Complex Made Simple: Tax Developments Every Corporate Counsel Should Know

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Goodmans LLP

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About Goodmans

Goodmans is recognized as one of Canada's leading business law firms offering market-leading expertise in specialties such as mergers and acquisitions, corporate finance, securities, corporate/commercial, banking and finance, private equity, REITs and income securities, tax planning, restructurings, litigation and commercial real estate. Founded in 1917, Goodmans has offices in Toronto and Vancouver with over 200 lawyers.

Goodmans provides a complete range of legal advice and representation to domestic and foreign business clients ranging from entrepreneurial businesses to multinational corporations, financial institutions, pension funds and governments across a wide range of industries.

Our lawyers are consistently recognized by leading industry arbiters, and in various surveys of clients and peers conducted by *Lexpert*, *Lexpert/American Lawyer Media*, *Chambers and Partners*, *Practical Law Company*, *Euromoney*, *International Financial Law Review, Law Business Research* and *Best Lawyers in Canada*. According to *Chambers and Partners*, as Canada's 21st largest law firm, Goodmans ranks solidly first in Canada on the proportion scale with over 20% of our lawyers recognized as the best in their fields.

Below is a sampling of our recent accolades:

- The Lexpert/American Lawyer *Guide to the Leading 500 Lawyers in Canada* (2011 edition) lists 22 Goodmans partners among the leading Canadian lawyers excelling in 16 practice areas of law.
- The *Canadian Legal Lexpert Directory 2011* recognizes 40 Goodmans lawyers as being top-tier in their fields and leaders in 26 distinct areas of law.
- Chambers Global's *Guide to the World's Leading Lawyers 2011* ranks 41 individual Goodmans lawyers among Canada's finest. Goodmans' Restructuring/Insolvency Group stands alone as Number 1 in Canada for the 10th consecutive year and the Corporate M&A, Real Estate and Telecommunications practices are also ranked top-tier.
- In 2008 and 2009, Goodmans was named "National Law Firm of the Year for Canada" at *International Financial Law Review's* Americas Awards.
- *PLC Which Lawyer? Yearbook* ranks Goodmans in their top category in capital markets and restructuring and insolvency and "highly recommended" for banking and finance, construction, corporate real estate, corporate mergers and acquisitions, dispute resolution, private client, private equity/venture capital, tax and telecoms and media.
- *International Financial Law Review* 1000 ranks our M&A and insolvency and restructuring practices top tier and also recognizes our strength in capital markets and bank lending.
- *The Best Lawyers in Canada 2012* ranks 54 Goodmans lawyers across 27 practice areas, as among the best lawyers in Canada.
- *American Lawyer Media's 2010 Go-To Law Firm for the Top 500 Companies* guide selected Goodmans as a "go-to" law firm for financial service companies in the area of Canada.

Corporate Tax

Goodmans' tax group is among the best in Canada. Our tax practice is transaction-driven and focused on providing our clients with dynamic, strategic and practical tax advice in structuring their business transactions. Our tax group has played a key role in the successful and efficient completion of the firm's M&A, corporate finance and restructuring transactions, frequently developing innovative structures and planning to address complex transactions and structuring challenges.

Goodmans' tax lawyers have worked on many of the country's most innovative deals. We bring the same energy, expertise, innovation and practicality to all of our transactions and have advised public and private companies, private equity funds, investment banks, venture capital investors, entrepreneurs and start-up companies.

The members of the tax group possess deep experience and knowledge that results in practical, innovative and dependable tax advice for our clients. Many of our tax partners are currently ranked by Chambers Global *The World Leading Lawyers*, *The Canadian Legal Lexpert Directory*, *The Lexpert/American Lawyer Guide to the Leading 500 Lawyers in Canada, The Best Lawyers in Canada*, Euromoney's *Guide to the World's Leading Tax Advisors* and Practical Law Company's *Which Lawyer?*

Goodmans has a wealth of experience in dealing with both tax compliance and litigation matters. Our tax dispute resolution group consists of individuals skilled at negotiating with tax authorities and at conducting tax appeals before the tax courts. Our lawyers have represented clients at every type of tax and trade tribunal, including the Tax Court of Canada, the Ontario Municipal Board, the Supreme Court of Ontario, the Federal Court of Canada and the Supreme Court of Canada. Our clients, whether individuals or corporations, receive high quality and effective advice and counsel in reaching settlements when involved in a taxation dispute.

Our areas of expertise include:

- Domestic and international mergers and acquisitions, joint ventures and corporate reorganizations, both public and private
- Corporate finance transactions and public and private equity and debt financings
- International tax planning including transfer pricing disputes
- Private equity transactions, including fund formation, financings, acquisitions and dispositions
- Real estate transactions and financings
- Executive compensation planning
- Commodity taxation
- Trust, estate and personal domestic and international tax planning
- Tax dispute resolution and tax litigation.

Tax Litigation

Our Tax Litigation group advises clients on all aspects of tax disputes in Canada and around the world. We have recognized expertise in resolving disputes. Our group consists of experienced individuals skilled at negotiating with tax authorities and at conducting appeals before the tax courts. Our clients, both individuals and corporations, receive top-notch advice and counsel in reaching settlements.

Goodmans has a wealth of experience in litigation matters, having appeared at every type of tax and trade tribunal including the Tax Court of Canada, the Ontario Municipal Board, the Supreme Court of Ontario, the Canadian International Free Trade Tribunal, the Federal Court of Canada and the Supreme Court of Canada.

Members of our group have recently appeared before the Federal Court of Appeal in *Craig* v. *The Queen* (leave to appeal to the Supreme Court of Canada pending), *Magicuts Inc.* v. *The Queen*, and *Cardella* v. *The Queen*. They have recently appeared before the Tax Court of Canada in appeals including *Daniels* v. *The Queen* and *Crown Forest Industries* v. *The Queen*. They have settled tax disputes involving the general anti-avoidance rule, offshore financings, interest deductibility, take-over expenses, GST, transfer pricing, director's liability, and many other issues.

