably likely to adopt the ruling as if it were a consent judgment. Furthermore, if the TCC aggressively assesses costs against any party who fails to agree with a preliminary ruling and then loses at trial, future parties will generally be less likely to risk rejecting the ruling. Given the TCC's trend toward assessing more substantial cost awards to promote settlement, strong cost sanctions in the PRD stream would not be unexpected.

Lower-cost, expedited resolution is an access-to-justice issue for taxpayers, and it is hoped that the PRD pilot project lowers the cost of litigation for a matter that is, for lack of a better term, middling in terms of the amount in issue. The PRD pilot project starts on September 1, 2019 in Toronto and Vancouver and runs for six to nine months; the TCC will evaluate the results after the pilot project.

Expert Witness Panels

Depending on the matters in dispute, expert witnesses can be integral to a hearing. In brief, a qualified expert is an individual with specialized knowledge who provides fair, independent, and unbiased opinion evidence necessary to help a trier of fact appreciate the technical matters in issue (see *Mohan*, [1994] 2 SCR 9). The experts' objectivity is key: although they are hired by a party, experts are expected to rise above the role of hired guns who advocate for their client's position, and they should serve only the interests of the court. Experts in TCC appeals must adhere to a code of conduct that affirms their duties and obligations, including independence (see *Kaul*, 2017 TCC 55, for a recent discussion).

Expert evidence may be integral sometimes, but there are challenges associated with its use: its production is costly and time-consuming, it adds to a proceeding's length, and evidence led by each parties' expert(s) is likely to be discordant (probably, if there is a dispute). The Tax Court of Canada Rules (General Procedure) and case law impose some reasonable constraints. For example, the TCC has affirmed a high standard for parties seeking leave to call more than five experts under rule section 145(4). Recently, in *Canadian Imperial Bank of Commerce* (2018 TCC 248), the TCC considered, among other things, the court's discretionary gatekeeping power in managing expert evidence, under which the court will take into account cost to the parties and strain on judicial resources. Expert evidence should not be duplicative and should not unduly extend or complicate proceedings; the TCC has frowned on the "piling on" of experts.

Obviously, if experts disagree on complex matters, non-experts face some difficulty—which opinion is right and/or whom should be believed? In valuation matters, if a court is not completely satisfied with expert evidence, it is not supposed to simply adopt a number somewhere between what is put forward by different experts, but should form its own opinion, which is carefully considered and based on all of the conflicting evidence (see *Bibby*, 83 DTC 5148 (TCC)). That approach may defeat the purpose of having experts: if the court must form its own opinion from what is likely both complex and conflicting evidence, has the teaching function of the experts been fulfilled?

Expert witness panels are described as concurrent expert evidence in some jurisdictions and (regrettably) "hot tubbing" in others; the practice can take different forms. Alternative approaches to adducing expert evidence may make trials shorter and thus less expensive, and better serve a trier of fact by allowing both the trier of fact and experts to focus on and explore issues on which the experts disagree.

TCC Practice Note no. 22, dated March 11, 2019, sets out the TCC's new protocol for an experts' panel. Initially, a judge reviews matters involving experts for issues such as whether the rules governing reports were followed and the nature of any challenge to experts' qualifications (disputes may be resolved by consent and judicial assessment or on a voir dire). If the experts are qualified, the judge considers any dispute

The editor of *Canadian Tax Highlights* welcomes submissions of ideas or of written material that has not been published or submitted elsewhere. Please write to Vivien Morgan at vmorgan@ctf.ca.

Published monthly

Canadian Tax Foundation
145 Wellington Street West, Suite 1400
Toronto, ON M5J 1H8
Telephone: 416-599-0283
Fax: 416-599-9283
Internet: http://www.ctf.ca
ISSN 1496-4422 (Online)

regarding reports and whether it goes to weight, credibility, or substance. The practice note states that the judge also determines the possible exclusion of an expert or experts, suggesting that an experts' panel is presumed to be the default position. The judge also reads the experts' reports with the written consent of the parties.

Before the experts' panel is set, the judge orders the experts to attend a pre-trial meeting at which the judge works with them to narrow the issues, discuss points on which they disagree, and discuss whether there are common areas of agreement. The panel is set only after all factual evidence has been put on the record by the parties.

Once the panel is set, the judge prepares questions. The judge presents the questions to each panel member in a way that allows the judge to understand and compare answers in real time: the same question is posed to each expert in turn, with an exchange among panel members to seek a full and comprehensive explanation and expansion on answers. After judicial questioning is completed, counsel may in turn examine their experts and cross-examine the others; both examinations are, however, limited to clarifications, expanding on answers, and any new matters. In this regard, the experts' panel regime veers away somewhat from being adversarial and more toward an inquisitorial approach.

An experts' panel may be engaged every time expert evidence is part of an appeal, but a panel is likely to have a pronounced effect in large transfer-pricing matters because in such cases multiple experts tend to be put forward.

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