Canadian Tax Highlights

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Voluntary Disclosures Continue To Increase

In late January 2016, the CRA issued to Parliament its annual report, which discusses, among other things, the performance of its voluntary disclosures program (VDP).

The VDP permits a taxpayer to voluntarily disclose non-compliance and to correct tax-reporting and payment deficiencies in exchange for penalty and possible interest relief. To be accepted under the VDP, a disclosure must generally (1) be voluntary, (2) be complete, (3) report non-compliance that otherwise might attract a penalty, and (4) involve non-compliance that is at least one year past the compliance's due date.

Of particular concern to a taxpayer who wants to make a voluntary disclosure is the requirement that the disclosure be "voluntary." The CRA will generally not accept a disclosure as voluntary if the agency has already commenced enforcement action against the taxpayer (or, in certain circumstances, against third parties or persons associated with or related to the taxpayer). Enforcement action includes requests or requirements for information issued by the CRA that relate to unfiled or incorrectly filed returns, unremitted taxes and instalments, deductions required at source, and registration obligations.

The CRA is authorized to grant relief under the VDP pursuant to subsection 220(3.1) and analogous provisions in other federal and provincial taxing statutes. (See the VDP summary in *Information Circular* 00-1R4, "Voluntary Disclosures Program," March 21, 2014.)

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The CRA report notes the significant increase in the number of voluntary disclosures under the VDP in the past year:

- More than $1.3 billion of unreported income was voluntarily disclosed under the VDP, a 65 percent increase over the previous year.
- Of the unreported income disclosed under the VDP, $780 million was attributable to offshore holdings, a 157 percent increase over the previous year.
- Under the VDP, 19,134 voluntary disclosures were made, a 21 percent increase over the previous year.

The CRA does not provide detailed figures for the penalties and interest waived under the VDP, but it does report levying gross interest and penalties under the Act of almost $4.8 billion over the past year. That amount includes the waiver of federal interest and penalties of almost $275 million under various statutory programs, such as the VDP. The CRA administers the VDP on behalf of those provinces that have delegated responsibility for income tax collection and administration to the federal government. It may therefore be assumed that significant provincial interest and penalties may also have been waived under the VDP.

The CRA's annual report attributes the ongoing increase in voluntary disclosures to several factors, including the CRA's heightened efforts to share data with foreign tax administrators, its enhanced audit activities, and its use of advanced risk-profiling algorithms.

The CRA's new offshore tax informant program (OTIP) was specifically mentioned. OTIP offers financial awards to an individual who provides information relating to certain types of "major international tax non-compliance." Over the past year, the CRA received 1,920 separate contacts from potential informants under OTIP, leading to over 200 written submissions and 110 cases that are currently under review.

OTIP may have motivated taxpayers to make disclosures under the VDP, but the numbers disclosed suggest that a relatively small percentage of contacts from the public are progressing under OTIP to written submissions or are resulting in cases being reviewed. The small number of contacts that are leading to detailed reviews may be attributable to the relatively narrow parameters for participation in the program. (Among other requirements, the CRA must generally be able to collect at least $100,000 of federal tax, excluding interest and penalties, in connection with undisclosed international non-compliance.)

The CRA's annual report also notes that, effective January 1, 2015, certain financial intermediaries were required to file specific identifying information with the CRA in connection with cross-border electronic fund transfers in excess of $10,000.

The CRA indicated that it was notified of approximately 3 million international electronic fund transfers during the first three months of the 2015 calendar year. It is understood that the CRA will use the information to monitor compliance with the Act and with other tax statutes. We have heard informally that this new reporting regime may have encouraged taxpayers to file voluntary disclosures before the CRA detected their undeclared offshore accounts.

The federal government is expected to continue to aggressively pursue non-compliant taxpayers and to further develop its information-sharing and enforcement capabilities in the coming years. In particular, the automatic information exchange mechanism contemplated by the Common Reporting Standard (developed by the OECD for implementation under the Multilateral Competent Authority Agreement) may enhance the CRA's ability to identify undisclosed offshore accounts held in the names of Canadian-resident taxpayers. It is understood that Canada may commence the automatic sharing of financial information under this protocol as early as 2018.

The VDP (and equivalent provincial programs) will continue to represent functional and pragmatic avenues for taxpayers to address past tax-reporting and payment deficiencies. The CRA continues to emphasize its offshore compliance programs, and as a result the VDP's importance to taxpayers should continue to grow.

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Foreign Rectification Orders

The TCC recently concluded that the minister was not bound by rectification orders from Barbadian and Cypriot courts (2016 TCC 43). Each court was in the jurisdiction of a subsidiary of Canadian Forest Navigation Co. Ltd. (CFN).

CFN was a CCPC based in Quebec since 1976. CFN and its subsidiaries owned and operated cargo vessels for the transportation of commodities such as steel, fertilizers, and grain. During 2005 and 2006, the Barbadian and Cypriot subsidiaries paid dividends of $151,589,355 and $102,326,866, respectively, to CFN. The funds were distributed out of those subsidiaries to comply with the shipping rules in subsection 250(6).

CFN reported the dividends from both subsidiaries in its income and claimed an offsetting exempt surplus deduction (paragraph 113(1)(a)). The minister began an audit of CFN in early 2008. The Barbadian subsidiary obtained a rectification order from the Supreme Court of Barbados in the High Court of Justice on August 13, 2010, before the reassessment denying deductions under paragraph 113(1)(a) was issued to CFN. The rectification order rectified and replaced—nunc pro tunc and "by resolutions"—the previously paid dividends with indebtedness from CFN in favour of the Barbadian subsidiary. The District Court of Nicosia in Cyprus issued a similar rectification order after CFN filed its notice of objection but before it filed its notice of appeal. The minister did not receive notice of either court's proceedings.

