UPENDING THE SURPLUS ORDERING RULES: IMPLICATIONS OF THE NEW REGULATION 5901(2)(b) ELECTION

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The draft legislation released by the Department of Finance on August 19, 2011 includes substantial revisions to the foreign affiliate reorganization and distribution rules in the Income Tax Act (Canada). While much attention has focused on the more controversial proposals relating to upstream loans and hybrid surplus, the package also contains many welcomed changes that will make it easier for Canadian corporations to manage their foreign affiliate groups.

This article considers the new rules addressing foreign affiliate distributions, and in particular the new election proposed in Regulation 5901(2)(b) that will allow taxpayers to treat a top-tier foreign affiliate dividend as being paid out of pre-acquisition surplus. This new election, coupled with the new foreign affiliate deemed dividend rule in proposed subsection 90(2), gives taxpayers considerable flexibility and certainty with respect to the treatment of foreign affiliate distributions for Canadian tax purposes. Taxpayers with foreign affiliate groups may consider routinely utilizing this new election for distributions to Canada from their top-tier foreign affiliates.

Foreign Affiliate Deemed Dividend Rule — Subsection 90(2)

Historically, it has been possible to effect a distribution of capital by a foreign affiliate and treat it as a reduction of the shareholder’s adjusted cost base under subparagraph 53(2)(b)(ii). However, it is not always clear under foreign corporate law whether such a distribution qualifies as a “reduction of the paid-up capital of the corporation”, as required to ensure capital reduction treatment for Canadian tax purposes. For example, some jurisdictions treat amounts paid for the subscription of shares as “share premium” distinct from legal capital and permit distributions of these amounts to the shareholder effectively as a return of capital that is distinct from a dividend of profits. Recent comments from the Canada Revenue Agency at the May 2011 IFA International Tax Seminar exacerbated the uncertainty with respect to whether these types of foreign affiliate capital distributions could qualify for subparagraph 53(2)(b)(ii) basis reduction treatment.

Finance has addressed this uncertainty with proposed subsection 90(2), requiring mandatory dividend treatment for Canadian tax purposes. In particular, where a foreign affiliate makes a pro rata distribution on all the shares of a class (other than on a liquidation or redemption, acquisition or cancellation of shares), the proposed rule deems the distributed amount to be a dividend.

Proposed subsection 90(2) will therefore render irrelevant the foreign corporate law treatment of a foreign affiliate distribution. For all Canadian tax purposes, pro rata foreign affiliate distributions will be deemed to be dividends and will engage the normal surplus ordering rules in Regulation 5901. The effect is that foreign affiliate distributions will now result in a mandatory elevation of surpluses up the chain. It will no longer be possible to
isolate taxable surplus (and now also hybrid surplus) in a lower-tier affiliate by causing it to make capital distributions rather than dividends — instead, all distributions by a foreign affiliate will be deemed to be dividends that, under the regular surplus ordering rules (which the August 19, 2011 proposals will modify to put hybrid surplus in the hierarchy after exempt surplus and before taxable surplus), will be paid first out of exempt surplus, then hybrid surplus, and then taxable surplus.

Thus, subsection 90(2) gives taxpayers the benefit of certainty of treatment of foreign affiliate distributions, but at a price — the potential elevation of hybrid surplus and taxable surplus which can be disadvantageous where there is insufficient underlying foreign tax.

Pre-Acquisition Surplus Dividend Election — Regulation 5901(2)(b)

Proposed Regulation 5901(2)(b) is a necessary relieving corollary to the deemed dividend rule in subsection 90(2). It allows taxpayers effectively to override the new deemed dividend treatment for top-tier foreign affiliates, and preserves the ability to make top-tier distributions to the Canadian corporate parent with consequences equivalent to returns of capital, potentially avoiding dipping into hybrid surplus and/or taxable surplus.

Regulation 5901(2)(b) will apply at the election of the Canadian corporation receiving a dividend from a top-tier foreign affiliate. The effect of the proposed election is to deem the portion of the dividend that would otherwise be paid out of exempt surplus, hybrid surplus, or taxable surplus, to instead be paid out of pre-acquisition surplus.

