PARSONS & CUMMINGS LIMITED
MANAGEMENT CONSULTANTS

245 Yorkland Blvd., Suite 100 Willowdale, Ontario M2J 4W9
Tel: (416) 490-8810   Fax: (416) 490-8275
Internet: www.parsons.on.ca

TAX LETTER

March 2012

"RECTIFICATION" — FIXING TAX MISTAKES
NO WITHHOLDING TAX ON MOST INTEREST PAID TO NON-RESIDENTS
GASOLINE TAX REFUND FOR CHARITIES AND PERSONS WITH DISABILITIES
SPOUSAL SUPPORT — PAYMENTS TO THIRD PARTIES
LEAP YEAR REMINDER: TRUST T3 RETURNS
GST OR HST ON WHEELCHAIRS
AROUND THE COURTS

"RECTIFICATION"- FIXING TAX MISTAKES

Tax planning sometimes goes wrong.

Transactions executed for tax purposes often involve corporate reorganizations, issuing new classes of shares, mergers, transfers, etc. What happens if someone forgets to sign and file the right document, or the lawyers forget to draft the right documents to make the transaction work?

Or worse yet, what happens if you or your corporation engage in some transaction, such as a real estate deal, setting up a trust, or a transfer of property within a family group, and aren't properly advised about the tax consequences, and a huge tax problem results?

Surprisingly, it may be possible to fix the problem by going to Court. Not the Tax Court of Canada, but the superior court of the province whose law governs the corporation or the transaction. (In Ontario, for example, this is the Ontario Superior Court of Justice; in British Columbia it is the B.C. Supreme Court; in Alberta, Saskatchewan or Manitoba, it is the Court of Queen's Bench; in Quebec it is the Quebec Superior Court.)

One can apply to the Court for a *retroactive* order **"rectifying"** a contract or document. The Court may be quite sympathetic, as long as you are simply trying to fix a mistake and get the effect you intended, or would have intended if you had known about the problem.

When the doctrine of "rectification" first started to be used by the Courts to fix tax problems, the Ontario Court of Appeal stated in the *Juliar* case in 2000: "The court has a discretion to rectify where it is satisfied that the document does not carry out the intention of the parties... If a mistake is made in a document legitimately designed to avoid the payment of tax, there is no reason why it should not be corrected." There have been numerous court cases since then allowing this kind of rectification.

Until recently, the court would not allow rectification if the judge believed that taxpayers were trying to change the past rather than trying to implement something that was intended all along. However, in a number of recent cases, the concept of rectification has expanded to include situations such as "if we'd known the tax consequences of this arrangement, we wouldn't have done it".

Sometimes the Court will apply **rescission** instead of rectification, so as to cancel a contract completely (e.g., *Stone's Jewellery v. Arora* (Alberta, 2009)). In Quebec, until recently it was believed that the province's *Civil Code* permits only **nullification** of a contract, not rectification. However, rectification was allowed in two Quebec cases now headed to the Supreme Court of Canada (the Court has already granted leave to appeal), *Riopel* and *Services Environnementaux AES*.

In a very recent (2012) Ontario case, *Orman v. Marnat Inc.*, the Court declined to order rectification but instead issued a "**declaratory order**" that certain amounts received by early investors in a Ponzi scheme, originally reported as income, were actually returns of capital.

In another recent (2012) case, *McPeake*, the British Columbia Supreme Court rewrote a family trust formed in 1997 to change the terms so that the trust was not inadvertently subject to the "reversionary trust" rules in the *Income Tax Act*.

The Courts give lip service to the rule that rectification is only intended to correct errors, "to restore the parties to their original bargain, not to rectify a belatedly recognized error of judgment by one party or the other". In practice, however, if the parties to the contract or transaction are in agreement that it should be rewritten, the Courts will often go much further and will allow it to be changed to avoid unexpected tax consequences.

