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Current Items of Interest 7

Recent Cases 7

THE US TAX CLASSIFICATION OF THE CANADIAN RESP

— *Max Reed and Stephen Albers*[1]

Registered Education Savings Plans ("RESPs") are commonly used products that allow people to save for their children's education on a tax-deferred basis. Resulting from the use of language like "beneficiary", "trust", and "trustee" in the Canadian *Income Tax Act* (the "ITA"), there has been concern over whether an RESP is a trust for US federal tax purposes. If the RESP is a trust for US federal tax purposes, it would likely be a grantor trust. A US person who subscribes would thus likely have to file US Form 3520 and Form 3520-A each year. This significantly adds to the compliance cost of keeping the plan — perhaps outweighing its benefits. The potential penalties for not filing a Form 3520/3520-A are at a minimum US $10,000/year.

This article suggests that the RESP is not a trust for US federal tax purposes and that the RESP can be disclosed by way of a form letter attached to the annual US Form 1040. In support of this position, we make the following arguments:

(1) The RESP is likely not a trust under Canadian law;

(2) There is no specific IRS authority that the RESP is a trust for US federal tax purposes;

(3) There is a good, but not perfect, argument that the RESP is not an entity separate from its owner for US federal tax purposes;

(4) The RESP is unlikely to be classified as a trust for US federal tax purposes;

(5) Even if the above legal conclusions are wrong, a disclosure letter should constitute reasonable cause and thus any penalty for failing to disclose the RESP should be excused.

1) The RESP is likely not a trust under Canadian law

The RESP is likely not classified as a trust under Canadian law. The ITA defines the RESP as an arrangement entered into between an individual ("subscriber") and a person or organization offering the product ("promoter") for the purpose of some third party's ("beneficiary's") post-secondary education.[2]

The subscriber makes contributions to the RESP on a tax-deferred basis. The property in the RESP is taxable in the hands of the individual to whom it distributes. For example, if the RESP is collapsed by the subscriber, the subscriber reclaims their contributions. As such, any income that has accrued inside of the plan is taxable in the hands of the

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[2] *Income Tax Act*, RSC 1985, c 1 (5th Supp) (as amended) [ITA] s 146.1, "education savings plan."

subscriber. Note that the subscriber has already been taxed on the principal. This is the reason the RESP works as a tax deferral mechanism in the first place. The government may match the subscriber's contributions. If the plan is collapsed early, the government reclaims its contributions.

The general structure of a trust under Canadian law is the following: a settlor (or donor) gives up property to a trustee for the benefit of some third party. The trustee must hold legal title of the property.[3] The trustee is bound by fiduciary obligations to administer the trust on behalf of the beneficiary.

In the case of an RESP, the subscriber keeps title to the property until such time as the beneficiary uses it for their post-secondary education. Note that under the ITA a promoter never takes title to the property in the RESP. In fact, it belongs to the subscriber until such time as the beneficiary attends a post-secondary institution, or there is a succeeding subscriber.[4]

To create a trust, Canadian law requires three certainties: that of intention, of matter, and of object.[5] Canadian courts have held that the RESP does not meet the certainty of intention — therefore it should not be a trust under Canadian law. In *Payne*, a bankrupt's seizable assets were ruled to include an RESP.[6] With respect to the RESP, the Court held that Mrs. Payne was "not holding title to the plan for the exclusive enjoyment of her sons. She has the authority to cancel the plan at any time and obtain a repayment of her principle [*sic*] and interest."[7] The decision cites the fact that the RESP lacks the certainty of intention to create a fiduciary relationship as the reason the RESP is not a trust under Canadian law.[8] The same result was reached in *Re Vienneau*, a 2007 case from the New Brunswick Court of Queen's Bench, where the court went on to rule that the RESP lacks the necessary certainty of intent and is therefore not a trust.[9] In *MacKinnon v Deloitte & Touche* the Saskatchewan Court of Queen's Bench affirmed the reasoning in *Payne*.[10]

Well-established principles of Canadian trust law support this view.[11] The Supreme Court of Canada has held that the certainty of intent is an objective test.[12] In the context of an RESP, there is no such objective certainty of intent as the subscriber may collapse the RESP at any time, as well as use it to secure a loan. As noted in *Vienneau*, "one cannot give in trust and still retain rights of disposition; the settlement must be binding on the donor."[13] As such, the RESP should not be classified as a trust under Canadian common law.

Under Quebec Civil law, the RESP is likely not a trust either. Section 1260 of the Quebec Civil Code states, "a trust results from an act whereby a person, the settlor, transfers property from his patrimony to another patrimony constituted by him which he appropriates to a particular purpose and which a trustee undertakes, by his acceptance, to hold and administer." Under an RESP, the subscriber retains ownership of the property. It is not transferred to another patrimony and therefore cannot constitute a Quebec trust. Additionally, there is no contract between the settlor and

[3] Gillen, Mark R. and Faye Woodman, *The Law of Trusts: A Contextual Approach* (Emond Montgomery: Toronto, 2015) at 7.