Example of Regulation 5901(2)(b) Relief

By way of example, consider a Canco that has an adjusted cost base of $100 in its top-tier foreign affiliate, FA1. Due to a recent sale of excluded property foreign affiliate shares, FA1 realized a capital gain of $75 and now (under the August 19, 2011 proposals) has $75 of hybrid surplus with low underlying foreign tax, and no other surplus balances.

Assume under the foreign corporate law it is possible for FA1 to distribute the $75 gain amount as a capital reduction. Under current provisions of the Act, provided this results in a “reduction of the paid-up capital” of FA1, the effect of the capital distribution would be a reduction of Canco’s adjusted cost base of its FA1 shares by $75, without triggering an income inclusion from a dividend paid out of the hybrid surplus.

However, under the August 19, 2011 proposals, subsection 90(2) will instead deem FA1’s capital distribution to be a dividend. But for Regulation 5901(2)(b), Canco would be forced to receive the $75 distribution as a deemed dividend paid out of hybrid surplus, and would suffer a net income inclusion under sections 90 and 113.

Canco could avoid this adverse result by making the Regulation 5901(2)(b) election to treat FA1’s capital distribution (deemed under subsection 90(2) to be a dividend) to be a dividend paid out of pre-acquisition surplus. Canco would thus be entitled to a deduction under paragraph 113(1)(d) in respect of the $75 distribution, and would be required to reduce its adjusted cost base of the FA1 shares by this amount under subsection 92(2). This of course is exactly the same result as could be achieved under the current provisions of the Act where FA1 makes a capital reduction. This illustrates the relieving effect of the new Regulation 5901(2)(b) election, allowing the taxpayer to offset the potential adverse consequences of the new foreign affiliate deemed dividend rule in subsection 90(2).

Elective Retroactive Application

Both subsection 90(2) and Regulation 5901(2)(b) are proposed to apply to foreign affiliate distributions made after August 19, 2011. However, a taxpayer can elect to apply these rules retroactively to foreign affiliate distributions made by all of its foreign affiliates after February 27, 2004. The election must be made by the later of the Canadian corporation’s filing-due date for its taxation year in which the proposed amendments are assented to, and one year after the day they are assented to. The taxpayer may then further elect to apply the deemed pre-acquisition surplus dividend treatment to any particular top-tier foreign affiliate dividend paid after February 27, 2004, by making that further election within 365 days after the proposed amendments are assented to.

This potential retroactive application is appropriate, because the August 19, 2011 draft legislation also abandons the “surplus suspension” proposals that were part of the February 27, 2004 legislative package. These proposals would have suspended the surplus consequences resulting from internal dispositions of excluded property, among other things. Taxpayers may therefore have computed surplus accounts, and caused foreign affiliate distributions, on the basis of surplus suspension proposals that will no longer apply. Such taxpayers may now need to revisit internal reorganization transactions implemented since February 27, 2004, recalculate surpluses under the August 19, 2011 rules, and determine if the retroactive Regulation 5901(2)(b) election is required to avoid any historic top-tier foreign affiliate distribution now being treated as paid out of taxable surplus, when that taxable surplus was previously thought to have been suspended.
Broader Impact of Regulation 5901(2)(b)

In one sense, Regulation 5901(2)(b) is a relieving rule in response to subsection 90(2) that merely allows taxpayers to effectively continue to do what has always been permitted, namely, to effect top-tier foreign affiliate capital distributions.

But viewed in a wider context, the pre-acquisition surplus election in proposed Regulation 5901(2)(b) could arguably be considered a significant change to the fundamental surplus ordering mechanics at the core of Canada’s foreign affiliate system. Taxpayers now have the opportunity to systematically reverse the traditional surplus ordering rule by electing to treat their top-tier foreign affiliate distributions as pre-acquisition surplus dividends. This is much more flexible than under the current system, in which the ability to effect top-tier foreign affiliate capital distributions is constrained by the particularities of the foreign corporate law.

