

# **2022 TAX DISPUTE RESOLUTION MONTHLY UPDATE**

## **SESSION 8**

**28 JUNE 2022**

# LEGAL DISCLAIMER

- Today's session will be a high level overview, for general information purposes, and does not constitute legal advice
- For specific advice relating to the topics discussed today, please contact your legal counsel
- Information in this presentation reflects laws and other relevant standards that are in effect as of the date of the presentation

# SPEAKERS



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# DISCUSSION TOPICS

Expanded mandatory disclosure rules for reportable transactions and a new category of notifiable transactions – Part two: Practical considerations

Structuring business sales as hybrid transactions and ss. 84(2) – Case law update

SR&ED Tax Court appeals, a case study



# **REPORTABLE AND NOTIFIABLE TRANSACTIONS – PART TWO: PRACTICAL CONSIDERATIONS**

# MANDATORY DISCLOSURE RULES

- **Draft legislation released on February 4, 2022 includes:**
  1. Changes to existing “reportable transaction” rules
  2. Creation of a new class of “notifiable transactions”
  3. Enhanced penalties for the failure to file an information return for reportable and notifiable transactions

# REPORTABLE TRANSACTIONS

- **Reportable transaction – “avoidance transaction” having any one (existing definition requires two) of the following “hallmarks”:**
  1. Contingent fee arrangement
  2. Confidential protection
  3. Contractual protection
- **“Avoidance transaction” one of the main purposes is to obtain a tax benefit**
  - Lower threshold – currently a primary purpose test

# NOTIFIABLE TRANSACTIONS

- **Notifiable transactions – designated by Minister of National Revenue (CRA) with concurrence of Minister of Finance**
  - Will include transactions CRA considers abusive and transactions CRA identifies to be of interest
  - Includes transactions that are the same as or substantially similar to designated transactions

# INFORMATION RETURNS

- **Information returns with respect to reportable and notifiable transactions:**
  - due 45 days after the earlier of:
    - the day the taxpayer becomes contractually obligated to enter into the transaction; and
    - the day the taxpayer enters into the transaction

# FAILURE TO REPORT

- **Significant penalties for failing to file information return, subject to due diligence defence**
  - Taxpayer:
    - \$500 X weeks failure continues to a maximum equal to greater of:
      - \$25,000, and
      - 25% of the tax benefit
    - If a corporation with asset carrying value  $\geq$  \$50 million:
    - \$2,000 X weeks failure continues to a maximum equal to greater of:
      - \$100,000, and
      - 25% of the tax benefit
  - Promoter or advisor, total of:
    - Fees charged,
    - \$10,000, and
    - \$1,000 X days failure continues, up to \$100,000

# PRACTICAL CONSIDERATIONS AND UNCERTAINTIES

- **As currently drafted, transactions that are not aggressive tax planning are subject to the rules.**
  - Increased administration and compliance costs for taxpayers, including as a result of advisors being required to report
- **Obligation to report a reportable or notifiable transaction by *each* advisor and promoter**
  - “Advisor” includes ***each*** person who provides any advice with respect to creating, developing, planning, organizing or implementing the transaction or series

# COMING INTO FORCE

- **New reporting requirements apply to transactions entered into after 2021**
- **Penalties will not apply to transactions entered into prior to draft legislation receiving Royal Assent**



# **STRUCTURING BUSINESS SALES AS HYBRID TRANSACTIONS – CASE LAW UPDATE**

# OVERVIEW

- The traditional dynamic for business sale negotiations often involves a seller wanting to sell shares of the corporation that operates the business and a buyer wanting to acquire assets
- Hybrid business sales structured to allow for both an asset sale as well as a share sale developed, often to allow a seller to make use of their lifetime capital gains exemption
- Historically the CRA looked to apply ss. 84(2) to recharacterize share sale proceeds in such transactions as dividends. After the TCC decision in *Geransky* (2001 D.T.C. 243 (TCC)), the CRA generally respected hybrid sale transactions
- However, recent cases have reignited CRA reviews of hybrid business sale transactions

## SUBSECTION 84(2)

- Generally ss. 84(2) applies where funds or property of a corporation resident in Canada have been distributed or otherwise appropriated in any manner whatever for the benefit of shareholders of any class of shares in its capital stock, on a winding up, discontinuance or reorganization of its business
- In *Geransky* the buyer was interested in the cement plant and related assets of an operating company (“**Opco**”) the shares of which were owned by a holding company (“**Holdco**”)
- Opco had two distinct businesses
- Holdco incorporated a new company (“**Newco**”), the target assets were transferred to Holdco via a dividend in kind payment and then moved to Newco on the redemption of Holdco’s shares in Newco