[4] ITA s 146.1(1)(c).

[5] See *Knight v. Knight* (1830) 3 Beav. 148, as well as D.W.M. Waters, ed. *Law of Trusts in Canada* (Toronto: Carswell, 2005) at pp. 9-14, 353-356, 929-935, 351-352. See also, *Sommerer v The Queen*, 2011 TCC 212 [*Sommerrer*] at para 66.

[6] *Re Payne* 2001 ABQB 894 [*Payne*] at para 14.

[7] *Payne supra* note 6 at para 9.

[8] *Payne supra* note 6 at paras 12, 13.

[9] *Re Vienneau* 2007 NBQB 332 [*Vienneau*] at para 11.

[10] *MacKinnon v Deloitte & Touche*, 2007 SKQB 39 *[MacKinnon*] at para 10.

[11] There is some authority to the contrary on this point. In *McConnell v McConnell*, 2015 ONSC 2243 at para 124, Price J. found in that case that the possible subjective intent at the time of creation of the RESP meant that it was a trust. This is ultimately incorrect on the basis of the test established by the Supreme Court and noted in all doctrinal sources on trust law. Even if the logic in *McConnell* holds, a US citizen who was questioned by the IRS may simply state that he or she did not have the requisite subjective intent at the time of the plan's creation to create a trust.

[12] *Pettkus v Becker* [1980] 2 SCR 834 [*Pettkus*] at 11. This approach has subsequently been applied at the Supreme Court in a Quebec civil law case in creating a constructive trust where no express one existed: see *Beaudoin-Daigneault v Richard and Registrar of Compton* [1984] 1 SCR 2.

[13] *Vienneau supra* note 9 at para 11.

the trustee that specifies a particular purpose. Though the RESP is indeed created for the benefit of a third party, as noted a subscriber can withdraw the monies in the RESP at any time without breaching the contract.

Finally, it is important to note that a trust, under Canadian tax law, is a separate taxpayer. If the RESP was a trust it would be a "personal trust". Section 248(1) of the ITA specifies that trusts are separate taxpayers that file separate tax returns. Even trusts where the income is attributable to another party under s. 75(2) of the ITA must file a nil tax return. Trusts that are mere agency agreements are exempt from this requirement under subsection 104(1) of the ITA. An RESP is not required to file a tax return itself. This suggests, but is not determinative of the fact, that it is not considered a trust for Canadian income tax purposes. In short, under Canadian common law, Canadian civil law, and Canadian tax law, an RESP is likely not a trust.

2) There is no official IRS guidance on the US tax classification of an RESP

The IRS has specifically stated that it considers the Registered Retirement Savings Plan ("RRSP") to be a grantor trust for US federal tax purposes.[14] Based on the analysis below, this position may be untenable. Regardless, there is no specific IRS authority classifying the RESP as a trust for US tax purposes.

3) An RESP is Not Likely Subject to US Entity Classification Regime

In order to be subject to entity classification in the United States (and thus possibly exposed to the onerous reporting obligations imposed on its owners), the entity in question must be separate from its owners.[15] Whether the RESP is separate from its owners is a question of US tax law and is not dependent on local law.[16]

In Revenue Ruling 2004-86, the IRS noted, in determining whether an entity is separate from its owners and therefore an entity eligible for classification, "generally, when participants in a venture form a state law entity and avail themselves of the benefits of that entity for a valid business purpose, such as investment or profit, and not for tax avoidance, the entity will be recognized for federal tax purposes."[17] The RESP is not an entity under Canadian law. The RESP has no business purpose. Later in Rev. Rul. 2004-86, the IRS identifies the following characteristics of why the Delaware Statutory Trust is an entity separate from its owners.[18] The RESP meets very few, if any, of these criteria:

- *Under local law the entity is recognized as separate from its owners*. Under Canadian law, the RESP is not recognized as an entity separate from its owners. The Canada Revenue Agency ("CRA") notes that, to be a legal person, an entity must have "[an] existence separate from the personality and existence of the person who created it and that possesses its own capacity to acquire rights and assume liabilities."[19] The RESP has no such capacity and so under Canadian law it is not an entity separate from its owners.
- *Creditors of the owners of the entity may not assert claims directly against the property held by the entity*. Recall that creditors of the subscriber can seek satisfaction directly out of the assets of an RESP.[20]
- *The entity may sue or be sued and is subject to attachment and execution as if it were a corporation*. The RESP may not sue or be sued. Only the financial institution sponsoring it or its holder may be sued.
- *The entity's beneficial owners have the same limitation of liability as shareholders in a corporation*. The RESP provides no limitation of liability to its holder.

[14] IRS Notice 2003-75.

[15] Treas. Reg.§301.7701-1.