Complex Made Simple: Tax Developments Every Corporate Counsel Should Know

Panellists

Maureen Berry

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Agenda

8:00am – 8:05am	Introduction and Overview
8:05am – 8:20am	Doctrine of Rectification
8:20am – 8:40am	Current Proposals ▪ RRSP Proposals ▪ Partnership Deferral Proposals ▪ Reporting – Aggressive Tax Planning
8:40am – 9:00am	Stock Options and Executive Compensation
9:00am – 9:20am	CRA Audits, Privilege and Directors' Liability
9:20am – 9:30am	Questions

Doctrine of Rectification

- Remedy that is part of inherent jurisdiction of the courts to correct mistakes that do not reflect the true agreement of the parties.
- Courts typically impose a high standard of proof on an applicant seeking rectification because of the risk of imposing on a party a contract that he did not make.
- In general, applicant must establish that the written instrument, as originally drafted, does not reflect the true agreement of the parties and that the parties share a *common and continuing* intention to contract in the amended form of agreement.
- Rectification is available only if the mistake occurred in recording the agreement; the court will not correct a mistake in the substance of the agreement itself.
- Recent cases involving tax matters have adopted a broad scope for permitting rectification.

Doctrine of Rectification

Court Ordered Rectification vs. Self-Correction

- Rectification must be ordered by a court in order to be effective and binding as against third parties such as CRA. CRA cannot collaterally attack the validity of the order in a proceeding in the Tax Court of Canada. (See *Wilson* ([1983] 2 S.C.R. 594) and *Dale* (97 D.T.C. 5252)).
- *Sussex Square Apartments* (99 D.T.C. 443, aff'd 2000 D.T.C. 6548)
  - Taxpayer transferred leases in several apartments. Intention was to sublease the apartments so that consideration paid to the taxpayer would be prepaid rent (eligible for reserve), and not immediately taxable as proceeds of sale.
  - British Columbia Supreme Court converted some leases to subleases; remainder of leases were converted into subleases without the benefit of a court order. Tax Court of Canada refused to respect as subleases those leases that had been self-rectified (at page 451):

    "[I]t would be pushing the *Dale* principle too far if I applied it to contractually agreed fiscal revisionism without the benefit of a court order."

Doctrine of Rectification

- Seminal case is *Juliar* (46 O.R. (3d) 104, aff'd 50 O.R. (3d) 728)
  - Transfer of shares of Opco to Holdco in exchange for a promissory note. Taxpayer intended transfer to be tax-free.
  - Miscalculation of ACB of Opco shares resulted in deemed taxable dividend under section 84.1 of the Tax Act.
  - Ontario Superior Court of Justice rectified transaction by retroactively substituting shares of Holdco for the promissory note.
  - Subsection 85(1) election late-filed.
- Four requirements for rectification:
  1) a prior agreement;
  2) a common intention;
  3) a final document which does not properly record the parties' intentions; and
  4) a common or mutual mistake.

Doctrine of Rectification

- *AIM Funds Management* (2009 O.J. No. 4798):

> “To obtain an order rectifying a contract, the applicant must prove: (1) a common intention held by the parties to the contract before the making of the written contract alleged to be deficient; (2) that this common intention remained unchanged at the date that the written contract was signed; and (3) that the written contract, by mistake, does not conform to the parties’ prior common intention.”

Examples of Rectification Orders

- *Re GT Group Telecom Inc.* ([2004] O.J. No. 4289): Ontario Superior Court of Justice retroactively converted the wind-up of a subsidiary into a vertical amalgamation and re-sequenced the acquisition of the amalgamated company so that the acquisition occurred after the amalgamation.

Doctrine of Rectification

- *Re Columbia North Realty* (2006 D.T.C. 6124)
  - Barbados company capitalized a Nova Scotia company without receiving shares for its capital contributions. Nova Scotia company then distributed cash to Barbados company as a return of paid-up capital, resulting in deemed dividends subject to withholding tax.
  - Nova Scotia Supreme Court retroactively issued common shares in consideration for its capital contributions, resulting in distributions being treated as returns of paid-up capital.
- *Bramco Holdings Co.* ([1994] O.J. No. 329, aff'd [1995] O.J. No. 157)
  - Applicant seeking to avoid land transfer tax liability applicable to a non-resident purchaser. Application to change the purchaser of the land to a resident sister corporation.
  - Ontario Court of Appeal refused rectification: applicant had deliberately planned to transfer land to non-resident purchaser to save income tax; the incidence of the higher rate of land transfer tax was simply not understood by the applicant.

Doctrine of Rectification

- *QL Hotel Service Ltd.* ([2008] O.J. No. 1365, aff'd [2009] O.J. No. 4117)
  - Taxpayer intended that transfer of tangible personal property be structured to qualify for exemption from Ontario retail sales tax. Exemption did not apply because property was transferred to wholly-owned subsidiary at time of transfer.
  - Ontario Superior Court of Justice granted rectification by issuing share immediately before transfer of property
- *Saffron Rouge* (2008 D.T.C. 6112)
  - Ontario Superior Court of Justice refused to grant rectification order to convert a corporation that had qualified as a CCPC before it issued certain shares to non-residents back into a CCPC retroactively to permit shareholders to access capital gains exemption.

Doctrine of Rectification

Requirement to Notify CRA

- Income Tax Technical News 22 (January 11, 2002), CRA stated:

  "1. If we are not properly informed about the rectification application, our reaction will be to contest the rectification order in Provincial Court.

  2. If we think the process has been abused, we will consider taking the right case through the Tax Court process."

- 2005 Canadian Tax Foundation Conference:

  "It will no longer be our position to contest a rectification if we have not been made aware of it. Rather, as is the case for all rectification files, we will challenge those situations that we believe are abusive."

Doctrine of Rectification

- Cases are divided on whether CRA must be notified:
  - *Snow White* (2005 D.T.C. 5150): rectification order granted to revise the structure of a film production to permit the film to qualify for certain federal and provincial film production tax credits that would otherwise be lost. CRA was served with a copy of the notice of the application, but was not made a party. British Columbia Supreme Court:

    "The procedure followed by the Petitioner in serving the materials and notifying C.C.R.A. and the Attorney-General of Canada representing C.C.R.A. is an appropriate procedure to be followed when rectification of an instrument is requested where the parties to the instrument have entered into a transaction in order to be entitled to arrange their affairs to avoid the payment of tax or to take advantage of tax incentives available to them."