The new ordering rule, when modified by a Regulation 5901(2)(b) election and taking into account the proposed amendments to subsection 93(1.1) discussed below, enables a taxpayer to treat a top-tier foreign affiliate distribution (i) first as depleting the Canadian corporate parent’s adjusted cost base in the foreign affiliate shares, (ii) then as a dividend out of the exempt surplus of the top-tier foreign affiliate determined on a consolidated group basis, (iii) only thereafter as a dividend out of the consolidated group hybrid surplus balance, (iv) then as a dividend out of the consolidated group taxable surplus, and (v) lastly as a capital gain.

Automatic Subsection 93(1) Election

Key to this result is proposed paragraph 93(1.1)(b). This is a new rule that will force a mandatory subsection 93(1) election in respect of any capital gain realized by a Canadian corporation on shares of a top-tier foreign affiliate that results from the application of subsection 40(3), because of an election under Regulation 5901(2)(b).

The explanatory notes indicate that the mandatory subsection 93(1) election in this circumstance is intended to prevent taxpayers from using the new pre-acquisition surplus election to convert low-taxed hybrid surplus or taxable surplus into a capital gain. It certainly achieves this result — and moreover, by virtue of its automatic application, it facilitates the potentially advantageous surplus reordering that enables the taxpayer to defer distribution of the “bad” hybrid surplus and taxable surplus in its foreign affiliate group, until after the “good” top-tier basis and exempt surplus attributes are depleted.

Example of Surplus Reordering Using Regulation 5901(2)(b)

Consider the case of Canco in the example above, with a $100 adjusted cost base in the shares of FA1. Suppose FA1 has $75 of exempt surplus from its active business earnings and $75 of hybrid surplus with low underlying foreign tax, resulting from its post-August 19, 2011 sale of excluded property foreign affiliate shares. FA1 then pays a $150 dividend to Canco.

Under the surplus ordering rule in Regulation 5901(1) (as amended for hybrid surplus), the $150 dividend is paid first out of FA1’s $75 exempt surplus, and then out of FA1’s $75 hybrid surplus. The $150 dividend is included in Canco’s income under section 90, but Canco may deduct only $75 under paragraph 113(1)(a) in respect of the exempt surplus dividend. The subsection 113(1) deduction in respect of the grossed-up (low) hybrid underlying tax by assumption will not be sufficient to fully offset the income inclusion, and Canco will be subject to Canadian tax on the dividend from FA1.

However, Canco can improve this result by electing under Regulation 5901(2)(b) to treat FA1’s $150 dividend as paid out of pre-acquisition surplus. The dividend is included in income under section 90 but fully deducted under paragraph 113(1)(d). This results in a grind of $150 in Canco’s adjusted cost base of the FA1 shares under subsection 92(2) and paragraph 53(2)(b). Since Canco’s adjusted cost base in the FA1 shares was initially only $100, the excess amount of $50 (the negative basis) is deemed under subsection 40(3) to be a gain of Canco from a disposition of its FA1 shares. This is precisely the situation envisioned by proposed paragraph 93(1.1)(b), which engages proposed subsection 93(1.1) and results in Canco being deemed to have made an automatic election under subsection 93(1), and to have designated the amount prescribed in Regulation 5902(6). In this example the result is an automatic subsection 93(1) election of $50, capped at the amount of Canco’s capital gain in respect of the FA1 shares. FA1 is thus deemed to have paid a dividend of $50 to Canco, and under the regular surplus ordering rule this $50 dividend is prescribed to be paid out of FA1’s exempt surplus, and is fully deductible by Canco under paragraph 113(1)(a).

The overall effect in this example is that Canco receives the $150 dividend from FA1 first as a depletion of its $100 adjusted cost base of its FA1 shares, and second as a $50 deemed dividend that is paid tax-free out of exempt surplus. By using the Regulation 5901(2)(b) election, Canco can upend the regular surplus ordering rule and cause the dividend to first deplete its “good” attributes (basis and exempt surplus) before dipping into its “bad” attribute (hybrid surplus with insufficient underlying foreign tax). Moreover, this result occurs automatically, without the need for Canco to take
the positive step of filing the subsection 93(1) election form. Of course, Canco thereafter has nil adjusted cost base in its FA1 shares. The result achieved is deferral of tax, compared to the base case involving distribution of the hybrid surplus.