[16] Treas. Reg. §301.7701-1(a)(1).

[17] Rev. Rul. 2004-86.

[18] Rev. Rul. 2004-86

[19] Interpretation Bulletin IT-343R (Sept. 26, 1977).

[20] *Payne supra* note 6.

- *The entity can merge or consolidate with or into other entities*. While property can be transferred from one RESP to another, it is unclear whether an RESP can be merged or consolidated with another RESP. An RESP can certainly not be merged with a different type of entity.

The RESP looks and operates more like a complex bank account that is subject to certain contractual restrictions than it does a legal entity. Such contractual relationships may sometimes rise to the level of an entity for US federal tax purposes. Reg §301.7701-1(a)(2) states, "A joint venture or other contractual arrangement may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom." There is no business carried on by the RESP and it is not a joint venture to divide profits. Consider the following analogy to illustrate the point that the RESP is nothing more than a bank account with restrictions placed on it. Funds held in a trust account in escrow are subject to severe contractual limitations. But we do not think of this trust account as a legal entity. The same should be true of the RESP. If the RESP is not an entity separate from its owners for US federal tax purposes, then no separate US tax reporting is required to disclose it. Of course, the funds held in an 8938 or FBAR would have to be reported on those forms if the appropriate thresholds are met.

4) Alternatively, the RESP is likely not a Trust for US Tax Purposes

Assume for the sake of argument that the RESP is subject to the US entity classification regime. Even in this case, the RESP is not a trust for US federal tax purposes. To fully understand this argument, it is necessary to go through all of the steps under the US entity classification rules established under Treasury Regulation 7701 to classify an RESP for US tax purposes. For clarity, the multiple steps required to arrive at this conclusion are set out sequentially.[21]

(1) *Is the entity separate from its owners?*[22] If not, the entity classification regime does not apply. An RESP, as mentioned above, is likely not separate from its owners. However, assume for the sake of argument that this is not the case.

(2) *Are there special classification rules that apply to the entity?*[23] If so, those rules determine its classification and the general entity classification regime does not apply.[24] RESPs are not subject to a special entity classification regime. Certain types of entities, such as Real Estate Mortgage Investment Conduits, are subject to special rules under the Code.[25]

(3) *Is the entity a trust?* If an entity is not a trust, then it is classified as a business entity and subject to the rules classifying business entities.[26] RESPs are not trusts for US tax purposes. Of the types of trusts set out in Treasury Regulation §301.7701-4, there are only two that are possibly applicable: ordinary trusts, and investment trusts.[27] Consider each one in turn.

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[21] For a more in-depth analysis of entity classification, see Max Reed and Stephen Albers Chalhoub, "The US Tax Classification of Canadian Mutual Fund Trusts," Canadian Tax Journal 63:4, 947-89 (2015).

[22] Treas. Reg. §301.7701-1(a).

[23] Treas. Reg.§301.7701-1(b).

[24] Treas. Reg. §301.7701-1(b).

[25] Treas. Reg. §301.7701-1(b).

[26] Treas. Reg. §301.7701-2(a).

[27] There are others but they are clearly inapplicable to the question at hand.

(a) *Is an RESP an "ordinary trust"?* An "ordinary trust" is an arrangement in which the trustee "take[s] title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts."[28] As noted above, the specified trustee under the ITA (the sponsoring financial institution) does not take title to the RESP property under Canadian law. Instead, the subscriber retains title. It is possible to conceive of the subscriber as the trustee, but as noted under Canadian law no trust relationship is created between the subscriber and the beneficiary. Canadian courts have held that the beneficiaries have no legal right against the titleholder if such holder decides to collapse the RESP and keep the monies for themselves.[29] Unlike other Canadian trusts, such as an alter ego or family trust where legal ownership of property is indicated through the use of the "(in trust)" nomenclature, the subscriber normally does not formally indicate that the property has been placed in an RESP. Arguably, the RESP's primary purpose is to allow for Canadian tax deferral and to take advantage of government grants rather than to conserve the property for the beneficiary.

Even if it is admitted that the subscriber plays a role similar to that of trustee and takes title to the property, there is an official IRS revenue ruling that recognized that, in situations of "mere agency", there is no trust relationship for US federal tax purposes. Rev. Rul. 2013-14 dealt with the Mexican Land Trust. The purported trust bought land on behalf of the taxpayer, but was subject to the taxpayer's complete control and was under no obligation to administer or conserve the property.[30] The same is true of the RESP. There is no obligation on the subscriber to conserve the property. The subscriber may terminate the RESP at any time. The subscriber retains all US tax responsibility for the plan. Thus, under the logic of Rev. Rul. 2013-14, the RESP should not be considered a trust.

(b) *Is an RESP an "investment trust"?*[31] An investment trust, although imprecisely defined in the US Regulations, can be thought of as "a trust created to facilitate direct investment in the assets of the trust through a pooling arrangement that creates the opportunity to diversify investments."[32] An RESP is clearly not such an arrangement. It is therefore not an "investment trust."