The TCC concluded that the minister was not bound by the rectification orders from the Barbadian and Cypriot courts because the orders had not been recognized by a Canadian court of a competent jurisdiction. Each rectification order was treated like a non-money foreign judgment. The TCC cited the SCC in *Pro Swing Inc. v. Elta Golf Inc.* (2006 SCC 52):

> This procedure is even more necessary in the case of a non-money foreign judgment. A domestic court enforcing that kind of judgment may have to interpret and apply another jurisdiction's law. The recognition and enforcement of such judgments will require a balanced measure of restraint and involvement by the domestic court that is otherwise unnecessary when the court merely agrees to use its enforcement mechanisms to collect a debt. This means that the domestic court may have to consider relevant factors so as to ensure that the foreign judgments do not disturb the structure and integrity of the Canadian legal system and do not conflict with domestic law. [The court cited *Pro Swing* here.]

CFN filed an appeal to the FCA. It will be interesting to see how the FCA views a rectification order for a foreign transaction if a foreign court issues the order and views the order as enforceable in Canada. When a corporation realizes that it does not have sufficient retained earnings to pay a dividend that it has paid, it is not unusual for it to seek and obtain a rectification order that the dividend paid was in fact a capital distribution. The facts in this case do not provide enough information to determine why it was necessary to seek the recharacterization mandated by a rectification order. Did the CRA need to have notice of this type of rectification? Does it matter that the rectification did not change the tax consequences in Canada? And does it matter that the transaction being rectified was not a Canadian transaction but rather a foreign transaction of Barbados or Cyprus, respectively?

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QCA Upholds Abusive Tax Audit Award

On January 25, 2016, the Quebec Court of Appeal (QCA) handed down its long-awaited decision in *Agence du revenu du Québec c. Le Groupe Enico inc.*, 2016 QCCA 76. The decision, which received extensive media coverage in Quebec, largely upheld a multimillion-dollar award for damages against Revenu Québec following an audit "riddled with errors" that resulted in the insolvency and collapse of Groupe Enico. Groupe Enico was a consulting group founded by the well-known businessman Jean-Yves Archambault, and at its peak it employed almost 40 people.

The trial judgment (2013 QCCS 5189) issued in October 2013, spanned over 200 pages and documented a litany of misconduct by the Revenu Québec personnel involved with the case. In particular, the auditor was found to have (1) infiltrated the taxpayer under false pretenses, (2) misappropriated and destroyed relevant taxpayer records, and (3) proposed and issued intentionally inflated reassessments and then advised the collections department that the reassessed amounts were at risk and should be subject to immediate and urgent recovery action. Subsequent errors by the collections department included the seizure of a bank account to pay withholding taxes that had in fact been paid nine months earlier but had been improperly recorded. The collections department refused to cancel or scale back its recovery measures—which included the seizure of bank accounts and the unexplained non-payment of R & D tax credits—even after the audit department had admitted that the reassessed amounts were inflated. Due primarily to these and other actions by Revenu Québec, Groupe Enico's credit lines dried up and it was forced to make a proposal to creditors. Revenu Québec refused to accept the proposal unless it received payment of all of the amounts in its admittedly inflated reassessments. Groupe Enico was ultimately obliged to cease its activities and lay off its employees.

The trial judge said that "RQ [Revenu Québec] has acted, for the entirety of this file, with malice" and "with knowledge of the inevitable consequences that its conduct would have." Groupe Enico and Jean-Yves Archambault were awarded almost $3 million in damages, including $2 million in punitive damages. On appeal, the QCA concluded that Revenu Québec's "exorbitant" powers to enforce Quebec's tax regime come with a corresponding obligation to ensure that those powers are not misused:

> The more that a governmental body possesses exorbitant powers, the more it risks causing injury to the taxpayer if it exercises them in an abusive or unreasonable manner, or without consideration for the consequences that can follow. A duty of prudence and good faith in the exercise of these powers is naturally imposed. If RQ shirks this duty, it must not be surprised when the Courts, themselves also mindful of the public good, judge its lack of rigour with severity.

The QCA acknowledged Revenu Québec's difficulty in balancing the competing objectives of fighting tax evasion and ensuring that enforcement powers are not used improperly, but the court itself had no difficulty finding that Revenu Québec had crossed the line in the Groupe Enico audit. The QCA described the auditor's errors as, "at a minimum, negligence, recklessness or grave incompetence equivalent to bad faith," and it said that collections department employees had "acted without any discernment." The QCA also found no error in the trial judge's factual conclusion that Revenu Québec's misconduct—especially its inflated assessments and unreasonably aggressive collection actions—had directly precipitated Groupe Enico's losing access to credit and had thus caused its collapse.

The QCA also upheld most of the trial judge's damage award, including the punitive damage award of $1 million to Groupe Enico. The upholding of the punitive damage award was remarkable because Quebec law (unlike common law) requires that punitive damages be expressly authorized by statute before they can be imposed. For example, punitive damages may be awarded when a party intentionally violates a right protected by Quebec's Charter of Human Rights and Freedoms, which protects a person's "right to the peaceful enjoyment and free disposition of his property" (section 6). The QCA agreed that Revenu Québec's conduct—including the unlawful withholding of R & D credits, the unlawful seizure of Groupe Enico's bank account, and the issuance of "an excessive number of notices of assessment for exorbitant amounts that caused the discomfiture of the business"—was an intentional interference with Groupe Enico's property and thus was an intentional violation of its section 6 Charter rights.