Basis and Surplus Mixer

Many taxpayers may prefer to receive foreign affiliate distributions that first access the adjusted cost base in its top-tier foreign affiliates, before accessing surplus balances. In general, basis is easier (and less costly) for taxpayers to determine with certainty. Basis generally arises from the one-time acquisition of the foreign affiliate shares, whereas surplus balances constantly change over time and must continually be updated. Surplus calculations generally depend on foreign income tax law and are subject to complex adjustments. The complexity of surplus computations is compounded by the August 27, 2010 proposals including the deficit preservation rules, and by the August 19, 2011 proposals adding new hybrid surplus and hybrid deficit balances. In many ways, a taxpayer’s basis in its top-tier foreign affiliate shares may be a more cost-effectively calculated, reliable, certain, and thus “superior” tax attribute than the surplus balances in each of its foreign affiliates.

This suggests a possible modification of the traditional “surplus mixer” strategy by which a top-tier foreign affiliate is used as a holding company for multiple lower-tier foreign affiliates. This common structure facilitates the mixing of lower-tier distributions from exempt surplus and taxable surplus, and maximizes the extent to which top-tier distributions are paid to the Canadian parent corporation solely out of exempt surplus (or out of taxable surplus with sufficient underlying foreign tax).

Now, in light of the August 19, 2011 proposals, the ideal foreign affiliate holding structure may be one that maximizes and consolidates the Canadian corporation’s adjusted cost base of its top-tier holding company foreign affiliate. This could permit future profit distributions to be made to the maximum possible extent as deemed pre-acquisition surplus dividends under Regulation 5901(2)(b), before ultimately reducing that adjusted cost base to a negative amount and triggering automatic subsection 93(1) elections that dip into surplus balances of the underlying foreign affiliate group.

To the extent that foreign affiliates are held by the Canadian parent corporation in separate chains, the parent could consider contributing those chains into a single foreign affiliate holding company using tax-deferred share-for-share exchanges under subsection 85.1(3), effectively consolidating all of its available tax cost in the shares of the “basis and surplus mixer” top-tier foreign affiliate. This basis consolidation structure also highlights the strategic importance of the tax cost bump, under either paragraph 88(1)(d) or 111(4)(e), to increase the cost of top-tier foreign affiliate shares acquired indirectly upon the acquisition of control of a Canadian target corporation.

Elevation of Lower-Tier Surpluses

Another potential advantage of electing under Regulation 5901(2)(b) results from the automatic subsection 93(1) election that arises after the adjusted cost base in the top-tier foreign affiliate shares is fully depleted and a capital gain of the Canadian parent corporation is triggered under subsection 40(3). The subsection 93(1) election engages Regulation 5902 to determine the notional surplus balances of the top-tier foreign affiliate, for the sole purpose of computing the amount of the subsection 40(3) capital gain that is instead treated as a deemed dividend received by the Canadian parent corporation.

The Regulation 5902 mechanism for determining these notional top-tier foreign affiliate surplus balances requires that all lower-tier foreign affiliates notionally distribute their net surplus amounts up the chain to the top-tier foreign affiliate. Thus, the notional surplus balances of the top-tier foreign affiliate are determined on a consolidated basis that takes into account the surpluses (and blocking deficits) in the group as a whole — essentially the same as the “tax-free surplus balance” concept in proposed Regulation 5905(5.5) from the August 27, 2010 draft legislation.

The utility of this can be seen most readily in the case where the top-tier foreign affiliate itself has “bad” surplus — hybrid surplus or taxable surplus with insufficient underlying foreign tax — and no exempt surplus, or an exempt deficit. If lower-tier foreign affiliates have positive exempt surplus amounts, these exempt surplus balances will be notionally distributed up the chain and, subject to “filling the hole” of any blocking deficits, will be available under Regulation 5902 to shelter the subsection 40(3) capital gain. In effect, the Regulation 5901(2)(b) election mechanism permits the taxpayer to automatically elevate and access lower-tier surplus amounts. This is likely to become increasingly relevant over time if the various “deficit preservation” rules in the August 27, 2010 proposals are enacted and ultimately result in the more frequent creation or preservation of upper-tier exempt deficits in foreign affiliate groups.