If such a Court order can be obtained (whether rectification, rescission, nullification or a declaratory order), it will effectively be binding on the Canada Revenue Agency for tax purposes. The Federal Court of Appeal ruled, in the 1997 *Dale* case, that a retroactive order from a provincial superior court was binding on Revenue Canada as a determination of law within the province's jurisdiction. In that case the Nova Scotia Supreme Court had issued an order retroactively amending the articles of a corporation to permit the issuance of certain shares. The Court ruled that "an order of a superior court cannot be attacked collaterally unless it is lawfully set aside".

The limits of rectification are still being tested in the Courts. Note that rectification in the provincial superior courts cannot be used to remedy a failure to file a document with the Canada Revenue Agency on time, since that is a matter of federal jurisdiction. The provincial superior courts can make findings of fact which the CRA must accept for purposes of determining what transaction took place, but these courts cannot intrude directly on CRA administration.

The CRA's *Income Tax Technical News* No. 22 (available at www.cra.gc.ca) acknowledges that rectification is valid and that the CRA will generally accept a Court order rectifying past transactions.

So keep this possibility in mind if the tax consequences of your arrangements do not turn out as expected.

NO WITHHOLDING TAX ON MOST INTEREST PAID TO NON-RESIDENTS

Most payments of passive income to non-residents, such as dividends and royalties, as well as management fees, are subject to non-resident withholding tax. The rate of tax under the *Income Tax Act* is 25%, but it is often reduced by Canada's tax treaties to a lower rate, depending on the payee's country of residence.

Since 2008, no tax applies to interest payments by a Canadian resident to a non-resident, if the parties deal at arm's length (i.e., are not related nor acting in concert).

The only exception is "participating debt interest", which is interest that is contingent or dependent on the use of or production from property in Canada, or is "computed by reference to revenue, profit, cash flow, commodity price or any other similar criterion or by reference to dividends paid or payable to shareholders" of a corporation.

Thus, if you borrow money from a non-resident individual or institution, you can normally pay interest without non-resident withholding tax applying.

In some cases where a payment to a non-resident would be subject to withholding tax, it may be possible to restructure the arrangement to pay interest that is not taxed (provided it does not become "participating debt interest" as above). This can be a useful tax planning idea.

GASOLINE TAX REFUND FOR CHARITIES AND PERSONS WITH DISABILITIES

There is a little-known refund of excise tax on gasoline for persons with physical disabilities and for registered charities.

This refund is provided under the Federal Excise Gasoline Tax Refund Program, and is legislated in subsection 68.16(1) of the *Excise Tax Act*. It is a refund of **1.5¢ per litre of gasoline purchased** (the CRA also allows $0.0015 per kilometre driven). The gasoline must have been acquired "for the sole use of the purchaser and not for resale".

Any registered charity (or registered Canadian amateur athletic association) can claim the refund. It is also available to "a person who has been certified by a qualified medical practitioner to be suffering from a permanent impairment of locomotion to such an extent that the use of public transportation by that person would be hazardous".

The rebate can be claimed for up to two years from the date of purchase. To apply for the rebate, download Form XE8 from the CRA's web site, www.cra.gc.ca. The back of

the form includes instructions and further details.
For more information on this program, one can also call the CRA's Gasoline Tax Refund Unit at 1-877-432-5472.

SPOUSAL SUPPORT - PAYMENTS TO THIRD PARTIES

Spousal support payments are normally deductible if they meet certain conditions, such as being required under a Court Order or written separation agreement, and being "periodic" payments. They must also be made to the spouse (or ex-spouse) in a way that that person has discretion over how to use the funds. Generally the same conditions that allow a support payment to be deducted mean that it will be included in the recipient's income.

In limited cases, **payments to third parties** can qualify for deduction or tax credit. Possible ways for such payments to be deductible are as follows:

- The payor is **directed** by the recipient to pay a third party, so that the recipient is still considered to have "discretion" as to the use of the funds. Thus, for example, where a wife directed that her husband make cheques payable to her landlord for rent and he delivered the cheques to her, they were held to qualify since she retained discretion over the use of the funds (*Arsenault* case, Federal Court of Appeal, 1999).