  - *QL Hotel Service* Limited ([2008] O.J. No. 1365, aff'd [2009] O.J. No. 4117): Ontario Superior Court of Justice held that since the Minister had a direct interest in the matter, the Minister should be given notice of the application.

Doctrine of Rectification

- *Re Columbia North Realty* (2006 D.T.C. 6124): Nova Scotia Supreme Court observed that rectification order being sought would affect the tax payable by the applicant in prior taxation years. Since the rectification order would bind the Minister, unless appealed, it was appropriate that the Minister be given notice of the application in order to make submissions to the Court.
- *AIM Funds Management Inc.* (2009 O.J. No. 2408): Court stated that role of the Minister is to test the stated common intentions of the parties when the original agreement was executed and to ensure that all of the relevant information is before the Court:

  "[Attorney General] should be added as a party by intervention only (1) where it has already established its position as a creditor, such as by a tax assessment or ruling, and (2) where all parties to the application are aligned in interest, such that there would be no adverse party testing the assertions of the parties as to their common intentions. I do not intend by this to suggest that the AGC has a right to intervene in every rectification application where it satisfies both parts of this test, nor do I intend to limit interventions of the AGC to these situations. The intervention is a matter of the court's discretion and each case will be decided on its own facts."

Doctrine of Rectification

- *Prospera* ([2002] B.C.J. No. 3033): certain steps set out in amalgamation agreement were not carried out as intended. Taxpayer sought rectification transaction so that it would accord with the amalgamation agreement. British Columbia Supreme Court granted rectification notwithstanding that CRA had not been notified of the application.
- *Re Razzaq Holdings Ltd.* ([2000] B.C.J. No. 2573): Application to rectify the incorrect issuance of shares as part of a corporate reorganization to permit two brothers to transfer their shareholdings to their respective holding companies in order to separate their business interests. CRA was not a party to the petition. British Columbia Supreme Court observed that CRA was not, nor was it likely to be, a creditor of the applicant as a result of the improperly implemented section 85 rollover, and therefore concluded that it was not required to take CRA's interests into account.

RRSP Proposals

- 2011 budget proposals significantly impact the taxation of registered retirement savings plans (“**RRSPs**”) and registered retirement income funds (“**RRIFs**”). Rules propose to extend the anti-avoidance provisions in the context of tax-free savings accounts (“**TFSAs**”) to RRSPs and RRIFs (“**Registered Plans**”). Proposals also change treatment of non-qualified investments. These rules will generally be effective after March 22, 2011.
- Broadly, the new rules implement a penalty tax on any income that is an “advantage” and on the acquisition by an RRSP of a “prohibited investment”.
- Rules also apply to “swap transactions” and “RRSP strips”.
- Tax applicable to prohibited/non-qualified investments is 50%, and tax applicable to “advantages” is 100%. Both penalty taxes may be refunded or waived in certain circumstances.
- Issuer of Registered Plan must exercise due diligence respecting qualified investments, and may be liable for penalty tax if issuer confers advantage.

RRSP Proposals

- **An “advantage” includes:**
  - Benefits from transactions that would not have occurred in an open market, where the transaction was undertaken to benefit from the tax attributes of a Registered Plan;
  - Payments made to a Registered Plan for services;
  - Payments of investment income, where the income is tied to the existence of another investment;
  - Benefits from “swap transactions”, which are transfers of property between Registered Plans and other accounts controlled by the holder of the Registered Plan;
  - Income, including capital gains, derived from a “prohibited investment”;
  - Certain income from “non-qualified investments”, the amount of which has not been removed from a Registered Plan within 90 days of a request by the Minister that the income be removed; and
  - Benefits from “RRSP strip” transactions.

RRSP Proposals

"Prohibited Investment"

- A "prohibited investment" generally includes:
  - Debt of a holder.
  - Investments in entities in which the holder, or a non-arm's length person, has a significant interest (generally 10% or more), or with which the holder does not deal at arm's length.
- A qualified investment may be a prohibited investment. Certain changes made to determine qualified investment status for private company shares.
- Gains and income from prohibited investments are "advantages", subject to 100% penalty tax (gains and income from non-qualified investments must be paid to holder).

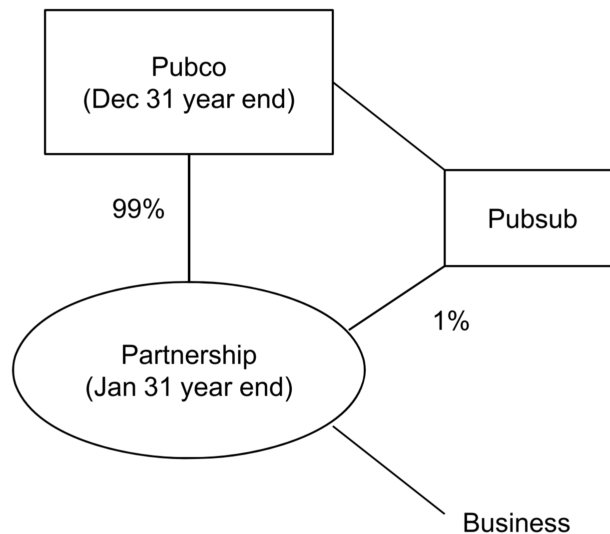
RRSP Proposals

Problem Areas

- Registered Plan may have owned qualified investment on March 22, 2011 that is now a prohibited investment under the proposals (for example, certain private company shares, public company if >10% owned by holder and non-arm's length persons). Limited grandfathering is available, and election must be filed before July, 2012.
- Private company shares (timing of 10% test / open market / change in status).
- Public company shares (breadth of 10% test).
- Mutual funds.
- 100% advantage tax is excessive.