Conclusion: New Foreign Affiliate Distribution Opportunities

In light of the proposed Regulation 5901(2)(b) election, taxpayers may wish to reconsider and modify traditional foreign affiliate profit repatriation strategies. The election allows taxpayers to upend the normal surplus ordering rules and treat top-tier foreign affiliate dividends as first depleting the Canadian parent corporation’s adjusted cost base in its...
top-tier foreign affiliate shares, before accessing the surplus balances of the foreign affiliate group. Regulation 5901(2)(b) can thus be used to postpone repatriation of “bad” hybrid surplus and taxable surplus, by placing those attributes last in the revised surplus ordering hierarchy.

As a result of the Regulation 5901(2)(b) election opportunity, a taxpayer’s adjusted cost base in its top-tier foreign affiliate shares is arguably now an even more important and relevant tax attribute than ever before. Basis can usually be more reliably and cost-effectively determined than underlying surplus balances, and it is now the attribute that can systematically be accessed first. Consequently, taxpayers may now consider holding their foreign affiliate groups under a consolidating “basis and surplus mixer” foreign affiliate holding company, and routinely utilizing the new Regulation 5901(2)(b) election for top-tier foreign affiliate distributions.

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Notes:
1. R.S.C. 1985, c. 1 (5th Supp.), as amended (the “Act”). All statutory references in this article are to the Act and the Regulations thereunder.
2. In response to a question on this issue, the CRA stated that, notwithstanding its previous published position, its current position is that a distribution of share premium by a foreign affiliate would be treated as a shareholder benefit under subsection 15(1), and not as a return of capital or a dividend.
3. The election is not available where any electing corporation is a member of a partnership and that partnership is a shareholder of the dividend-paying foreign affiliate.
4. The reduction in adjusted cost base under subsection 92(2) would be reduced by foreign withholding tax, if any, but in this example where FA1 effects the distribution as a reduction of capital it is assumed there is no foreign withholding tax.
5. For instance, generally a distribution out of legal stated capital is not permitted under the business corporations law in most U.S. states.
6. Regulation 5902(6) is proposed to be amended to take into account the new automatic subsection 93(1.11) election, but the proposed amendment does not take into account that the automatic election can now apply to a disposition by a Canadian corporation of shares of a top-tier foreign affiliate. This technical oversight was raised by the Joint Committee on Taxation of the Canadian Bar Association and The Canadian Institute of Chartered Accountants in its submission to Finance dated October 19, 2011.
7. The provisions of paragraph 95(6)(b) would need to be considered but arguably would not ordinarily be applicable. Favourable CRA guidance would be welcomed.
8. The August 27, 2010 draft legislation proposes to reduce the maximum permitted bump amount by the “tax-free surplus balance” of the top-tier acquired foreign affiliate, under proposed Regulation 5905(5.4). The historic surplus balances of the acquired foreign affiliates would survive the acquisition of control, subject to possible downward adjustment at the top-tier foreign affiliate, under proposed Regulation 5905(5.2). In either case, the proposals ensure that after the acquisition of control, the tax-free surplus balance of the top-tier foreign affiliate, plus the adjusted cost base of the shares of the top-tier foreign affiliate, does not exceed the fair market value of those shares at the time of the acquisition of control.

CRA’S 2011 MEAL AND VEHICLE RATES

The CRA has released the 2011 meal and vehicle rates that can be used by individuals to calculate meal and travel expenses for purposes of the northern residents’ deductions, moving expenses, and transportation to obtain medical services. The flat rate meal amount remains at $17 per meal to a maximum of $51 per day. For the simplified method of calculating vehicle expenses, the 2011 per kilometre rates are shown in the chart below.