- Where the Court Order or agreement provides for periodic payment of an amount that would otherwise qualify for deducibility as spousal support, and provides for it to be "**for the benefit of**" the recipient and/or that person's children who are living with them, the payment is deemed to be a payment to the recipient. (*Income Tax Act* subsection 60.1(1)) This rule can allow certain payments to third parties to qualify, though the recipient may still need to have discretion over how the funds are used.

- Where the Court Order or agreement specifies the particular third-party expense, and specifically states that it is to be **deductible under *Income Tax Act* subsection 60.1(2)** and included in the other person's income under subsection 56.1(2), it can be deductible. This is the case even if the payment is a lump-sum and not a periodic payment. However, there are certain restrictions. For example, it can include mortgage payments, but only 1/5 of the original principal is deductible in any one year. It cannot be for the cost of acquiring any tangible property (unless for medical or educational purposes). It cannot be related to the cost of a home in which the payor resides.

- Expenses paid for children's programs can qualify for credit under the **Children's Fitness Tax Credit** (up to $500 in expenses) and/or the **Children's Arts Tax Credit** (also up to $500 in expenses), even if the child does not live with the parent claiming the credit. This can be a way for limited payments to third parties to qualify for tax relief. The credit is only 15% federally (plus in some cases a provincial credit), but there is no income inclusion for the other spouse.

As you can see, these rules are complex. Separated or divorced couples should always get professional advice when setting up any payment arrangements, so that they are clear on the tax consequences. Disputes over support payments are one of the most common matters to end up in the Tax Court of Canada, typically with an ex-husband claiming deductibility and an ex-wife who does not want to be taxed on the income.

LEAP YEAR REMINDER: TRUST T3 RETURNS

If you are the trustee of a trust, or otherwise responsible for filing a "T3" trust income tax return, you need to be aware of the effect of 2012 being a leap year.

The **deadline for filing the return** for a trust with a December 31 year-end is often thought to be March 31, but it is not. It is **90 days after the year-end**.

Because 2012 is a leap year, there were 29 days in February. As a result, the deadline is **Friday, March 30**, not Saturday March 31 (which would be extended by the CRA to Monday April 2 if the deadline were indeed Saturday).

Missing the deadline by just one day can result in a 5% penalty for any unpaid tax, and can cause even worse problems if certain elections that are required to be filed by the return deadline are not made on time.

GST OR HST ON WHEELCHAIRS

Many medical devices are "zero-rated", meaning not subject to Goods and Services Tax (GST) or Harmonized Sales Tax (HST). This applies to a wide variety of items, including prescription eyeglasses, crutches, dentures, hearing aids, incontinence products, and many other products.

An amendment to the legislation in 2008 affects the taxation of **wheelchairs**. Before February 26, 2008, all wheelchairs were zero-rated. Now a wheelchair that cannot be operated by the patient is no longer automatically zero-rated.

The general zero-rating for wheelchairs (section 14 of Schedule VI, Part II of the *Excise Tax Act*) will not apply to wheelchairs with casters that require a caregiver to wheel the patient around. To be tax-free, the wheelchair must be **specially designed to be operated by an individual with a disability**.

A different rule (section 14.1) allows any wheelchair to be tax-free, but only if it is prescribed by a physician for a *specific* consumer.

The same rules apply in Quebec to the Quebec Sales Tax (TVQ), which follows the GST/HST rules even though it is a separate tax.

As you can see, the rules governing the GST/HST are complex and sometimes arbitrary. Businesses that sell wheelchairs need to be aware of these rules, so as not to be at risk of assessment by the CRA for failing to charge tax. Hospitals and nursing homes that buy wheelchairs should be aware of the ways to ensure no tax applies. Consumers buying wheelchairs can save money if they are properly informed as to the rules.

AROUND THE COURTS

Ponzi scheme early investor did not earn income

In a Ponzi scheme, people are duped into putting money into investments that do not really exist. The promoter gets more and more people into the scheme, repaying the early investors with cash from the later investors, so that the early investors can report on how well the "investment" is doing.