The QCA decided a few points in favour of Revenu Québec. The court remarked on the inappropriate nature of some of the trial judge's criticisms of Revenu Québec's operating procedures, especially its use of quotas to motivate its auditors. The court also rejected the $1 million in punitive damages that the trial judge had awarded to Archambault personally.

Groupe Enico was decided just after a settlement in *Leroux* (2014 BCSC 720), in January 2016. The trial court in *Leroux* recognized for the first time that the CRA owes a common-law duty of care to a taxpayer under audit. This recognition enabled the taxpayer to sue the CRA for negligence when its misconduct during an audit caused injury. Leroux and the CRA settled the case while it was under appeal to the BCCA. In *Scheuer* (2016 FCA 7), the FCA suggested (without deciding) that the CRA has a duty of care in the performance of a statutory duty that involves the making of a discretionary decision. (However, the FCA held that the CRA does not have a duty of care when it issues a tax shelter number, because the issuance is mandatory if a promoter applies for a number in the prescribed manner.)

Quebec civil law has no concept of duty of care: liability is instead based on a unified framework of fault, damage, and causation similar to the common-law action for negligence when duty of care is established. *Leroux* and *Scheuer* are consistent in many respects with *Groupe Enico* for negligence actions with revenue officials, and the latter may become persuasive authority across Canada.

Although the QCA decision in *Group Enico* is currently available only in French (all translations in this article are the author's), the court translates its most important decisions into English. One hopes that *Groupe Enico* will be designated for translation as soon as possible.

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Updated FAQs for Streamlined Procedures

Early in 2016, the IRS updated its FAQs for the streamlined filing compliance procedures that apply to US taxpayers whether residing inside or outside the United States. The IRS first introduced the streamlined procedures in 2012, and it has modified them several times in the interim. The procedures offer a US taxpayer a simple process for coming into compliance with his or her US tax-filing obligations. The procedures continue to provide relief to many US citizens living in Canada who have failed to file US tax returns or report foreign accounts.

The new FAQs clarify how to complete the narrative statement of facts on form 14653 ("Certification by U.S. Person Residing Outside of the United States for Streamlined Foreign Offshore Procedures") and form 14654 ("Certification by U.S. Person Residing in the United States for Streamlined Domestic Offshore Procedures"). A certification on one of those forms must accompany a streamlined procedure submission. The updated FAQs also address a spouse's refusal to sign such a certification or a joint amended tax return. The IRS notes that many certifications submitted under the streamlined procedures contain insufficient information in, or omit information from, the statement of facts and in some cases include only one signature for a certification that relates to married taxpayers who file joint tax returns.

The narrative statement of facts must now include specific reasons for a failure to report income and information and to pay tax. The new FAQs state that a taxpayer must include the whole story, including favourable and unfavourable facts. FCA 13 (for domestic procedures) and FCA 6 (for foreign procedures) specifically state that the certification must include personal background, financial background, source of funds, and information about the taxpayer's contact with an account, including withdrawals and investment decisions. The FAQs further note that if a taxpayer or a return preparer inadvertently checks "no" on form 1040 (schedule B) regarding a financial interest or signature authority over a foreign financial account, the narrative statement of facts should provide an explanation. Commentators have suggested that the guidance still leaves some room for interpretation as to what information should be included in the statement of facts.

The new FAQs add FCA 14 (for domestic procedures) and FCA 7 (for foreign procedures) to address a situation in which a spouse or former spouse will not sign an amended return or joint certification on form 14654 or form 14653. A taxpayer may now submit a joint amended return with only his or her signature, as long as the return shows a net increase in tax. If the amended return shows a net decrease in tax or an increase in credit, the spouse's signature is still required: otherwise the spouse might be unaware of a refund resulting from an amended joint return. The taxpayer must also provide an explanation of why he or she cannot obtain a spouse's signature.

The updates to the streamlined procedures do provide some clarification for a Canadian who is considering his or her US tax-compliance options, particularly if the taxpayer's spouse is not willing to sign an amended tax return or certification. However, some issues with the procedures remain unresolved, including the non-residence requirement for foreign procedures, which may preclude someone who winters in the southern United States from coming forward under those procedures.

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Three-Year Bonus Plan Converted to DSU Plan: Partially Revoked Rulings

A recent technical interpretation (2015-0610801C6, November 24, 2015) clarifies the CRA's position that rights under a company's three-year bonus plan can no longer be converted to rights under a "deferred share unit" (DSU) plan (or vice versa) without creating taxable income for the employee on conversion. The CRA also says that a DSU plan cannot be excluded from the salary deferral arrangement (SDA) rules if it provides for early payments to be made in accordance with the permissible distribution events under US tax rules. The TI also addresses how the CRA will deal with taxpayers who have received or relied on previous favourable rulings concerning these conversions and early payments.

An SDA is defined in subsection 248(1). In general terms, an SDA is a plan or an arrangement that gives a person a right, in a taxation year, to receive an amount of salary or wages in a subsequent year and one of the right's main purposes is to postpone tax payable on an amount that is, is on account of, or is in lieu of salary or wages for services rendered by the taxpayer in the taxation year or one preceding. A taxpayer who has a right to receive an amount from an SDA is deemed (subsection 6(11)) to have received the amount in the year that it was earned, and therefore must include the amount in his or her income (paragraph 6(1)(a)), even though he or she received no monies.