- The shares of Newco were then acquired by the Buyer
- The CRA reassessed to recharacterize the proceeds of the sale of the Newco shares as dividends, pursuant to ss. 84(2)
- The TCC held, among other things, that it did not see where any funds or property of the corporation (“Opco”) ended up in the appellant’s hands in the transactions in issue
- In the course of its reasons, the TCC reviewed a number of surplus stripping cases (notably *RMM Enterprises* and *McNichol*)
- Both cases involve an identifiable corporate surplus that was transferred to the shareholders of a corporation

# RECENT DECISION - *MACDONALD*

- In the *MacDonald* decision (2013 FCA 110) the FCA upheld the application of ss. 84(2) to proceeds from the sales of shares of a medical professional corporation (“**PC**”)
- The assets of PC were first liquidated, sold by the shareholder of PC to his brother-in-law (“**JS**”) for a promissory note, who then transferred the shares to his newly incorporated company, again in consideration for a promissory note payable by the new company
- Dividends were then declared and endorsed over to JS and then over to the shareholder of PC
- The FCA focussed on the wording in ss. 84(2) respecting funds or property of a corporation being distributed or otherwise appropriated *in any manner whatever* for the benefit of the corporation’s shareholder and held that the reorganization involved a circuitous means of transferring corporate property to the PC shareholder

- This decision (2021 TCC 52) upheld the application of ss. 84(2) in relation to a hybrid business sale transaction (the decision is under appeal)
- The transaction was originally proposed as a straight asset sale but the parties converted it to a hybrid sale of assets and shares
- There was an ongoing agreement that the excess cash of the corporation could be distributed to shareholders prior to closing
- The TCC found that the purchasers were the instruments and intermediaries through which the distribution of the target corporation's funds or assets for the benefit of its shareholders took place, following a prior reorganization that brought about the hybrid sale

# TAKEAWAY POINTS

- *Foix* should not be read as authority that ss. 84(2) will automatically apply to hybrid business sale transactions
- Look to ensure that there is identifiable corporate funds or corporate surplus was distributed
- The value of corporate shares will always be tied to the value of the underlying assets. This is not enough to support the application of ss. 84(2)
- Even where there are identifiable corporate funds or surplus, look to ensure that there is some deliberate intent (i.e. circuitous means) to distribute the funds pursuant to the reorganization



**SR&ED TAX COURT OF CANADA (“TCC”)  
APPEALS  
A CASE STUDY**

# SR&ED TCC APPEALS

- **1 General Considerations**
- 2 Case Study
- 3 Practical Considerations

# SR&ED TCC APPEALS - GENERAL CONSIDERATIONS

- Five part test for determining eligibility of SR&ED expenditures
- **1** technological risk or uncertainty
- **2** formulation of hypotheses
- **3** accord with total discipline of scientific method
- **4** technological advancement
- **5** detailed record of hypotheses tested and results

# SR&ED TCC APPEALS - GENERAL CONSIDERATIONS

- Qualified expert testimony
- Overriding duty to assist the TCC impartially on matters relevant to their area of expertise
- Duty overrides duty to the appellant
- Must be independent and objective and not an advocate

# SR&ED TCC APPEALS

- 1 General Considerations
- **2 Case Study**
- 3 Practical Considerations

# SR&ED TCC APPEALS - CASE STUDY

- Sole issue was whether expenditures incurred on a certain project were SR&ED eligible
- Only witness was sole shareholder and president of appellant
- Conducted the subject activities himself, with student helping
- Was accepted by the TCC as litigant expert
- Appellant had also retained an expert

# SR&ED TCC APPEALS - CASE STUDY - RESULT

- TCC did not qualify the appellant's proffered expert witness
- TCC held that only the first of the five part test (for determining eligibility of SR&ED expenditures) was met and the appellant failed to meet the other four criteria
- SR&ED expenditures denied eligibility
- Federal Court of Appeal ("**FCA**") upheld TCC decisions

# SR&ED TCC APPEALS - CASE STUDY - RESULT

- TCC did not qualify the appellant's proffered expert witness
- Proposed expert report did not comply with TCC Rules or TCC Code of Conduct for Experts
- Requirements of impartiality and independence not satisfied
- Improper opinion on application of the law to the facts
- Failed at gatekeeper stage, balancing probative value with potential prejudicial effects

# SR&ED TCC APPEALS - CASE STUDY - ISSUES

- **3<sup>rd</sup> Criteria** - accord with total discipline of scientific method
- Appellant argued this requirement should not be applied
- The scientific method is different from the engineering method
- FCA rejected this argument

# SR&ED TCC APPEALS - CASE STUDY - ISSUES

- Scientific method criteria upheld
- **1** FCA previously considered and rejected the argument and, while not binding, it was not inconsistent with CRA guidance
- **2** Understanding of legislation as expressed in jurisprudence was not improper exercise of judicial legislation: “Parliament and the legislature rely on the courts to give definition, amplitude and precision to statutory language as required by the circumstances of the case.”