In the recent *Donna Johnson* case, an early investor in a Ponzi scheme had actually made money, receiving "fantastic" returns on her money. The promoter, Andrew Lech, told her that tax had already been paid on the income through a family trust that he managed. As a result, she did not report the income.

The Ponzi scheme later came to light, many people lost money, and Lech was sentenced to a lengthy term in prison.

The CRA taxed Ms. Johnson on the income she received from the scheme. She appealed to the Tax Court of Canada, arguing that there was no "source" of income, since she did not expect to receive other people's funds through a fraudulent scheme.

The Tax Court agreed with Ms. Johnson. Nothing was actually earned on the capital she invested; funds were merely shuffled around by the promoter. Nor did she "seek or expect fraudulently obtained funds".

As a result, Ms. Johnson did not have to pay tax on what looked like income from her investment.

This case is the flip side of a number of cases where the CRA has denied deductions to taxpayers who thought they were investing in a real business but who were defrauded of their funds. In such cases, business losses are usually disallowed. The *Johnson* case turns the tables on the CRA.

For another Ponzi scheme early-investor who can retroactively change his reported income to tax-free return of capital, see the *Orman v. Marnat Inc.* case discussed in the article above on Rectification.

Expenses to help manage related companies were non-deductible

The recent Federal Court of Appeal decision in *Lyncorp International Ltd.* is a cautionary tale about putting expenses in the right company.

Lyncorp was wholly owned by Mullen, who was an entrepreneur with significant investments in many businesses, most of which he held through Lyncorp. Mullen travelled extensively by private airplane, and Lyncorp paid some $400,000 in airplane costs for his flights in 2002 and 2003. Lyncorp deducted these expenses for income tax purposes, and also claimed input tax credits (ITCs) for GST purposes.

The CRA denied Lyncorp's deductions and ITCs on the basis that Lyncorp did not incur these expenses in the course of a business of its own. Lyncorp appealed to the Tax Court of Canada.

The Tax Court dismissed the appeal for the most part, though it did allow a portion of the expenses and ITCs which related to Lyncorp's own drilling business.

The Tax Court engaged in a careful analysis of the bases on which the deductions could be allowed, and the grounds on which they might be denied.

First, the Tax Court rejected the CRA's position that Mullen was simply "commuting to work" so that his expenses were personal expenses. His businesses were far-flung and these trips were generally not personal. However, some of the trips were to a home he had in Campbell River (along with business activities there), and he would go there with his family and spend time with them. The Court concluded that half of his time on these trips was personal and thus half of the associated airplane expenses were non-deductible.

Second, the Tax Court rejected the CRA's argument that Mullen's use of an airplane was simply for "personal convenience". The Court confirmed previous case law to the effect that the Courts should not "second-guess" a taxpayer's business decisions. Given Mullen's hectic schedule and his need to travel to numerous destinations, it was not at all unreasonable for him to minimize his time by using a private plane.

After winning on these two points, however, Mullen lost on the next two key points: were these expenses incurred for Lyncorp's business or property? The Tax Court concluded that they were not (except for the small portion relating to Lyncorp's drilling business).

Lyncorp was not carrying on the related companies' businesses. Lyncorp argued that it was providing "support services" to the other companies, but it was not charging anything for these services. This "intentional non-income producing activity" was not a business in the Court's view.

Lyncorp also argued that it incurred the expenses so as to maximize the other companies' profits, so that they could pay it dividends and because it had made loans to them. The Tax Court rejected this argument. The loans were non-interest bearing, so incurring expenses to support the loans would not be deductible. As to the possibility that the companies would pay Lyncorp dividends, the Court found no "direct cause and effect link".

Lyncorp appealed the decision to the Federal Court of Appeal, which dismissed the appeal. In the view of the Court of Appeal, the expenses might have been deductible, but it was not sufficiently clear what work Mullen actually did for the companies. The deductions were held not to be "consistent with commercial reality".

To avoid this problem, a holding company incurring expenses for related companies should charge them management fees, so as to justify the expenses — and, if necessary, lend the funds back to them.

* * *