(4) *How many members does the entity have?* If an entity is not a trust under Treasury Regulation §301.7701-4 or subject to special classification under the Code, then its classification is determined by reference to the number of members it has. If it has two or more members, it is either a partnership or a corporation.[33] If the entity has only one member, then it is either an association taxable as a corporation or an entity that is disregarded from its owner.[34] Although "member" is not defined in the Regulations, it is generally used as synonymous with beneficial owner. An RESP typically has one owner — the subscriber.

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[28] The full definition is as follows:

In general, the term "trust" as used in the Internal Revenue Code refers to an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. Usually the beneficiaries of such a trust do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. However, the beneficiaries of such a trust may be the persons who create it and it will be recognized as a trust under the Internal Revenue Code if it was created for the purpose of protecting or conserving the trust property for beneficiaries who stand in the same relation to the trust as they would if the trust had been created by others for them. Generally speaking, an arrangement will be treated as a trust under the Internal Revenue Code if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

[29] *Vienneau supra* note 9 at para 6.

[30] Rev. Rul. 2013-14 at 6.

[31] Treas. Reg. §301.7701-4(c)(1).

[32] *Supra* note 40.

[33] Treas. Reg.§301.7701-2(a).

[34] Treas. Reg. §301.7701-2(a).

(5) *Does the entity meet one of the automatic definitions of a corporation?* An entity is automatically classified as a corporation if it meets one of seven different definitions.[35] If it does not meet one of these seven different definitions, it must be examined under the default entity classification rules. An RESP does not meet any of these definitions of "corporation."[36]

(6) *Is the entity foreign or domestic?* An entity that does not meet one of the seven automatic definitions of corporation must be analyzed under the default entity classification rules. The first step is to determine whether the entity is foreign or domestic. An entity is classified as foreign if it is not domestic.[37] An RESP is a foreign entity.

(7) *Is the entity an "eligible entity"?* If an entity is not a per se corporation, then it generally would be an "eligible entity" and may elect to be classified as a corporation or partnership for US tax purposes.[38] Under the default rules, a foreign entity with one owner is a disregarded entity if all of its members have liability. The RESP provides no liability protection.

In short, if the RESP is subject to the US entity classification regime, then it is not a trust for US federal tax purposes, because it does not meet the appropriate definitions. Instead, it is likely a foreign disregarded entity because it has one owner and the entity does not offer that owner any liability protection. If it is a foreign disregarded entity, its owner would have to file US Form 8858 each year.

5) Conclusions

Canadian courts have said that an RESP is not a trust under Canadian law. There is a good argument that it is not an entity separate from its owner for US federal tax purposes. If so, no special reporting would be required. There is a strong position that the RESP is not a trust under the US entity classification rules. If so, no Forms 3520/3520-A are required. However, the RESP may be a foreign disregarded entity that would require a Form 8858. Undoubtedly, the income from an RESP is reportable to US persons on their Form 1040. It is disclosable on their FBAR or Form 8938 if those thresholds are met. Our view is that the best way to report the RESP is on a form letter that is attached to the Form 1040 annually. Such a form letter would suggest that the RESP is not an entity separate from its owner. The letter would request IRS guidance on how to report the RESP in future tax years. The IRS may not respond.

If the legal conclusions presented above are incorrect, and a US court ultimately concludes that the RESP is not a foreign trust, then any penalties should be excused by virtue of reasonable cause. In *James v. United States*, 2012 U.S. Dist. LEXIS 114356 (MD FL 2012) the court addressed whether the taxpayer had reasonable cause not to file the 3520. The Court defined reasonable cause as:

> The IRS has failed to issue regulations explicating the meaning of "reasonable cause" for failure to file Form 3520. In general, reasonable cause exists when a taxpayer exercises ordinary care and prudence in determining his tax obligations despite his failure to comply. See I.R.M. 20.1.1.3.2 (11-25-2011). Whether reasonable cause exists depends upon all of the facts and circumstances of the case, including the taxpayer's reason for failing to properly file, and the extent of his efforts to comply. Id. **Moreover, the Internal Revenue Manual ("IRM") provides that ignorance of the law may provide reasonable cause if: "A. A reasonable and good faith effort was made to comply with the law, or B. The taxpayer was unaware of a requirement and could not reasonably be expected to know of the requirement." I.R.M. 20.1.1.3.2.2.6 (11-25-2011)**. [emphasis added]

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[35] Specifically, an entity that is not classified as a corporation under Treas. Reg. §§301.7701-2(b)(1), 301.7701-2(b)(3), 301.7701-2(b)(4), 301.7701-2(b)(5), 301.7701-2(b)(6), 301.7701-2(b)(7), or 301.7701-2(b)(8) is an "eligible entity that may select its classification."