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AVERAGE EXCHANGE RATES FOR 2011

The Bank of Canada has released the 2011 average exchange rates for several currencies. These figures are reproduced in the Canadian Tax Reporter online and on DVD, accessed through “Quick Links” and will be reproduced in Volume 1 at paragraph 360 in a future update. The noon exchange rate for the U.S. dollar on December 30, 2011 was 1.017 and the closing rate on that day was also 1.017.
REVISED INFORMATION CIRCULARS

On December 30, 2011, the Canada Revenue Agency released two revised Information Circulars: IC77-6R, Designation as Associated Charities, and IC97-2R12, Customized Forms. Information Circular IC77-6R, dated December 30, 2011, cancels and replaces Information Circular 77-6, dated April 18, 1997. This circular describes the conditions whereby a registered charity can be designated as being associated with other registered charities as described in subsection 149.1(7) of the Income Tax Act. Information Circular IC97-2R12, dated November 14, 2011, cancels and replaces Information Circular 97-2R11, dated January 10, 2011. This circular sets out the CRA’s guidelines for the production and processing of customized forms. Both of these revised circulars are reproduced in Bulletins and Circulars on CCH Online, and will be in Volume 8 and on DVD in a future update.

PUBLIC CONSULTATIONS ON SR&ED DRAFT POLICY DOCUMENTS

As part of the public consultations on the Scientific Research and Experimental Development ("SR&ED") Policy Review Project, the Canada Revenue Agency ("CRA") released on December 22, 2011 the following three draft policy documents:

(1) Materials for SR&ED Policy (Draft);
(2) SR&ED Policy on the Development of an Asset (Draft); and
(3) SR&ED Policy on Running Production Trials (Draft).

The descriptions in these documents on the topics identified consolidate the content of the CRA publications dealing with the above subjects and are intended to clarify the position of the CRA on those topics when administering the SR&ED legislation under the federal Income Tax Act and Income Tax Regulations.

Taxpayers are asked to send their comments and suggestions on the clarity, readability, and completeness of those documents by February 20, 2012 to the following e-mail address: SRED_Policy-Politiques_RSDE@cra-arc.gc.ca. The CRA will consider all the comments and suggestions related to those documents but will not respond to individual submissions.

These draft documents are reproduced on CCH’s federal income tax News Tracker and will be added to the collection on CCH Online and DVD under Canadian Tax Reporter/CRA Publications/Scientific Research and Experimental Development/Policy Documents as soon as possible.

2012 CORPORATE TAX RATE CHARTS

Charts have been added to the product for 2012 federal and provincial corporate income and capital tax rates, payroll taxes, and health premiums. These charts can be accessed from the “Quick Links” feature in the Canadian Tax Reporter Table of Contents on CCH Online and will be added to the DVD and to Volume 1 in print in a future update. The 2012 personal tax rate charts will be available shortly.

RECENT CASES

Minister’s Basis for taxpayer relief decision flawed, but affirmed since result correct

The corporate taxpayers’ common financial representative (the "Representative") filed their foreign property ownership T1135 forms for 1998 and 1999, but not for 2000 to 2003, in the mistaken belief that it was unnecessary to do so. In the Representative’s view, the Canada Revenue Agency was getting all the information provided in a T1135 form from other filings it made. The taxpayers subsequently late-filed their T1135 forms, but the Minister assessed them for late-filing penalties and interest. The taxpayers filed requests for relief from the late-filing interest and penalties, on the ground that their actions had resulted from a mistaken belief on their part, coupled with an "administrative oversight" on the part of the Representative. In a second-level decision, the Minister granted the taxpayers only partial relief from the interest accruing during a six-month period in which he delayed in replying to their requests. The Minister’s position was that the taxpayers’ relief claims did not fit within the scenarios set out in the relevant Information Circular. In denying the taxpayers’ applications for judicial review, the Federal Court found the Minister’s position to be reasonable, in that he had not fettered his discretion by limiting himself to the scenarios in the Information Circular, because he had before him a broad range of materials from the taxpayers, which he fully addressed (2010 DTC 5154, 2010 DTC 5155, 2010 DTC 5156, 2010 DTC 5157, 2010 DTC 5158). The taxpayers appealed to the Federal Court of Appeal.
The taxpayers’ appeals were dismissed. The Minister’s decision was unreasonable, because he did not draw upon s. 220(3.1) to guide him in the use of his discretion but in fact limited himself to the scenarios in the Information Circular. On the evidence, it was not open to the Federal Court to find otherwise. However, there was no practical end to be served in setting the Minister’s decision aside, because the taxpayers’ explanations for their conduct were entirely without merit, and could not succeed even if the Minister was ordered to make a redetermination. Despite his breach of the applicable principles, the Minister still reached the only possible decision on the facts in this case, and that decision should not be disturbed.