An SDA specifically excludes certain plans, including a plan or arrangement under which a taxpayer has a right to receive a bonus or similar payment for services rendered by the taxpayer in a taxation year and that bonus will be paid within three years following the end of the year (paragraph (k)). An SDA also excludes a prescribed DSU plan that is designed to fit under regulation 6801(d). A payment under a DSU plan may be made only after the date of the participant's death, retirement, or loss of office or of employment but no later than the end of the first calendar year commencing after death, retirement, or loss.

Under a typical DSU plan, an employee can defer a portion of his or her annual bonus and convert it into phantom units whose value is pegged to the value of the employer corporation's shares. The amount that the employee ultimately receives is therefore linked to the value of those shares.

The TI considers the conversion of the rights under a three-year bonus plan that meets the conditions of paragraph (k) into rights under a DSU plan that satisfies regulation 6801(d) (or vice versa). The CRA ruled favourably in the past to allow such a conversion without triggering tax. However, the TI says that the past rulings no longer reflect the CRA's position and that such a conversion does not satisfy the conditions of either paragraph (k) or regulation 6801(d): the Act was not intended to provide the kind of flexibility offered in such a conversion. Allowing the conversion of rights under a three-year bonus plan could effectively permit payment of an amount after the third calendar year, and the conversion of rights under a DSU plan could permit payment of an amount before death, retirement, or termination of employment. Accordingly, the CRA's view is that the rules do not allow a plan to provide a taxpayer with the flexibility to subsequently convert rights under a paragraph (k) plan into rights under a paragraph 6801(d) plan, or vice versa. Therefore, the CRA says that the plan's terms can never provide a taxpayer with conversion rights.

The CRA also considers a situation in which a DSU plan includes participants who are subject to income tax in both Canada and the United States. To qualify for a US and a Canadian deferral, the plan must meet the requirements of both Code section 409A and regulation 6801(d). Code section 409A allows earlier payments than regulation 6801(d) does. For example, section 409A allows payments to be made as a result of (1) a service reduction to less than 20 percent of the previous level, (2) a change in control of the employer, or (3) an unforeseeable emergency. For a participant who is subject to both Canadian and US taxation, the CRA confirms that a DSU plan cannot provide for the full range of distribution events permitted by section 409A and also comply with regulation 6801(d).

The CRA says that it is in the process of revoking advance income tax rulings given for three-year bonus plans and DSU plans whose terms allow these kinds of conversions or early payments. The CRA notes that, if a taxpayer receives a revocation letter, the revocation does not apply either to any units credited on or before the date specified in the letter (including units with unexercised conversion rights on that date) or to additional units credited at any time for those units (such as dividend equivalents and proportional adjustments due to stock splits or corporate reorganizations).

The CRA notes that some taxpayers established three-year bonus plans and DSU plans that relied on the positions in the CRA's published rulings even though the taxpayers themselves did not obtain rulings. The CRA indicates that it will continue to apply the positions in these published rulings to any units credited on or before November 24, 2015 (including units with unexercised conversion rights on that date), as well as to additional units credited at any time for those units.

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Ontario Retirement Pension Plan, Part 2

On February 16, 2016, the federal and Ontario departments of finance announced that the Ontario Retirement Pension Plan (ORPP) will phase in starting on January 1, 2018, one year later than originally announced. (For an overview of the ORPP, see "Ontario Retirement Pension Plan," *Canadian Tax Highlights*, December 2015; that article should be read in conjunction with this article.) This article outlines the governments' February 16, 2016 announcement and the key details of an Ontario technical bulletin dated January 26, 2016.

February 16, 2016 announcement. A large employer (500 or more employees) is not required to remit ORPP premiums until January 1, 2018 instead of January 1, 2017. Essentially, the phased-in contribution rates previously applicable to a medium-sized employer (50 to 499 employees) for 2018 and 2019 now also apply to a large employer. Furthermore, a large employer must register with the ORPP starting in January 2017 (also one year later than originally required). The accompanying table shows the amended contribution rates that apply to employees and their employer when the employer does not have a registered workplace pension plan. The announcement also indicates that Ontario and the federal government will work with other jurisdictions to explore a range of potential CPP enhancements and that the federal government will work with Ontario to facilitate ORPP administration.

Contribution Rates for the ORPP as a Percentage of Earnings

Year	2017	2018	2019	2020	2021
Small employer (≤ 49 employees)	0.0	0.0	0.8	1.6	1.9
Medium employer (50 to 499 employees)	0.0	0.8	1.6	1.9	1.9
Large employer (≥ 500 employees)	0.0	0.8	1.6	1.9	1.9

Comparable pension plan tested at the subset level. An employer's registered pension plan that covers more than one group of employees and provides different benefit formulas, contribution rates, and accrual rates for different employee groups is tested for those different groups at the subset level to determine whether that plan subset meets the threshold of a comparable pension plan. A subset must be clearly identifiable within the pension plan or collective bargaining agreement (CBA); employees belonging to a subset are subject to the same contribution or benefit structure.

Multi-employer pension plan (MEPP). An MEPP can be a defined benefit (DB) plan, a defined contribution (DC) plan, or a combination, and it exists where two or more unrelated employers participate in and contribute to the same pension fund. An MEPP's comparability test is applied for an employer's CBAs and/or employee agreements at the subset level and uses either the DB accrual or DC rate threshold at the employer's option.

DC plans with voluntary contributions. An employee's voluntary contributions (and matching employer contributions) to a DC plan are not considered when one is determining whether the pension plan meets the ORPP comparability threshold. An employer with such a plan has until January 1, 2020 to amend the plan so that it meets the minimum DC contribution threshold, or else ORPP contributions must be made starting at that time.

Waiting period to join workplace pension plan. If a waiting period exists before an employee can join a workplace pension plan, both the employer and the employee must participate in the ORPP in the interim.