[36] An RESP does not meet any of the following definitions:
1) Treasury Regulations §301.7701-2(b)(1) — it is not a business entity organized under a federal or state statute that is referred to as incorporated;
2) Treasury Regulations §§301.7701-2(b)(3) — it is not a business entity organized under a state statute that refers to the entity as a "joint stock-company or joint-stock association";
3) Treasury Regulations §§301.7701-2(b)(4) — it is not an insurance company;
4) Treasury Regulations §301.7701-2(b)(5) — it is not a State-chartered entity that conducts banking activities;
5) Treasury Regulations §301.7701-2(b)(6) — it is not wholly owned by a foreign government;
6) Treasury Regulations §301.7701-2(b)(7) — it is not taxable as a corporation under a specific section of the IRC; and
7) Treasury Regulations §301.7701-2(b)(8) — it is not on the per se corporations list.

[37] IRC §7701(a)(5).

[38] Treas. Reg. §301.7701-3(a).

The RESP offers no US tax benefits. It has no tax avoidance or minimization purpose. Admittedly, its US tax classification is uncertain — although we find the above arguments compelling. Ordinary taxpayers cannot be expected to engage in the complex, comparative international tax law analysis to determine whether or not some forms need to be filed to disclose such a banal financial product that is offered by the Government of Canada. Absent IRS guidance, disclosing the RESP by letter and requesting IRS guidance is a textbook good faith effort to comply with a complex law. Thus, even if the IRS disagrees with the legal conclusions presented here, disclosing the RESP by way of form letter should constitute sufficient reasonable cause to excuse any penalty the IRS may attempt to levy.

CURRENT ITEMS OF INTEREST

Canadian Mining Industry Supports Carbon Pricing

[The following article was originally published in Global Tax Weekly, Issue 181]

The Mining Association of Canada ("MAC") has announced its support for the introduction of a carbon price applicable to all sectors of the Canadian economy.

MAC published "Principles for Climate Change Policy Design," in which it set out the main features of its proposed carbon price. It said the carbon price should be revenue neutral, with the revenue raised used to fund the development of lower-emission technologies and to ensure a level playing field for tradeexposed industries that are emission intensive.

According to MAC, any national carbon price should work in tandem with existing provincial schemes, to avoid duplication, and be simple to understand and administer. The regime should also be predictable, flexible, and sensitive to changing economic conditions and geographic circumstances. It should likewise take into account the action taken by companies to reduce their climate footprints.

Pierre Gratton, President and CEO of MAC, said: "Today one of Canada's largest industries is coming out in support of a carbon price, identifying it as the most effective and efficient means of driving emissions reductions and making real progress in the global fight against climate change. MAC's support of a carbon price is guided by our principles for climate change policy design, and is based on 16 years of our members' continuous efforts to reduce emissions through technology and innovation and become more energy efficient."

RECENT CASES

Dissolved corporation required to effect revival in order to initiate appeal to Tax Court

The appellant corporation was incorporated in 2000 under the Ontario *Business Corporations Act* ("BCA") but was dissolved, and its certificate cancelled, in early 2007. In 2010, an assessment was issued against the corporation by the Minister of National Revenue and the corporation appealed from that assessment. The Tax Court of Canada held that the appellant, as a dissolved corporation, lacked the capacity to initiate an appeal to that Court from an assessment issued against it under the *Income Tax Act*. The Tax Court adjourned the appellant's pending appeal for 60 days in order to allow it to take steps to revive its corporate status. Instead, the appellant appealed to the Federal Court of Appeal from the order holding that it lacked capacity to appeal from its assessment to the Tax Court.

The appeal was dismissed. The appellate Court held that the question of whether a dissolved corporation has the legal capacity to initiate and continue an appeal in the Tax Court of Canada was a question of law, reviewable on a standard of correctness. It held as well that the Tax Court had reached the correct conclusion with respect to that question, but differed from the Tax Court on the reasons. The Tax Court had held that changes in statutory language relating to the effects of corporate dissolution made previous decisions of the Federal Court on that issue distinguishable, but the appellate Court determined that the Tax Court erred in reaching that conclusion. It was, however, open to the Federal Court of Appeal to depart from its prior decisions where warranted, and it concluded that such a departure was justified. Specifically, the appellate Court held that when the current legislative regime was considered, it was correct to conclude that the filing of a notice of appeal in the Tax Court constituted the initiation of a legal proceeding. As subsection 242(1) of the BCA does not authorize a dissolved corporation to initiate a civil proceeding, it followed that the Tax Court did not err by adjourning the appeal and requiring the corporate appellant to revive its corporate status so that it could continue the appeal. The appellate Court held as well that, while there were circumstances in which the statute did not permit the filing of articles of revival, other mechanisms existed to permit revival, such that the right of revival was real and not illusory. The appeal was dismissed, and the adjournment ordered by the Tax Court was continued for a further 60 days in order to allow the appellant to revive its corporate status.