Partnership Deferral Proposals

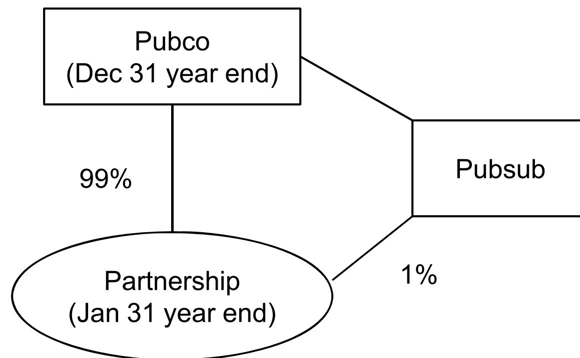
- On March 22, 2011, Department of Finance announced measures to limit the deferral of tax on income earned by a corporation through a partnership if the partnership has a fiscal period that differs from the corporation's taxation year. Draft legislation was released on August 16, 2011.



Current Rules

Income earned in Partnership's fiscal period ending January 31, 2012 is included in Pubco's income for its taxation year ending December 31, 2012 – without the partnership structure, eleven months of income (February – December, 2011) would be taxable in Pubco's 2011 taxation year.

Partnership Deferral Proposals



Partnership Deferral Proposals

In addition to normal partnership allocation, a notional amount of income equal to 11/12 of income earned in Partnership's fiscal year ending January 31, 2011 is included in Pubco's income for its taxation year ending December 31, 2011.

- In general, the proposals apply where (i) a corporation has a "significant interest" in a partnership at the end of the last fiscal period of the partnership that ends in the corporation's taxation year; (ii) another fiscal period of the partnership (the "**Stub Period**") begins in the year and ends after the year; and (iii) at the end of the year, the corporation is entitled to participate in the partnership for the Stub Period.
  - "Significant interest" – the corporation (or the corporation together with related or affiliated persons) is entitled to more than 10% of the income (or loss) of the partnership or to more than 10% of the assets (net of liabilities) of the partnership if it were to cease to exist.

Partnership Deferral Proposals

Adjusted Stub Period Accrual ("ASPA")

- Corporate partner must include in its income a notional amount of partnership income "accrued" to it during the Stub Period (ASPA).
- ASPA is calculated on a partnership-by-partnership basis and either by reference to partnership income in a prior fiscal period or by a lesser amount designated by the corporate partner.
  - a designation to suppress ASPA exposes the corporate partner to a potential income inclusion in respect of any underreported ASPA.
- In computing its income for a particular taxation year, a corporate partner may deduct an amount that was included in its income as ASPA in the previous taxation year.
- A corporate partner that is a member of multiple partnerships cannot directly net its ASPA in respect of the partnerships.

Partnership Deferral Proposals

Transitional Relief

- Transitional relief available to alleviate the cash flow impact that a corporate partner will face on the initial application of the rules (i.e. up to 24 months of income).
- Corporate partner that is eligible for transitional relief may deduct an amount from its income equal to a "specified percentage" of its "qualifying transitional income" ("**QTI**"). Any amount of QTI deducted in computing income for a taxation year must be included in corporate partner's income in the following taxation year.

Practical Limitations

- Deduction of QTI limited to the corporation's income for the particular year.
- QTI reserve in a subsequent year may be affected by the reserve in a preceding year.
- QTI reserve is lost if the partnership no longer "principally carries on the activities to which the reserve relates".

Partnership Deferral Proposals

Fiscal Period Alignment Rules

- Single tier alignment election is generally possible.
- In a multi-tier partnership structure, where there is at least one partnership with a corporate partner that owns a significant interest, each partnership within the structure will automatically have a calendar year fiscal period.
- May file a multi-tier alignment election designating an off-calendar fiscal period.
- It seems that newly formed partnerships will not be entitled to elect under a multi-tier alignment election to maintain an off-calendar year fiscal period.

Partnership Deferral Proposals

Problem Areas

- Rules are very technical, and apply in many situations. Finance was asked to increase threshold for application of rules from 10% but declined to do so.
- Partnerships with two joint venture partners that have different year ends.
- Netting partnership income and losses is subject to risk of under-reporting ASPA.
- QTI reserve rules are narrow in certain circumstances.
- Various issues with acquisitions of control of corporate partners.
- Effect of ASPA on other tax accounts (CDA, RDTOH, GRIP, safe income, SBD, etc.).

Reporting – Aggressive Tax Planning

- Backgrounder released on May 7, 2010 – draft legislation released on August 27, 2010.
- Purpose of proposals is to facilitate identification of potentially abusive transactions.
- Current trend in global tax administration to require more detailed reporting of “aggressive” transactions. Similar rules enacted in Quebec and in other jurisdictions. Canada has also entered into many tax information exchange agreements.

Reporting – Aggressive Tax Planning

What is "aggressive" tax planning?

- "Reportable transaction" – each transaction or series of transactions that includes an "avoidance transaction" and that has 2 or more of the following hallmarks:
  - contingent fees (amount payable to advisor or promoter is based on amount of tax benefit, success of achieving tax benefit, or broadly marketed tax transactions);
  - confidential protection for promoter or advisor (disclosure of tax structure is prohibited);
  - contractual protection (insurance, indemnity or other protection respecting success/failure of tax planning or dispute costs, or assistance in the course of a dispute).

Reporting – Aggressive Tax Planning

Consequences

- If a "reportable transaction" has been implemented, each participant (every person for whom a tax benefit results), and each advisor or promoter that received a contingent fee or a payment in respect of contractual protection, is required to file an information return which fully describes the transaction.
- Filing by any person of information return with "full and accurate disclosure" of all relevant transactions satisfies reporting obligation for all persons required to file. However, because of due diligence defence, different parties may have different reporting obligations.
- If filing is not made, tax benefits are effectively suspended until penalties and interest are paid in full. Tax benefits remain subject to challenge by CRA under GAAR or otherwise.
- Penalties are equal to the total of contingent fees and payments for contractual protection in respect of a transaction. Joint and several liability for all persons required to file, subject to limits for promoters and advisors.