Employer opt-in to the ORPP. An employer that has a comparable pension plan, but wants to provide additional pension benefits to employees, can opt into the ORPP at any time after 2019. If the employer opts in, contributions are required for all members of the employer's comparable pension plan—not just select subsets—at the full 3.8 percent rate. The Ontario bulletin is unclear whether the employer must make all the contributions or whether both the employer and employee contribute.

Employed in Ontario. ORPP contributions are required for any employee who is employed in Ontario. An employee is considered to be employed in Ontario if he or she must report to work at, or is paid by, an Ontario establishment of the employer. For example, the employee is considered to be employed in Ontario if his or her employment contract says that the employee works from a home office and the payroll department or the employment records are located in Ontario. The Ontario bulletin is unclear whether an employee who is paid by an Ontario establishment but reports for work at a non-Ontario establishment of the employer is employed in Ontario. The bulletin indicates, however, that the definition is intended to be consistent with CPP rules regarding location of employment. That intended consistency suggests that the employee is not considered to be employed in Ontario.

Post-retirement return to work. An individual who is collecting ORPP benefits and resumes employment is eligible but not required to opt into the ORPP. If the individual opts in, his or her ORPP benefits cease until he or she leaves the workforce.

Non-resident workers. The ORPP applies to a non-resident employee who is employed in Ontario unless the employee is treaty-exempt from Canadian tax.

Pensionable earnings. ORPP pensionable earnings cover both cash and non-cash earnings, including bonuses and commissions. The contribution rates apply to a maximum of $90,000 (indexed after 2017) of the employee's earnings, reduced by a $3,500 basic exemption. Contributions are required for an employee aged 18 to 70, for a maximum contribution period of 52 years. The normal retirement age to start receiving an ORPP pension is 65, but an employee can elect to begin receiving actuarially adjusted benefits as early as age 60 or as late as age 71.

Leave of absence and workplace injury or illness. An employee on a leave of absence that is protected under the Employment Standards Act, 2000 (ESA) or Workplace Safety and Insurance Act, 1997 (WSIA) can elect to continue to contribute to the ORPP during the leave. If an employee makes the election, the employer must contribute as well; contributions are based on the employee's earnings before the leave. Leaves that are protected under the ESA or WSIA include pregnancy, parental, workplace injury, and illness leaves.

Survivor benefits. ORPP survivor benefits are payable to a member's surviving spouse, beneficiary, or estate. The amount of the benefit depends on various factors, such as whether a plan member dies before or after retirement, has an eligible spouse, or his or her spouse waived entitlement to the joint and survivor pension before the member's retirement.

Small pensions. The ORPP permits a small pension amount to be paid to a member in a lump sum. If a member retires with a pension entitlement of less than $480 per year (indexed after 2017), he or she can receive the actuarial equivalent value lump sum of his or her pension entitlement. A plan member who turns 70 and retires during the 2017-22 transition period receives a lump-sum benefit payment equal to his or her contributions to the plan; any other plan member who retires during that period receives benefit payments starting in 2022.

Shortened life expectancy. A plan member whose life expectancy is two years or less due to a terminal illness can request to receive immediately a lump sum equal to the actuarial equivalent value of his or her pension entitlement.

Plan review. The ORPP will be reviewed five years after its full implementation to help ensure that the plan is meeting its intended objectives. Subsequent reviews will occur every 10 years. At least 60 percent of ORPP members must consent to any fundamental change to the ORPP that will affect plan members' benefits substantially and that is not a direct result of adjustments to funding policy.

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Regulation 102 Withholding Relief for Non-Resident Employers

The release of form RC473, "Application for Non-Resident Employer Certification," fulfills the 2015 federal budget promise to relieve compliance obligations relating to non-resident employees in Canada who are treaty-exempt from Canadian taxation. The new regime allows a qualifying non-resident employer to apply for certification; if approved, the employer is relieved of regulation 102 withholding and (perhaps) reporting requirements for payments to qualifying non-resident employees. The CRA indicated that it will implement the certification process retroactive to January 1, 2016, even though the related legislation is not yet enacted. A transitional window for an employer's certification has been created: an application that is received by March 1, 2016 and approved allows for the backdating of the certification period to January 1, 2016. If an application is filed after the transitional period and an employee-specific waiver was not obtained, the employer must continue to withhold and remit tax on payments made to employees until certification is granted.

Past rules required that all employers withhold Canadian income tax from remuneration paid to a non-resident employee who provides services in Canada, even if the employee is eligible for a treaty exemption. To mitigate the cash-flow challenges of regulation 102 withholding, the CRA allowed an employee to apply for a waiver of that obligation on a case-by-case basis. The waiver process generally was administratively burdensome and sometimes impractical, because a separate waiver was required for each individual employee and must have been received in advance of the services' provision. Employer certification is designed to reduce or eliminate many of these administrative challenges. The waiver process will remain available, however, for an employer and any employee who either does not qualify for the new certification program or is otherwise better served by the existing waiver program.

Any employer resident in a country with which Canada has a tax treaty is eligible to apply for certification. A partnership (90 percent or more of whose annual income is allocated to partners resident in countries with which Canada has a tax treaty) and a US limited liability company are also eligible for certification.

A certified employer is not subject to regulation 102 withholding on payments that it makes to a qualifying non-resident employee. A qualifying non-resident employee

- is resident in a country with which Canada has a tax treaty at the time of payment;
- is not liable to income tax on the payment because of the treaty; and
- has fewer than 45 work days in Canada in a calendar year or is present in Canada for any purpose for fewer than 90 days in any 12-month period.