¶49,326, *1455257 v. The Queen*, 2016 DTC 5046

Taxpayer as transferee liable for taxes owing by transferor when loan was repaid

The taxpayer has been in the paint and decorating business since 2001. When it was founded by Michael Soutar the business needed financing for working capital and equipment. It received an operating line of credit and capital loan from the Bank of Nova Scotia ("BNS") and Michael's father, Ronald, gave a personal guarantee and a first registered charge over his house. In 2002, Ronald sold his house with the bank taking a reduced first charge and a collateral cash deposit of $120,000. In 2004, after the capital loan was repaid, the bank reduced the collateral cash to $75,000 ("GIC deposit") and requested a hypothecation agreement. After Ronald's death in 2007, the bank demanded its credit facilities be repaid. It realized on the $75,000 GIC, applying it against the taxpayer's indebtedness by applying the funds to its outstanding line of credit. The taxpayer is appealing a s. 160 assessment with the minister, arguing that Ronald Soutar transferred $75,000 on the loan repayment date to the BNS for the benefit of the taxpayer at a time he owed taxes for his 2002 and 2005 taxation years.

The appeal was dismissed. For a s. 160 assessment to succeed there must be a transfer of property between non-arm's length parties for no or inadequate consideration at the time the transferor owes taxes. The only issue was at what point in time the transfer took place. The taxpayer argued the transfer took place in 2001 when the guarantee and charge were given. There was no transfer in 2001 as guarantee is a contingent liability until there is a demand made and a charge is not a transfer of property. When the $75,000 was paid into the taxpayer's account in 2007 a transfer occurred and it received the benefit at a time when the transferor, Ronald, owed taxes. The bank realized on the GIC, converted it to cash, credited the taxpayer and then repaid itself. There was a transfer from the indebted taxpayer, Ronald, to the creditor bank through the taxpayer, a non-arm's length transferee. The actions taken in 2001, 2002, and 2004 granted the security, substituted, and amended it but no transfers took place. In 2007, on the loan repayment date, when the deposit was made into the taxpayer's account, the taxpayer received legal and beneficial ownership of the funds and that was the time of the transfer. The conditions for a s. 160 assessment were satisfied.

¶49,320, *M. Soutar Décor 2000 Ltd v. The Queen*, 2016 DTC 1053

Penalty for failure to file by electronic means upheld on appeal

The corporate taxpayer filed its 2014 income tax return in paper form. A penalty under section 162(7.2) was subsequently assessed by the minister, on the basis that the corporation was a prescribed corporation which was required to file by electronic means. The corporate taxpayer appealed from the assessment of that penalty, arguing that no such penalty could apply where there was no tax payable for the year, that it was not a prescribed corporation subject to the electronic filing requirement, and, finally, that there was a due diligence defence to the imposition of the penalty.

The appeal was dismissed. The principal argument put forward by the appellant was that no penalty could be imposed under the *Income Tax Act* where no tax was payable. The Court reviewed the relevant statutory provision and held that the wording of subsection 162(7.2) did not make the penalty for failing to file an electronic return conditional in any way on tax being payable by the corporation. Rather, the only condition to the imposition of the penalty was a failure to file an electronic return as required by subsection 150.1(2.1), which applied where the taxpayer is a prescribed corporation. The appellant had argued as well that it was not such a prescribed corporation. Specifically, it argued that the minister's finding that the corporation had revenues in excess of $1 million was incorrect. The Court held that the appellant bore the onus of proving that its revenue did not exceed the $1 million threshold, but that no clear or convincing evidence was presented to the Court. Consequently, the appellant had not refuted the minister's assumptions. The final argument raised by the appellant was that it was unaware of the electronic filing requirement and that its sole shareholder and director did his best to meet all tax filing requirements. The Court held, however, that it had not been shown that reasonable precautions had been taken to avoid the events which led to the imposition of the penalty. Specifically, there was no evidence that the necessary systems had been put in place to deal with the corporation's tax obligations, or that professional assistance in the handling of the corporation's tax matters had been sought. The penalty under section 162(7.2) was properly imposed.

¶49,319, *Kokanee v. The Queen*, 2016 DTC 1052

Proper exchange rate for tax-exempt amount of pension income — minister entitled to use annual average exchange rate

The taxpayer is a retired employee of the International Civil Aviation Organization ("ICAO"), an agency of the United Nations, receiving a monthly pension from the UN Joint Staff Pension Plan. At the time of his retirement in September 2000, he chose the "local track" option which converted his pension amount from US to Canadian dollars at the date of retirement, using an average exchange rate over the thirty-six preceding months and including the last month of employment. That rate was 1.47. From 2001 through 2008, the taxpayer used the annual average exchange rate ("AAER") to calculate the exchange rate. In July 2009 he wrote to the CRA requesting that the rate as of September 2000 (being 1.47) be used for the 2001 through 2008 taxation years. This was not done due to a lack of supporting documentation. In 2010, the taxpayer received $59,753 Canadian under the pension plan of which $12,024 US was exempt. The taxpayer used the exchange rate of 1.47 in calculating his pension deduction, seeking to deduct $17,677, and is appealing the minister's recalculation. The minister used the AAER for 2010 which was 1.0562, reducing the taxpayer's claim from $17,677 to $12,701.

