TAXADVISOR

Not Arm's Length

Recipients are liable for the interest – and outstanding taxes – on assessments

COURT REPORT

BY JAMIE GOLOMBEK

Imagine ten years ago you invested in an art-flip donation tax shelter. At the time, you had some reservations about whether or not the scheme would actually work, so you decided to transfer your biggest asset, your principal residence, to your spouse.

Sure enough, several years ago, you were reassessed. You objected, along with all the other investors, and ended up in court. You lost both in Tax Court and the Federal Court of Appeal and just learned that your request to have the Supreme Court of Canada hear the case was rejected. In other words, all avenues of appeal have now been exhausted.

Your tax debt, along with compound non-deductible arrears interest, is now triple what the initial tax savings was and you don't have enough assets to pay the tax man. Good thing you had the foresight to transfer that home into your spouse's name, right?

Not so fast. Under section 160 of the *Income Tax Act*, the CRA has the right to go after your spouse for your tax debt since you made a transfer to a non-arm's length person for less than fair market value consideration.

But hold on a minute – you made that transfer a decade ago. Certainly the statute of limitations has expired. Surely the CRA can't go after your spouse ten years later? Or can it?

That was the issue the Supreme Court of Canada had to determine in a recent tax case decided by the Court last month. On July 12, 2007, the SCC handed down its decision in *Canada v. Addison & Leyen Ltd.* (2007 SCC 33).

CANADA V. ADDISON & LEYEN LTD.

In 1989, Addison & Leyen Ltd. ("Addison") along with various other companies and individuals, owned shares in a bottling company, York Beverages (1968) Ltd. ("York"). York had sold its bottling business the year before, and the shareholders sold their York shares to another company, Synergy Inc. ("Synergy").

Synergy was going to use York's cash to purchase seismic data (which had considerable tax write-offs associated with it) and reduce York's tax liability to zero. After the bottling business was sold, but prior to the sale of the York shares, Addison and the other shareholders received various payments from York in the form of dividends, directors' fees, loan repayments, etc.

In 1992, the CRA reassessed York for the 1989 taxation year, determining that the seismic data had been overvalued. The reassessment was for over $3.2 million of tax owing, including a penalty and arrears interest.

While York objected to this assessment, the CRA never followed up. To date, the CRA has neither confirmed the assessment nor have the shareholders filed an appeal to the Tax Court.

Eventually, the CRA must have concluded that it would never get any of the taxes owing from York and in February, 2001, some nine years after the original assessment was issued to York, the CRA decided it would go after York's shareholders instead, using section 160 of the Act since they were non-arm's length persons that received a "transfer" (e.g., dividends) from their corporation.

Addison and the other shareholders objected in May, 2001, but again, the CRA never dealt with the objections nor had the shareholders filed an appeal to Tax Court.

In 2005, the shareholders who were assessed as personally liable for the tax debt of the company some 16 years earlier went to court, not to argue the substantive tax facts of the actual case, but rather to get a judicial review on procedural grounds, arguing that "the long delay in issuing the assessment was abusive, prevented them from mounting a proper challenge to the validity of the assessment in the Tax Court and deprived them of any possibility of indemnification by the primary taxpayer."

The Supreme Court carefully reviewed the wording of the *Income Tax Act*, which states that the CRA can reassess "at any time" using section 160 of the Act since there is no specific limitation period mentioned. As a result, it

Continued on page 6

ADVISORCOMPLIANCE

Excessive Regulation or Overdue Reform?

COMPLIANCE MATTERS

BY REBECCA COWDERY AND PREMA THIELE

As we write our inaugural column in mid-July, the Canadian securities regulators are working overtime slogging through a mind-boggling 270-plus letters responding to the registration reform proposals of proposed National Instrument 31-103 published earlier this year. Writers from all over Canada have contributed many thousands of comments: each with their own bone to pick and their own unique perspective. Given that the regulators are moving quickly to finalize the reform proposals by the official, but unrealistic, deadline of mid-2008, we expect that they will not be able to respond in depth to the comments. We have read the comment letters and offer up our predictions on the expected response to some of the most common comments.

Cowdery

Thiele

Drop the exempt market dealer concept! Virtually all writers commented on the concept of a new national dealer category of "exempt market dealer," with its requirements for capital, insurance and proficiency. Particularly firms and investors based in Western Canada protested about "irrelevant burdensome controls," "money grabs" (presumably by the regulators), "invasive" and "excessive" regulation. Two aggressive letter-writing campaigns – one by those who deal in exempt securities and another by investors who invest in them – have as their central theme that the exempt market is doing just fine on its own. The new proposals will force many out of business and limit investment opportunities for investors.

Notwithstanding the vehemence of some of the comments, we expect that the perceived benefits of enhanced investor protection and strengthened confidence in the capital markets through additional regulatory scrutiny of exempt market activity, regulatory harmonization in the exempt markets and a level playing field among market participants will trump these concerns. We also know that regulators question whether all investors participating in the exempt markets are indeed so sophisticated as to warrant the current lack of regulatory oversight.