In addition, if the qualifying non-resident employee earns less than $10,000 of Canadian-source compensation during the year, the annual requirement to report such remuneration on form T4 is now waived. This waiver is significant because, consequently, the employee need not apply for and obtain a Canadian taxpayer identification number.

Form RC473 must be completed and submitted to the Pacific International Waivers Centre of Expertise located at the Vancouver Tax Services Office. The CRA recommends filing the application at least 30 days in advance of when the employer wants the certification to be effective. If the application is approved, the CRA will inform the employer in writing. Until such approval is received, the employer must withhold Canadian tax at source or ensure that an appropriate waiver has already been received by the employee. An approved certification application is valid for up to two years.

Employer certification results in a number of obligations on the part of an employer, including the following:

- tracking and recording both the number of days that each qualifying non-resident employee works or is present in Canada and the income attributable to those days;
- ascertaining whether the employee is a resident of a country with which Canada has a tax treaty;
- determining whether the qualifying non-resident employee's remuneration is expected to be exempt from Canadian tax under the relevant tax treaty;
- determining whether the qualifying non-resident employee either works in Canada for less than 45 days in the calendar year that includes the time of payment, or is present in Canada for less than 90 days in any 12-month period that includes the time of payment;
- obtaining a CRA business number and, if required to make remittances, a program account for payroll purposes;
- completing and filing T4 slips for those employees who earn in excess of Cdn$10,000 of Canadian-source remuneration for the year;
- filing any necessary Canadian corporate income tax returns for calendar years under certification; and
- upon request, making books and records available in Canada for inspection by the CRA.

Even if a qualifying employer is exempt from income tax withholding, it may still be required to withhold CPP contributions and/or EI premiums, subject to exceptions under these regimes.

CRA-approved certification can be revoked if the CRA determines upon inspection of the books and records that the employer has not fulfilled the obligations above. It is therefore important for an employer to develop and implement processes and internal controls that will allow for the tracking of employee presence in Canada for both work and non-work purposes.

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Revenu Québec Responds to Ombudsperson

On January 26, 2016, Revenu Québec released its 2015-16 action plan following the 2013-14 and 2014-15 annual reports on the public service that were tabled in the National Assembly by the Quebec ombudsperson, Raymonde Saint-Germain. The ombudsperson's reports were critical of the audit and collections practices of Revenu Québec. Consequently, the finance minister, Carlos Leitão, ordered the president of Revenu Québec to develop an action plan to address the severe and "unacceptable" issues encountered by various taxpayers in their dealings with the provincial tax authority. (See "Quebec Ombudsman Lambastes Revenu Québec" and "Head of Revenu Québec Summoned," *Canadian Tax Highlights*, October 2014 and October 2015, respectively.)

The action plan comprises 19 steps in five distinct categories. The following is a brief overview of some noteworthy initiatives undertaken by Revenu Québec.

- **Charter of Taxpayers' Rights.** Reiterating Revenu Québec's commitment to integrity, respect, equality, and service excellence, the first initiative is the adoption of a Charter of Taxpayers' Rights. The Charter will outline Revenu Québec's undertakings with respect to equality, confidentiality, accessibility to services and pertinent information, and the exercise of taxpayers' rights. The agency has also undertaken to train its staff in its various Charter obligations. The Charter is set for release by March 2016.
- **Creation of an independent tribunal.** Revenu Québec proposes that the provincial government establish a new, independent tribunal to deal with taxpayers' complaints about procedural fairness during the objections process. The tribunal's head is to be named by the government and is to be independent of Revenu Québec. It will be interesting to see how the practice of this tribunal is made to dovetail with the current appeals process outlined in the Tax Administration Act. Normally, once the minister has rendered a decision on an objection, a taxpayer has 90 days to appeal to the Court of Quebec. Given that the creation of this new tribunal is intended to avoid any escalation to litigation, a complaint to the new tribunal will presumably suspend the 90-day limitation period; suspension has not yet been confirmed.
- **Suspension of QST recovery.** In contrast to most income tax assessments, the amount of a taxpayer's GST or QST assessment may be collected by Revenu Québec even if that assessment is still under objection. Collection can be a significant hardship for some businesses. The action plan adopts the administrative practice of suspending QST collection procedures for an otherwise tax-compliant taxpayer if Revenu Québec is satisfied that the amounts assessed can eventually be collected. However, this administrative concession appears to apply to QST only and not to GST, which Revenu Québec collects on behalf of the CRA.
- **Appeal to small claims court for corporate assessments.** Under the simplified procedure of the small claims division of the Court of Quebec, parties are not represented by a lawyer, and the trial judge leads discussions, examines witnesses, and frames the issues in dispute. This cost-effective option is currently available only to an individual who is appealing a Revenu Québec decision on an objection for an amount less than $4,000. Revenu Québec recommends extending the rule to corporations.
- **Statistics publication.** Revenu Québec will publish, quarterly, statistics on the number of assessments upheld or overturned during objections and appeals.
- **Customer satisfaction surveys.** Beginning in July 2016, on completion of an audit, Revenu Québec will send out surveys to the taxpayer to solicit his or her evaluation of interactions with the file auditor. Survey results will be publicly available.

The imbalance of power between Revenu Québec and taxpayers has desperately needed the government's attention. A few items require clarification, but taxpayers should view the action plan as a positive development that reduces this inequity.

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GST/HST on Medical Marijuana

In *Hedges* (2016 FCA 19), the FCA upheld a TCC decision (2014 TCC 270) that GST/HST applies to sales of dried marijuana used for medicinal purposes, even though medications are generally zero-rated for GST/HST purposes. The result may be technically correct, but it is potentially at odds with current social, economic, and political realities.