The appeal was dismissed. The date on which the tax-exempt amount arose will determine the exchange rate to be used. The taxpayer argued that the date on which the tax-exempt amount arose was in September 2000, when the amount of investment in the plan was fixed while the minister contended that the exempt amount arises each month, when the benefit payment is received by the taxpayer. The amount exempt from Canadian tax is that portion of the pension income that would be excluded from taxable income in the United States, which is to be determined by US law. Under the Internal Revenue Code, the amount of a pension received which is attributable to the cost of the plan is tax-exempt and may be claimed as a deduction on the taxpayer's Canadian tax return. US taxation guides provide that, as an administrative practice, the tax-free portion is calculated when the annuity begins and remains the same regardless of whether the amount of the benefit payment changes. Based on US law and administrative practice, the exempt amount arises each month when the benefit is paid to the taxpayer. The minister has discretion in the application of the appropriate exchange rate and it was appropriate for the AAER for 2010 to be used.

¶49,321, *Korfage v. The Queen*, 2016 DTC 1054

Appeal from reassessment dismissed where minister providing required timely notification

The taxpayer was a limited partner in a partnership. She claimed a limited partnership loss for the 2001 taxation year which was initially allowed on assessment but later reduced on reassessment. The taxpayer appealed from the reassessment, arguing that it was invalid because she did not receive, and the minister could not prove that she received, proper notification as required by section 152(1.5) of the *Income Tax Act*.

The appeal was dismissed. The Court reviewed the statutory provisions governing notice given to members of a partnership. Section 244(20) of the *Income Tax Act* provides that all notices or documents sent to a partnership at its place of business or to the general partner of a limited partnership are considered to have been provided to each member of the partnership. The Court found that the presumption found in that provision was conclusive, particularly in light of jurisprudence which held that such deeming provisions were absolute and did not create a rebuttable presumption. It was agreed by the parties that the relevant notices were sent to the general partner of the appellant's limited partnership on a timely basis, and so each limited partner of that partnership, including the appellant, was deemed to have been provided with such notices. The Court held as well that, even if the presumption set out in the statute was rebuttable, it would nonetheless hold that the reassessment was valid as, in its view, the allegation made by the appellant that she did not receive requisite notice was not credible.

¶49,322, *Menzies v. The Queen*, 2016 DTC 1055

Employment expenses incurred by car salesman partly allowed — objective assessment that they were required under contract

The taxpayer was appealing a Tax Court decision that disallowed expenses he claimed as deductions from employment income. The taxpayer was employed by a Ford car dealership in Miramichi, New Brunswick. He received a fixed salary for work as a sales manager and commission for his work as a car salesman, and had no written contract with the dealership. The expenses he claimed included mobile phone charges, promotion costs for a local sports team, gifts to mechanics, vehicle transfer costs to bring new cars to the dealership, and costs of accessories installed on sold cars.

The appeal was allowed in part, with each party bearing its own costs. The minister was directed to vary the assessment to allow deductions for the costs incurred in transporting the cars to the dealerships and for the expenses to buy accessories for sold cars. Expenses can only be deducted from employment income if they are required to be paid under the contract of employment. That is a question of mixed fact and law and the trial decision should only be reversed if there is a palpable or overriding error or an error on a question of law. The trial judge erred in relying on the personal perspective of the employer as to what was required rather than on an objective assessment of the contract. The trial judge also erred in failing to address the possibility that some expenses might be deductible while others may not. The trial judge did not distinguish between expenses related to development and marketing of sales which the taxpayer was not required to incur and others, which when viewed objectively, were necessary to fulfil his responsibilities to sell cars and earn commissions. The taxpayer's evidence showed a mutual understanding that the expenses incurred to bring cars to the dealership and to install accessories were required under his contract. There was an agreement that the taxpayer would be repaid for the expenses incurred to purchase accessories or enhancements to vehicles where the dealership was also covering part of the costs. Without incurring those expenses he could not earn the higher percentage commission the dealer agreed to pay if the cars were in Miramichi nor could he deliver the merchandise promised to the customers. These expenses are to be distinguished from non-deductible expenditures that are geared to helping produce income by building positive client relationships.