Reporting – Aggressive Tax Planning

Problem Areas

- **Various definitions and concepts are too broad.**
  - Contingent fee includes "a fee that ***to any extent*** is based on the amount of a tax benefit" (fixed fee retainers/value billing/repeated transactions/tax a small component of overall legal advice). Consider wording of engagement letters.
  - Confidential protection means "anything that prohibits" the disclosure of the details of the transaction (engagement letters, opinions, normal commercial agreements).
  - Contractual protection means any form of protection that protects against any failure to achieve a tax benefit (representations as to tax pools).
  - Advisor includes anyone providing assistance or advice with respect to planning or implementation of transactions.
  - Obligations imposed on "every person for whom a tax benefit results" (current or future shareholders).

Reporting – Aggressive Tax Planning

Problem Areas (cont'd)

- Lawyers may have reporting obligation and potential liability for penalties. Conflicts with professional responsibility, confidentiality, objectivity. In response to CBA submission, Minister Flaherty assures that rules are not designed to require disclosure of matters that are subject to solicitor-client privilege.
- Not clear how penalties are apportioned or who has primary responsibility to pay.
- Coming into force: transactions after 2010. Broad "series of transactions" concept for historic transactions that end after 2010.

Stock Options and Executive Compensation

Changes to Stock Compensation Rules enacted in 2010 relate to:

- Withholding and remittance obligations.
- Deductions in respect of cashing out stock options.
- Election to defer tax on stock option benefit for public company stock.

Changes to Other Executive Compensation Arrangements

- CRA has announced a review of conversions of one form of incentive plan to another (i.e., RSUs to DSUs).
- No rulings will be given pending review.

Stock Options and Executive Compensation

Taxation of Stock Options

- Employee stock options are generally taxable to an optionholder
  - when exercised for non-CCPC options (s. 7(1)).
  - when the option shares are disposed of for CCPC options (s. 7(1.1)).
- Amount of the stock option benefit equals the in-the-money amount of the option.
- Share units and bonuses paid in stock are also taxable when the shares are acquired.
- Provided certain requirements are met (s. 110(1)(d) and 110(1)(d.1), an employee can deduct 50% of the stock option benefit (25% for Quebec provincial tax purposes).

Stock Options and Executive Compensation

- In order to qualify for the 50% deduction under s. 110(1)(d)
  - the exercise price under the option must be not less than the fair market value of the share on the day the option is granted.
  - the share must be a “prescribed share” (Reg. 6204).
  - employee must deal at arm’s length with the employer.
- “Plain vanilla” common shares will generally qualify as prescribed shares; however, share with redemption or retraction rights, fixed dividend or liquidation entitlements typically will not.
- Rights contained in other agreements in respect of the share, such as shareholders agreements or employment agreements, must also be taken into account in determining whether a share is a prescribed share.
- In order to qualify for the 50% deduction under s. 110(1)(d.1) with respect to CCPC options, the employee must not have disposed of the share (otherwise than as a consequence of death) or exchanged the shares within 2 years after the date it was acquired.

Stock Options and Executive Compensation

Withholding requirements

- Prior to the 2010 amendments, CRA took position that withholding in respect of a stock option benefit was required under s. 153(1) of the ITA.
- However, administrative relief was granted to Canadian residents where:
  - withholding would result in *bona fide* hardship to the employee (generally applied if employee's cash remuneration from the entity conferring the stock compensation benefit was insufficient to fund withholding), or
  - the stock compensation benefit was conferred by a non-resident (i.e., parent or affiliate of the employer), the non-resident was not paying any cash remuneration to the optionholder and the Canadian resident employer did not compensate the non-resident in any way with respect to the options.

Stock Options and Executive Compensation

- New s. 153(1.01) has been added to the ITA.
- It provides that stock compensation benefits under s. 7(1) are "remuneration paid as a bonus" for purposes of tax withholding requirements, resulting in an employer's obligation to withhold.
- There are three exclusions to this requirement to withhold:
  - amounts deductible under s. 110(1)(d) – this allows the 50% deduction to be taken into account in determining the amount subject to withholding
  - stock option benefits in respect of CCPC options (which are not taxable until the share acquired on exercise of the option is disposed of)
  - amounts deductible where securities are sold upon the exercise of an option and the proceeds are donated to charity.
- CRA is also now prohibited from taking into account the fact that a stock option benefit is a non-cash benefit in determining whether the hardship rules should apply (s.153(1.31)).

Stock Options and Executive Compensation

- Very limited grandfathering – options granted before 2011 pursuant to a written agreement entered into before March 4, 2010 that contained a prohibition on the disposition of shares for a period of time after exercise.
- No particular mechanism for withholding is required by the provision.
  - Employer needs to find a solution, which may necessitate changes to plan documents and agreements to ensure that a source of cash available to fund the remittance obligation is available.
  - Mechanisms may include sale of shares on employee's behalf through a broker, withholding from other remuneration, or the employee funding the remittance obligation.
  - Funding the withholding likely more difficult if shares are not publicly-traded.

Stock Options and Executive Compensation

Cash-Out Rights

- Many option plans allow optionholders to elect to surrender their options for cash equal to the “in-the-money amount” of the option (a “cash-out right”).
- The use of this cash-out right did not prevent the 50% deduction (under s. 110(1)(d)) if the deduction would have been available had the option been exercised.
- Prior to March 4, 2010, if an employer paid cash on the exercise of a cash-out right, the employer could generally deduct 100% of the amount paid.

Stock Options and Executive Compensation

Cash-Out Rights

- New subsections 110(1.1) and 110(1.2) provide that the employee will be denied the 50% deduction under s. 110(1)(d) unless the employer elects to forego its deduction (and any deduction by non-arm's length persons) in respect of the cash-out payment.
- Election is made by completing Box 86 on the T-4 slip.
- Employee must file evidence of the election with the tax return claiming the 110(1)(d) deduction.
- New rules apply to all cash-out rights exercised after March 4, 2010, regardless of when the option was granted.
- The election must apply to all of an employee's options under a particular option agreement, although not necessarily all option agreements with a particular employee.