The supplier in *Hedges* was a marijuana grower based on Gabriola Island in British Columbia. The supplier sold his product to the BC Compassion Club Society (BCCCS), which in turn supplied the marijuana to its members. To become a member of the BCCCS, an individual must provide confirmation from a health-care practitioner that he or she suffers from an ailment for which marijuana is believed to be effective.

The central issue in *Hedges* was whether the marijuana sold by the grower to the BCCCS was zero-rated. The grower's position was based on a provision in schedule VI of the Excise Tax Act (VI-I-2(d)), which generally zero-rates a drug containing a substance prescribed as a controlled narcotic under federal legislation, such as cannabis (the plant from which marijuana is derived) and THC (the principal psychoactive constituent of cannabis). But the provision has an important exception—namely, that the sale of the drug is not zero-rated if it "may be sold to a consumer without a prescription."

The grower maintained, among other things, that the marijuana was a drug because it was represented as being sold for therapeutic use, regardless of whether the sales were legally permitted. The TCC agreed, but refused to interpret the exception as referring only to over-the-counter drugs, which are generally taxable and not zero-rated. The court framed the main question as follows: Did the existence of the medical marijuana regulations administered by Health Canada mean that the drug was legally available without a prescription and was therefore captured by the exception? Did the possibility of legal sales without a prescription to some consumers mean that sales to every consumer were taxable?

The medical marijuana regulations have established a system under which an individual can apply for an authorization to possess (ATP), which entitles the holder to acquire and consume marijuana. The ATP application process requires a medical declaration from a health-care practitioner that sets out, among other things, the individual's symptoms and the maximum daily amount of marijuana to be consumed by the individual. The regulations also govern the granting of licences to certain marijuana producers who are thereby entitled to sell marijuana to ATP holders. The CRA insisted that all licensees collect GST/HST on all marijuana sales. (The supplier in *Hedges* was not a licensed producer, and only some BCCCS members had an ATP.)

At trial, the grower argued that the words "may be sold to a consumer" in the exception must be interpreted as "may be sold to any consumer." From a policy perspective, this argument is compelling: the fact that a drug is legally available only to a specific handful of people should result in its being zero-rated, regardless of whether other people may and do obtain it illegally. The grower argued that the question should be whether every consumer can legally obtain the drug with or without a prescription. If consumption is restricted to particular people and the drug is not accessible to the general public, then the drug should be zero-rated, just like traditionally accepted prescription drugs.

However, the TCC found no evidence of such an underlying policy and rejected that interpretation. Additionally, the court concluded that an ATP is not a prescription and that, because the drug is obtainable (albeit by a limited class of people) without a prescription, the exception to the zero-rating provision applies and the sales are taxable. The TCC expressed strong criticism of the provision's poor drafting, emphasizing that the government's intention should be far more clearly stated than it is.

The FCA dismissed the grower's appeal. The arguments were limited by the parties to the meaning of the exception. Unfortunately, the FCA's decision generally bypasses the grower's main argument: that a drug legally available to some consumers but not to others should be zero-rated. Rather than providing a clear determination of the exception's scope, the FCA chose to respond narrowly to the unlawful nature of the grower's sales.

If no appeal is made to the SCC, then the focus will turn to the political arena. Despite the current government's vocal support for legalizing marijuana for general use, little has been said about how the government's intended legal regime will be structured. The government has not pronounced on the proposed GST/HST status of medical marijuana, although it has said that no changes are planned for the near future. (Sales of marijuana for recreational use will certainly be taxable.) In the US context, Washington and Colorado are the two states to have already legalized marijuana, but their approaches differ.

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Stepbrothers Blood-Related

A recent technical interpretation (2015-0584261E5, November 3, 2015) confirms that step-siblings are related for the purposes of the Act even though they do not share a common birth parent. The TI reviews the rules that determine whether certain taxpayers are "related persons" for the purposes of the Act, and it concludes that step-siblings are connected by a "blood relationship."

For the purposes of the Act, related persons are deemed not to deal at arm's length (paragraph 251(1)(a)). The concept of "related" (and others such as "associated" and "affiliated") triggers many tax rules throughout the Act.

"Related persons" are defined to include, among others, individuals connected by blood relationship, marriage or common-law partnership, or adoption (paragraph 251(2)(a)).

For the purposes of the Act, persons are considered to be connected by, among other things, blood relationship if one is the child or other descendant, or brother or sister, of the other (paragraph 251(6)(a)).

Subsections 252(1) and (2) describe relationships, and they include an extended definition of "child" for the purposes of the Act. A "taxpayer's child" includes a person of whom the taxpayer is the legal parent (paragraph 252(1)(a)), and it also includes a child of the taxpayer's spouse or common-law partner (paragraph 252(1)(c)). Furthermore, an individual is considered to be a parent of a taxpayer who is the individual's child (subparagraph 252(2)(a)(i)).

The TI considers whether stepbrothers Son A and Son B are connected by blood relationship. Son A is the birth son of Mom A and Dad A, and Son B is the birth son of Mom B and Dad B. Mom A and Dad B live in a common-law partnership. The CRA concludes that Son A and Son B are connected by blood relationship and are therefore related for the purposes of the Act.