# SR&ED TCC APPEALS - CASE STUDY - ISSUES

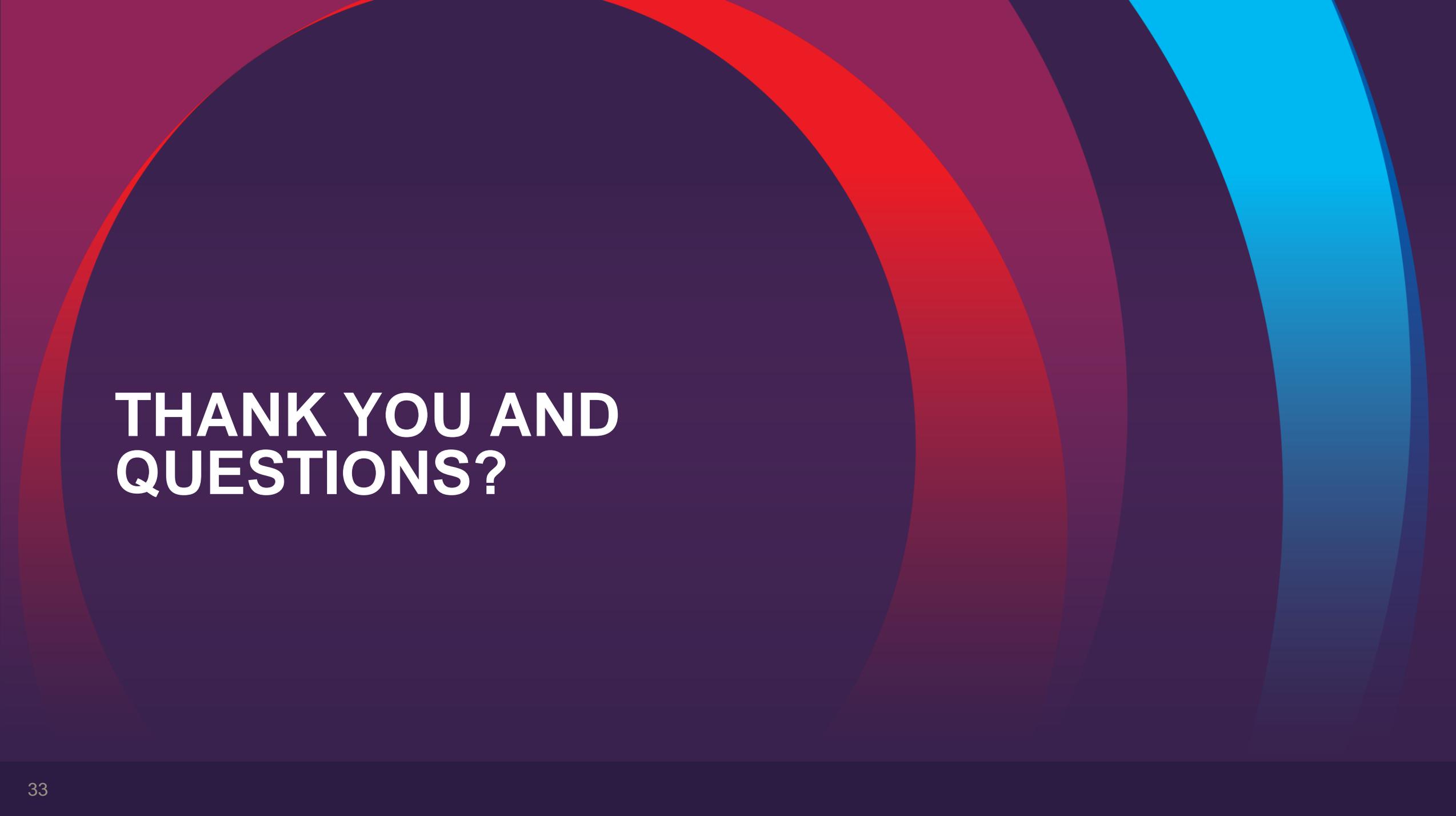
- **3** TCC did not adopt restrictive approach to what constituted scientific method and applied the criteria “within the context of [the appellant’s] business environment”
- **4** no proven distinction between scientific method and engineering method

# SR&ED TCC APPEALS

- 1 General Considerations
- 2 Case Study
- **3 Practical Considerations**

# SR&ED TCC APPEALS – PRACTICAL CONSIDERATIONS

- Retain independent subject matter expert
- To more effectively pursue the argument, need to retain expert to testify on distinction between scientific research versus experimental development and that the concepts have been conflated, especially relating to documentary requirements
- SR&ED TCC appeals, since they seek tax credits, can be appropriate for contingency fee arrangements



**THANK YOU AND  
QUESTIONS?**

# SURVEY

- Please complete our survey by scanning the QR code below