Stock Options and Executive Compensation

- If cash-out rights are exercised from time to time, need to ensure that no deductions are claimed with respect to those for which an election was made.
- Consideration need be given as to whether employer or employee gets the benefit of a deduction when a cash-out right is exercised – how will the competing interests be managed?
- Consider whether there will be a trend in option agreements toward explicitly stipulating whether an election will be made or whether cash-out rights will no longer be included on a regular basis in option agreements.
- The election may also be required in circumstances when the employer would not otherwise be entitled to a deduction for cash paid on the surrender of an option.

CRA Audits, Privilege and Directors′ Liability

Maintaining Books and Records

- All taxpayers who are carrying on business are required to keep records and books of account (s. 230 ITA).
- Note purpose requirement in s. 230

  “as will enable the taxes payable under this Act …
  to be determined”

- Do non-source materials have to be retained?
- Retention period – s. 230(4)
  - Prescribed Periods – Regulation 5800 – minute books, corporate records, two years after dissolution of corporation
  - Other records – six years from the end of the taxation year to which the records relate
  - Records relevant to objection or appeal must be kept until completion of objection or appeal

CRA Audits, Privilege and Directors' Liability

- Generally, only documents that create legal relationships will create tax liability.
- If the purpose of a transaction is part of the statutory test, review of extraneous records is probably required.
- Does GAAR make purpose or intent relevant to <u>every</u> transaction?
- Record retention – Balance between minimizing CRA scrutiny and maintaining evidence for other purposes
  - *Husky Oil* – no negative inference drawn from taxpayer's systematic culling of all drafts, notes and non-essential correspondence from its files after completion of transaction

CRA Audits, Privilege and Directors' Liability

CRA Audit and Inspection Powers

- CRA's statutory audit and inspection powers are very broad and statutory language has been given full scope by the Courts.
- s. 231.1 – general audit and inspection power
  - low threshold – "for purposes related to the administration or enforcement of the Act."
  - What can be examined?
    - books and records of a taxpayer
    - any document of the taxpayer or any other person
  - that relate or may relate to information in, or what should be in, the books and records of a taxpayer
  - "may relate" threshold has been given broad meaning by the Courts
- Owner or manager of the business must give all reasonable assistance and answer all proper questions relating to the administration or enforcement of the Act.

CRA Audits, Privilege and Directors' Liability

CRA Audit and Inspection Powers

- Requirement to provide information (s. 231.2 ITA) for purposes relating to:
  - administration or enforcement of the Act;
  - a comprehensive tax information exchange agreement; or
  - a tax treaty between Canada and another country
- CRA may require:
  - information, including return of income; and
  - any document
- Cases have made it clear that CRA can require the creation of information through a s. 231.2 requirement.

CRA Audits, Privilege and Directors' Liability

- Section 231.2(2) of ITA – Unnamed persons
  - requires CRA to obtain judicial authorization to issue requirements in respect of unnamed persons
  - however, threshold for granting the authorization is low
  - the judge must be satisfied:
    - a group is ascertainable; and
    - the requirement is for the purpose of verifying compliance with any duty or obligation under the Act by the person or persons in the group

Redeemer Case

- Supreme Court of Canada upheld very broad audit and inspection powers under s. 231.1
  - s.231.2(2) not necessary if information relating to unnamed persons is relevant to the compliance of a taxpayer under audit
  - s.231.2(1) or (2) must be used where information is sought from a third party not under audit

CRA Audits, Privilege and Directors' Liability

CRA Audit and Inspection Powers

- Foreign Based Requirements (s. 231.6 ITA)
- Section 231.6(8)
  - If there is a failure to comply substantially with foreign based requirement, introduction by the taxpayer of any foreign based information covered by the requirement may be prohibited

CRA Audits, Privilege and Directors' Liability

CRA Audit and Inspection Powers

- CRA Interpretation "Acquiring Information from Taxpayers, Registrants and Third Parties"
  - Sets out CRA's administrative position regarding its audit powers
  - Provides some limits to process

    "Officials will always attempt to collect information from the most direct source in the least intrusive manner possible"

- Accountant's Working Papers
  - CRA states:

    Accountant's and auditor's working papers may be necessary, although not routinely required

CRA Audits, Privilege and Directors' Liability

Privilege

- Now recognized as substantive right not just a rule of evidence.
- Therefore, privilege can be asserted at any time against any form of disclosure.
- Canada recognizes one of the broadest rights to privilege.
- However, privilege is an exception. The general rule is all relevant documents must be produced.

CRA Audits, Privilege and Directors' Liability

- Litigation Privilege
  - covers solicitor-client and other communication where litigation is occurring or pending
  - covers communications by lawyer and taxpayer with third parties
  - covers work product documents
  - privilege is temporary – lasts during litigation and ceases following litigation including follow-up litigation (*Black v. Canada*)
  - litigation must be the dominant purpose for preparation of the document

CRA Audits, Privilege and Directors′ Liability

- Solicitor-Client Privilege
  - Covers communications between solicitor and client for the purpose of giving legal advice that are intended to be confidential
  - Not absolute (e.g. advice relating to future criminal activity) but as close to absolute as possible
- Belongs to client.
- May be waived with client's informed consent.
- Inadvertent disclosure does not automatically eliminate privilege.
- Onus on those seeking to set aside privilege.

CRA Audits, Privilege and Directors' Liability

- Limitations
  - Does not apply to every communication between solicitor and client
  - Does not apply where legal advice is not sought or given
  - Where communication is not intended to be confidential (for example, copies outside of solicitor-client relationship)
  - Does not apply to facts
  - Privilege does not attach solely because documents are in the possession of a solicitor
  - Something not privileged cannot become privileged because it is imbedded in a solicitor-client communication

CRA Audits, Privilege and Directors' Liability

- In-House Counsel
  - Privilege applies to communications by in-house counsel to the corporation
  - However, does not apply to all communication by in-house counsel
  - Must satisfy general rules of solicitor and client privilege
  - Does not apply to business advice
  - Does not apply to general corporate policy
  - In-house counsel privilege not generally accepted in Europe

CRA Audits, Privilege and Directors' Liability

- Common Interest Privilege
  - Information must be shared between parties on a confidential basis
  - Parties must have sufficient common interest
    - defendants in litigation
    - successful completion of a commercial transaction
    - “acting together against a common foe”
- Corporate Groups
  - Separate legal existence is the general rule
  - All members of a corporate group are not treated as one for the purposes of claiming privilege
  - Must apply common interest privilege to disclosure to corporate group or among members of corporate group
- Limited Waiver
  - Privilege will not be lost when privileged communication is provided by client to auditor pursuant to auditor’s statutory right to receive information.