The CRA says that Son A is the child of Mom A and Son B is the child of Dad B, because each of Mom A and Dad B is the respective son's legal parent (paragraph 252(1)(a)). Furthermore, the CRA notes that, because Mom A and Dad B are common-law partners, Son B is also the child of Mom A, and Son A is also the child of Dad B (paragraph 252(1)(c)). The CRA says that, because Mom A and Dad B are each the parents of each of Son A and Son B (subparagraph 252(2)(a)(i)), Son A and Son B have the same parents for the purposes of the Act. Thus, the CRA is of the view that Son A and Son B are brothers who are connected by blood relationship (paragraph 251(6)(a)). Therefore, Son A and Son B are related for the purposes of the Act (paragraph 251(2)(a)).

The CRA notes that its conclusion is based on the law and on previous TIs. Those previous TIs appear to be a 1994 TI (9429945, April 13, 1995) and a 2004 TI (2004-0074051R3, 2004). In the 1994 TI, the CRA concluded that a half-brother and half-sister (children with a common birth parent) are connected by blood relationship. In the 2004 TI, the CRA referred to a dictionary definition of "brothers" that includes males who have the same parents or parent; however, on the facts of the current TI, Son A and Son B do not share a common birth parent.

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Non-Resident Acquires Unsevered Realty

A non-resident wishes to acquire a single parcel of Canadian realty that comprises (1) commercial buildings and land and (2) vacant land with the right to develop residential units. The non-resident intends to renovate and improve the commercial realty and then earn from it rental income and long-term returns, and to enter into a joint venture agreement with an experienced Canadian developer for the development and sale of the residential realty. The non-resident acquiror has been advised to hold the commercial and residential realties through different structures in order to maximize tax efficiency, but there is insufficient time before closing to sever the parcel so that these realties can be owned and held separately on closing. The following structure and steps may minimize the associated tax consequences of earning rental income on and generating capital gains from the commercial realty and of generating income gains from the residential realty.

Assume that the commercial and residential realties represent one-third and two-thirds of the parcel's total value, respectively. The non-resident acquiror forms a foreign corporation (Forco) and a Canadian corporation (Canco). Because the parcel is not severed before closing, Forco and Canco cannot separately acquire the two realties, and thus a corporate bare trustee or nominee acquires and holds legal title to the single parcel of land. Forco and Canco each acquire an undivided beneficial ownership interest in the entire parcel: Forco's beneficial ownership interest is a one-third interest in the parcel, and Canco's beneficial interest is two-thirds. The non-resident acquiror severs the parcel as soon as possible after closing in order to maintain the relative values between the commercial and residential realties.

When severance is obtained, if the commercial realty still represents one-third of the total value of the parcel, then beneficial ownership in that realty is passed solely to Forco and beneficial ownership in the residential realty is passed solely to Canco without triggering any Canadian federal income tax. The partition rule generally provides that Forco's beneficial interest in the severed commercial realty is a continuation of its undivided one-third interest in the total parcel; Canco receives the same treatment in respect of the residential realty. The partition rule prevents a disposition of an interest in the property by either Forco or Canco (which triggers tax on a gain accrued in the intervening period) and an acquisition of real property by Canco from Forco (which triggers the notification and remittance obligations under section 116). The severance itself may increase the value of the whole parcel, a fact that underscores the need to rely on the partition rules even if external market conditions do not otherwise suggest a property value increase.

A favourable result may be available for income tax purposes, but the severance and the technical change in ownership interest result in a change in beneficial ownership for land transfer tax purposes (at least, in Ontario). Thus, land transfer tax may apply even if the transactions are not recognized for Canadian federal income tax purposes.

Because it is intended that Forco and Canco will each eventually acquire and own solely the commercial realty and the residential realty, respectively, Forco and Canco are established and structured with these purposes in mind. For the commercial realty, the acquiring bare trustee borrows on Forco's behalf the proportion of total bank debt that is equal to the commercial realty's relative value of the total parcel. The balance of the commercial realty's purchase price is funded

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by Forco and financed generally 60 percent by an internal interest-bearing debt advanced to Forco and 40 percent by equity contributed to Forco: this ratio ensures compliance with the thin capitalization rules. The interest rate on the internal debt must reflect an ordinary commercial arm's-length rate for debt with similar terms.

The non-resident acquiror ensures that the income earned from leasing the commercial realty is passive rental income only; a separate Canadian entity to be established by the non-resident may administer the leases and perform a property management function. The commercial realty might be leased to the intermediary Canadian company and subleased to the tenant; this structure further insulates Forco from carrying on business in Canada and earning other than passive rental income in Canada. (Some profit is likely left at the intermediary company level and taxed in Canada.) Forco makes a net rental election under section 216, and the rent paid to it is subject to 25 percent withholding tax on the net—as opposed to the gross—amount after deductible interest expense and other current expenditures.

On the ultimate sale of the commercial realty, one-half of the gain is taxable to Forco (the prevailing corporate rate is about 26.5 percent, for an effective rate of 13.25 percent). Forco must comply with the notification requirements mandated under section 116, and the prospective purchaser will likely insist on the obtaining and delivery of certificates of compliance in respect of the sale. Dividends paid by Forco to its shareholder from the after-tax rental income or sale proceeds are not subject to Canadian withholding tax.

For the residential realty, the bare trustee similarly borrows on Canco's behalf the proportion of total bank debt equal to the residential realty's relative value of the whole parcel. The purchase price balance for the residential realty is provided by Canco to the bare trustee and financed with amounts of internal interest-bearing debt and equity that comply with the thin capitalization rules; further capital is also provided in debt and equity amounts that comply with those rules. When the residential realty is severed from the parcel, Canco enters into a joint venture arrangement with a developer. Interest paid by Canco on the internal debt and dividends paid by Canco on its shares are subject to non-resident withholding tax. The debt and shares may be held in a particular foreign holding company structure that allows a reduction or minimization of such withholding tax under the terms of an applicable treaty.

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