¶49,324, *Urquhart v. The Queen*, 2016 DTC 5039

Judicial review application dismissed — filed late and failed to meet criteria for extension

The taxpayer, controlled by Roger Stokowski, transferred its assets to a partnership, also owned by Stokowski, through a transfer agreement. The parties filed a T-2059 election form which enables the parties to rollover tax consequences to a future date. The taxpayer was seeking judicial review of a decision rejecting its amended T-2059 form. The transfer agreement stipulated that the agreed amount for each asset would be the minimum amount allowed under the Income Tax Act, except for the goodwill amount which was set at $2,502,600, unless the parties otherwise agreed. After a reassessment in January 2010 which increased their tax liability in the year of transfer the taxpayer filed a Notice of Objection, arguing that the T-2059 form was in error with respect to the non-share consideration allocated to the assets. CRA informed the taxpayer that unless an amended T-2059 form was filed, no consideration could be given to changing the assessment. The amended form was filed and there were discrepancies between the non-share consideration in the notice of objection and the amended form. Despite repeated requests, no explanations were provided by the taxpayer. The CRA refused to accept the amended T-2059 on the basis that there was no provision in the transfer agreement requiring a reallocation and that the reallocation resulted in an overstated goodwill amount that contravened the agreement. The decision to refuse the amended form was communicated to the taxpayer by letter of January 2014. The taxpayer filed a judicial review application in May 2015. The taxpayer argued the decision refusing the amended form was procedurally unfair and unreasonable.

The application for judicial review was denied due to its late filing and for failure to meet the Court's criteria for an extension of time. In determining whether procedural fairness was followed the review is on the standard of correctness with the reviewing court making its own assessment. The respondent acted fairly throughout the proceedings. It was in constant communication with the taxpayer, gave opportunities for submissions and did not receive answers to the discrepancies in numbers used in the amended form and the notice of objection. The standard of review for the decision is that of reasonableness. The respondent argued primarily that the judicial review application should be denied as it was filed out of time and there is no reason to grant an extension. Judicial review applications are to be filed within thirty days of receipt of the decision. The taxpayer argued it was not until it received the respondent's reply in April 2015 to its appeal of the confirmation of the 2010 assessment that the taxpayer was aware of the judicial review filing implications. In determining whether the Court should exercise its discretion to grant an extension of time, various factors are to be considered. The taxpayer failed to meet the criteria for an extension. The taxpayer did not show a continuing intent to pursue the judicial review application. The January 2014 letter clearly set out that the amended form would not be accepted and there were subsequent letters from the CRA which mentioned that a judicial review application was the proper means to challenge the decision. The taxpayer was told that the objection procedure would be held in abeyance if the taxpayer filed a judicial review application but it failed to do so. The taxpayer had counsel throughout and should have brought the application earlier. There would be prejudice to the respondent to allow an extension as it would undermine the values of certainty and finality to CRA decisions. There was no reasonable explanation for the delay and no merit to the application. The taxpayer was given ample opportunity to explain the discrepancies. Based on the transfer agreement terms, it was reasonable for the respondent to deny the amended form. It was reasonable for the respondent to find that the transfer agreement required the goodwill to be fixed at a certain amount unless the parties agreed otherwise. The amended form increased the goodwill amount and decreased the number of partnership units issued but there was no evidence provided to substantiate the taxpayer's claim that a new agreement had been made.

¶49,325, *R & S Industries Inc. v. MNR*, 2016 DTC 5040

Minister justified in including unreported amount in taxpayer's income as income from an RRSP, and in reassessing beyond normal reassessment period

During 2001 the taxpayer invested $22,200 in an RRSP being held by a Co-operative. The RRSP promoters promised the taxpayer that he would receive from the Co-operative an amount equal to one half of the amount invested in the RRSP. The taxpayer admitted receiving a cash payment of some $10,000 from one of the promoters, and alleged initially that he had been told that this amount would not be subject to tax. In reassessing the taxpayer (in June 2008) for 2001 beyond the normal reassessment period, the minister included in his income an unreported amount of $10,765 allegedly received from his RRSP. On appeal to the Tax Court of Canada, the taxpayer admitted that he had received some $10,000 from the promoter, and that he ought to have reported this amount in his 2001 return. However, he did contest the amount of interest in the reassessment as being exorbitant. He also complained about the delays in resolving his case, and about the alleged dishonest conduct of the promoters in whom he had placed his trust.

The taxpayer's appeal was dismissed. The $10,765 amount shown in the minister's reassessment was clearly an amount received from the taxpayer's RRSP. Accordingly, through the combined operation of paragraph 56(1)(*h*) and subsection 146(8) of the Act, this $10,765 was properly included in his income for 2001. The reassessment beyond the normal reassessment period was also justified, inasmuch as the taxpayer made a negligent misrepresentation by failing to report the $10,765 in issue in his 2001 return. In addition, the court had no jurisdiction to grant the taxpayer any relief from the interest included in the reassessment, but the taxpayer could have paid this sooner, upon receipt of the reassessment.

¶49,318, *Filiatrault v. The Queen*, 2016 DTC 1051

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