CRA Audits, Privilege and Directors' Liability

Capturing and Maintaining Privilege

- Create evidence of the hallmarks of privilege
  - legal advice
  - confidentiality
- Maintain separate file of privileged documents, external and internal.
- Err on the side of claiming privilege.
- Mark documents privileged and confidential.
- Separate legal and business advice into different documents.
- Frame discussion as legal advice and not corporate policy and guidelines.
- Limit access to, and circulation of, privileged communications.

CRA Audits, Privilege and Directors′ Liability

- Have separate legal department letterhead, emails should bear legal advice notation
- Disclosure to third parties (auditors, persons with common interest) should indicate no waiver of privilege
- Include all relevant members of corporate group in solicitor's retainer
- Create a document retention policy and utilize it regularly, not in response to CRA request for documents

CRA Audits, Privilege and Directors' Liability

Directors' Liability

- Directors of a corporation that
  - fails to deduct or withhold amounts required under the ITA; or
  - fails to remit amount of net tax as required under the ETA; or
  - fails to repay to CRA an overpaid net tax refund

  are jointly and severally liable to pay the amount plus interest and penalty
- Liability only attaches to directors at the time the corporation was required to withhold, remit or pay
- Ongoing obligation to remit?

CRA Audits, Privilege and Directors' Liability

- Directors are only liable if the CRA cannot collect arrears from corporation through execution, dissolution or bankruptcy.

Directors' Liability – Limitations on Assessment

- Assessment of a director shall not be made more than two years after the person last ceased to be a director of the corporation
- Evidence of resignation: (i) in writing, (ii) corporation confirms; (iii) update public filings

Difference in Language of Two-Year Limitation in the ITA and the ETA

ITA – No action or proceedings to recover any amount payable by a director… shall be commenced more than two years after the director last ceased to be a director.

ETA – An assessment … of any amount payable by a person who is a director of a corporation shall not be made more than two years after the person last ceased to be a director.

CRA Audits, Privilege and Directors' Liability

Due Diligence Defence

- Director is not liable for a corporation's failure to withhold, collect or remit where the director exercised the degree of care, diligence and skill to prevent the failure that a reasonably prudent person would have exercised in comparable circumstances.
- Until 2004, the leading case was *Soper*, [1997] 3 C.T.C. 242 (FCA)
- In *Soper*, FCA held that 227.1(3) contained both an objective and a subjective test of due diligence for directors
  - "reasonably prudent person" – objective
  - "in similar circumstances" – subjective
- Under *Soper*, passive "outside" director is not required to exhibit the same degree of care, diligence and skill as an active or "inside" director.

CRA Audits, Privilege and Directors' Liability

- In 2004, Supreme Court of Canada decided *Peoples Department Store v. Wise*, 2004 S.C.C. 68
- *Peoples Department Store* dealt with directors' duty of care under the CBCA
- S. 122(1)(b) of CBCA very similar to s. 227.1(3) of ITA
- Supreme Court of Canada held that test was an objective test
- "comparable circumstances" are relevant to the determination of what a reasonably prudent person would do in those circumstances, not to the competence or incompetence of the particular director

CRA Audits, Privilege and Directors' Liability

Buckingham

- In *Buckingham*, [2011] 4 C.T.C. 216, the Federal Court of Appeal held that
  - Objective subjective test has been replaced by purely objective test
  - Objective test sets aside common law test that a director's management of a corporation is to be judged according to his own personal skills, knowledge and capabilities
  - Persons appointed as directors must carry out activities on an active basis
  - Particular circumstances of a director are not to be ignored but must be considered against an objective "reasonably prudent person" standard
- Standard is the same under ITA for withholding and remitting as under the ETA for collecting and remitting.
- Obligation is to prevent the failure to remit.
- After the fact attempts to cure failures do not amount to due diligence.

CRA Audits, Privilege and Directors' Liability

Liddle

However,

- In *Liddle*, decided after *Buckingham*, a different panel of the FCA endorsed *Soper* as the correct legal test
- *Buckingham* was not mentioned
- Cases may be reconciled by interpreting FCA in *Liddle* as holding that director could not satisfy even the lower *Soper* threshold so there was no need to consider *Buckingham*
- *Buckingham* has been followed in recent directors' liability cases
  - *Boles*
  - *Heaney*
  - *Gougeon*

CRA Audits, Privilege and Directors' Liability

Directors' Liability

- Positive steps should be taken to prevent failures
  - Corporation should have documented withholding procedures that are reviewed regularly
  - Request regular reports on withholding and remitting from management
  - Ensure there is legal support for any instances on non-withholding
- Regular reporting to audit committee
- Increased diligence required in times of financial difficulty
  - Discuss situation with banks or other lenders
  - Separate trust accounts for withholdings to ensure compliance
- Resign if board or management ignores withholding obligation

Questions?

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Profile

Maureen Berry is a partner at Goodmans. Maureen's practice focuses on tax law with an emphasis on corporate income taxation, domestic and international taxation, REITs and income funds, private corporation taxation, executive compensation, estate planning and taxation of trusts and estates. She also has an expertise in the taxation of charities and non-profit organizations.