¶47,914, Stemijon Investments Ltd., 2011 DTC 5169

Jeopardy collection order set aside

The Minister obtained from the Federal Court an ex parte jeopardy collection order (the “Order”) on the representations that the taxpayer was liquidating his assets and moving to Florida. The taxpayer applied to the Federal Court for an order setting aside the first Order.

The taxpayer’s application was granted. In obtaining the Order, the Minister’s counsel misled the judge by: (a) leaving the impression that the taxpayer was evading tax; (b) failing to tell the judge that the taxpayer intended to object to some outstanding tax assessments; (c) failing to tell the judge that the proceeds of the taxpayer’s liquidation of some assets were subsequently used to purchase a residence in Canada; and (d) leaving the impression that the taxpayer intended to move to Florida, whereas the evidence indicated that he intended to remain in Canada. The Order was set aside accordingly.

¶47,915, Proulx, 2011 DTC 5170

Application to set aside ex parte jeopardy collection order refused

The taxpayer applied under s. 225.2(8) for an order setting aside an ex parte jeopardy collection order previously obtained against him by the Minister from the Federal Court (the “Original Order”), and orders cancelling all writs of execution issued and all seizures executed under the Original Order.

The taxpayer’s application was dismissed. As a condition of issuing a jeopardy collection order, s. 225.2(2) requires the existence of reasonable grounds for believing that delay in collecting tax would jeopardize the Minister’s chances of recovering the tax. The taxpayer failed to report income of $3,108,468, and there were assessments of tax totalling at least $1,365,808 outstanding against him. His credit card balances amounted to $1,223,275, and he had appropriated funds totalling $1,556,266 from corporations of which he was a shareholder. Three months after receiving his assessments of tax, he gave his mother mortgages on two of his properties. He had also begun liquidating assets and withdrawing significant amounts from his investment and bank accounts, which he spent for his own benefit. In addition, he refused to provide the Canada Revenue Agency with a list of assets when requested to do so. Therefore, he failed to discharge the onus of showing that the Original Order issued against him did not meet the criteria in s. 225.2(2).

¶47,916, Tehrani, 2011 DTC 5171

Orders to produce documents quashed due to lack of disclosure

The Minister applied for and received ex parte orders requiring the respondent life insurance companies to provide identifying information concerning their clients who were involved in “10-8” plans. These plans involved two essential elements: a life insurance policy including an investment account and a loan secured by the life insurance policy in an amount equal to the balance of the investment account. The term “10-8 plan” refers to the interest rates applicable to these elements — the policyholder pays 10% interest on the loan and receives an 8% return on the investment in the life insurance policy. A 10-8 plan creates a tax benefit, because the 8% interest paid to the client is tax exempt as part of a life insurance policy, and the 10% interest payable on the loan may be tax deductible if it is used to produce income. Subsequent to these orders, the Minister, in compliance with court orders, produced internal documents suggesting staff believed that 10-8 plans complied with the letter, if not the spirit, of the Income Tax Act. The respondents applied for an order quashing the ex parte orders.

The respondents’ applications were allowed. The Court found that the Minister had failed to make full disclosure when applying for the orders, and that they must be cancelled. First, the Minister did not disclose the significant volume of information that the respondents had already provided. Second, and more troubling, the Minister did not disclose the internal documents. These documents were undoubtedly material and, had they been disclosed to the Court, could certainly have affected the outcome of the ex parte applications. The fact that the Minister had decided to undertake an “audit blitz” to “send a message to the insurance industry” was clearly relevant to the balancing exercise. While not
necessary to its decision, the Court was also of the opinion that, while the Minister had a valid audit purpose in requesting the information, the Minister’s primary purpose was to send a message to the insurance industry.

¶47,917, RBC Life Insurance Company, 2011 DTC 5172