Allow mutual fund dealers to trade in exempt securities! Many writers didn't understand how the exempt market dealer proposals would affect mutual fund dealers – can they or can't they also deal in exempt securities with their mutual fund dealer licence? And what about managers of pooled funds – do they need to be registered as exempt market dealers, in addition to their registration as portfolio managers? And if so, why?

> "Too much regulation, particularly if prescriptive and inflexible, will not be embraced."

Given that mutual fund dealers are subject to substantial regulatory oversight over all of their securities-related business, we believe there is no need for them to also be registered as exempt market dealers. Similarly, portfolio managers are already subject to significant regulatory requirements, hence there is little value to be gained by additional dealer registration. We suspect the regulators will agree.

Get the compliance rules right! Many commented on the proposals that would require a registered firm to set up a compliance system that will ensure compliance with securities regulations and that "manages the risks associated with its business in conformity with prudent business practices." Proficiency requirements for, and the description of the roles of, the Ultimate Designated Person and the Chief Compliance Officer, received particular attention, with many commenting that the regulators have the roles backward and the proficiency requirements wrong.

We think that the writers will win on this one – the UDP and CCO regime needs revision and compliance expectations need to be clarified. We hope that the CSA will look to the established compliance rule that applies to industry participants in the United States for guidance. Given our proximity with those markets, this would be useful from a cross-border perspective.

Give us a long transition period to the new rules! The lack of proposals for a transition to the new rules garnered forceful comment. Many suggested that transitions of several years were necessary to allow individuals and firms to ramp up to meet the new requirements. Others commented that individuals and firms that carry on business in the securities industry already should be grandfathered and not be required to comply with the new requirements, ideally forever, but certainly for a substantial period of time.

We suspect we will have to get real on this one. The regulators will allow for some transition, perhaps a year, maybe two, but it won't be forever and current industry participants won't be grandfathered.

Reflect the reality of independent contractors and incorporated reps! Many commented on what was not dealt with by the regulators – including the notion of principal and agent status for all registered firms and their representatives and incorporated salespersons.

We agree that this area is in dire need of regulatory reform. Whether the regulators will have the energy to develop an appropriate regulatory framework that will embrace these concepts is another question. We suspect that nothing in this area will be implemented on the same timeline as the reform proposals.

And there are many more comments. It is obvious that these proposals have touched a nerve.

Our predictions for what will happen next? The securities regulators will move forward quickly, perhaps too quickly for thoughtful reflection, but there will be a second publication of the proposals for comment. The reforms will not come into force by mid-2008. The cornerstones of the new regime will remain, with the biggest unknown being whether the securities regulators will keep the rules uniform on a national basis, which we believe is the most positive aspect of the present proposals. Finally, the securities regulators cannot ignore the overarching theme of the comments: too much regulation, particularly if prescriptive and inflexible, will not be embraced by today's securities industry. AER

Rebecca Cowdery and Prema Thiele are securities lawyers specializing in legal matters associated with the securities, investment management and insurance industries. They are partners in the Toronto office of Borden Ladner Gervais LLP. BLG contributed approximately 55 comments on the registration reform proposals in their submission. Their column will appear regularly and will focus on compliance and regulatory issues. The views expressed in their columns are their own and are not necessarily the views of other lawyers at BLG, the firm or its clients. No person should act or refrain from acting in reliance on any information found in these columns without first obtaining appropriate professional advice.

Not Arm's Length

Continued from page 5

found that despite the CRA's delay, the assessments under section 160 were still valid.

IMPLICATIONS

While this decision did not come as a surprise to many tax practitioners, it does serve as an important reminder to taxpayers that they need to tread carefully in this area. Specifically, section 160 makes a "non-arm's length" recipient (e.g., spouse, partner, relative, shareholder) of property personally liable for money or property transferred to them by a non-arm's length individual or corporation that owes tax.

Under this section, the "transferee" is personally liable for the value of what he or she received, less anything paid in return for the property, up to the tax liability of the "transferor" as of the year in which the property was transferred.

According to senior tax litigator Al Meghji of Osler LLP, who has successfully argued past tax cases in the highest court, "the Supreme Court was clearly aware that the absence of a limitation period in section 160 results in very harsh consequences, but it was not willing to read one in because it is up to Parliament to amend the provision and put in a limitation period if it sees fit."

The SCC's decision reinforces the principle that there really is no time limit on the assessment. In addition, based on prior cases, the recipient of the property can still be held liable even if they had no intention to avoid, or knowledge of, a tax debt.

Adds Meghji, "While the decision has serious implications in that there is little finality when it comes to section 160 assessments, nothing in the Supreme Court's decision takes away from a taxpayer's right to challenge such assessments on their merits in the Tax Court." AER

Jamie Golombek, CA, CPA, CFP, CLU, TEP is the Vice-President, Taxation & Estate Planning, at AIM Trimark Investments in Toronto.
Jamie.Golombek@aimtrimark.com