Maureen has provided tax advice in a number of mergers, acquisitions, restructurings and initial public offerings, including IPC US Income Commercial REIT, the first cross-border REIT completed in Canada, KCP Income Fund, Atlantic Power Corporation, Holloway Lodging REIT, Crombie REIT and RioCan REIT, Avion Group's acquisition of Atlas Cold Storage, the financing of Rio Tinto's acquisition of Alcan, CNL Income Properties, Inc.'s acquisition of retail properties from Intrawest, Harris Steel in its acquisition by Nucor Corporation, Royal Group Technologies' acquisition by Georgia Gulf Corporation, Vincor International's acquisition by Constellation Brands and Laidlaw in its restructuring.

Maureen also has experience acting on transactions in the energy, infrastructure and seniors care sectors. She has acted on a number of transactions in connection with the public financing of various wind power development projects and has also advised on a number of acquisitions of seniors care facilities.

Maureen has been recognized as a leading tax lawyer by Chambers Global *The World's Leading Lawyers for Business* and as a leading private client lawyer by PLC's *Which Lawyer?*

She has taught courses in the taxation of trusts, international tax and estate planning at the University of Toronto, Western University and Osgoode Hall Law School and was an instructor at the Bar Admission Course in the areas of tax and estate planning and corporate tax for a number of years.

Maureen has published numerous papers and has spoken at many professional seminars. She is a contributing author to the tax section of *The Canadian REIT Handbook* published by REALpac.

Education

University of Saskatchewan, B.Comm. (Most Distinguished Graduate), 1989
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Professional Affiliations

Canadian Bar Association
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Profile

Glenn Ernst is a partner in the Tax Group at Goodmans. Glenn practices in all areas of taxation including income taxation, commodity taxation and taxation litigation. Glenn has significant experience in most areas of income tax planning including mergers and acquisitions, corporate reorganizations, international acquisitions and international financings. He has recently acted in connection with the acquisition of a major Canadian hotel chain and an international publishing business and the restructuring of a Canadian forest products business.

He also has acted for various levels of government in connection with infrastructure projects including providing income tax and commodity tax advice in connection with the creation and subsequent sale of Highway 407. He provided income tax and commodity tax advice in the restructuring of one of Canada's leading privately owned real estate businesses. He has provided advice in connection with structured finance products including income funds and REITs and he was counsel to the Pan-Canadian Investors Committee in the successful $32 billion restructuring of the Canadian asset-backed commercial paper market. He continues to provide advice relating to the ongoing ABCP structure.

Glenn also has a significant commodity tax practice, including goods and services tax and provincial sales tax and land transfer tax planning in business acquisitions, mergers, and restructurings.

Glenn has extensive experience in income tax and commodity tax dispute resolution and has represented clients in proposed assessments and reassessments made by provincial and federal authorities such as the Canada Revenue Agency and the Minister of Finance (Ontario). He has also represented clients in the Tax Court of Canada, the Federal Court of Appeal and the Canadian International Trade Tribunal.

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Profile

Jon Northup is a partner and a member of the Executive Committee at Goodmans. He specializes in tax law.

Jon's practice focuses on corporate and commercial transactions, with a particular emphasis on mergers and acquisitions, corporate finance and structured finance transactions. Jon has recently provided tax advice on acquisitions involving, among others:

- Atlantic Power Corporation's $1.1 billion acquisition of Capital Power Income L.P.;
- Western Coal Corporation's $3.3 billion acquisition by Walter Energy, Inc.;
- Green Mountain Coffee Roasters, Inc.'s $915 million acquisition of Van Houtte Inc. from an affiliate of Littlejohn & Co., LLC and its US$157 million acquisition of Timothy's Coffees of the World, Inc.'s wholesale business from an affiliate of Sun Capital Partners, Inc.;
- Total S.A.'s $1.5 billion acquisition of UTS Energy Corporation;
- Gerdau S.A.'s US$1.6 billion privatization of Gerdau Ameristeel Corporation;
- Fortress Investment Group LLC's US$2.8 billion acquisition of Intrawest Corporation; and

Jon has extensive experience advising issuers and investment dealers on the structuring and taxation of public offerings, including offerings by REITs, income funds and similar yield-oriented issuers. He recently advised RioCan REIT on the first offering of preferred units by a Canadian trust. Jon has spoken frequently in both Canada and the United States on topics related to going public in Canada and the tax efficient structuring of income securities.

Jon is recognized as a leading practitioner of tax law by Chambers Global *The World's Leading Lawyers for Business* who describe him as having "a relaxed and client-friendly attitude: "He's calm, which makes him great to work with, but he's also extremely effective." Jon is also recommended for tax by *Best Lawyers in Canada* and for income funds by *The Canadian Legal Lexpert Directory*. Lexpert Magazine named Jon one of Canada's "Top 40 Under 40 Lawyers" in 2006 and one of the "20 Corporate Lawyers to Watch" in 2007.

Education

University of Victoria, B.A., 1993
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Profile

Mitch Sherman is a partner in the Tax Group at Goodmans. His taxation practice focuses on corporate and commercial transactions, including equity and debt financings, acquisitions, divestitures, syndications, corporate reorganizations, structured products, investment funds and international tax planning. Mitch has focused extensively on structured products such as income securities.

Mitch is recognized as a leading practitioner of tax law by Chambers Global's *Guide to the World's Leading Lawyers*, Lexpert/American Lawyer's *Guide to the Leading 500 Lawyers in Canada*, *The Canadian Legal Lexpert Directory*, Practical Law's *Which Lawyer?*, Euromoney's *Guide to the World's Leading Tax Lawyers*, *The Best Lawyers in Canada* and Law Business Research's *Who's Who Legal Canada*. Mitch joined Goodmans as an articling student in 1988. He has been a partner since 1995.

Mitch has authored numerous papers and is a frequent speaker on income tax matters. He is the Vice-Chair of the National Taxation section of the Canadian Bar Association and a member of the Executive of CICA-CBA Joint Committee on Taxation. He is a member and frequent contributor to the Editorial Board of the *Corporate Finance Tax Journal*. He has lectured at the Law Society of Upper Canada Bar Admission Course and has conducted seminars to senior Canada Revenue Agency officials on advanced corporate reorganizations and partnerships.

Education

University of Toronto, J.D., 1987

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