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WHAT IS AN "AVOIDANCE TRANSACTION"? THE FEDERAL COURT OF APPEAL FINDS FOR THE TAXPAYER IN *SPRUCE CREDIT UNION*

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The Federal Court of Appeal ("FCA") released its decision in *Spruce Credit Union* (2014 FCA 143) on May 30, 2014. In it, the Crown's appeal from the Tax Court of Canada's 2012 judgment (2012 DTC 1295) was dismissed. The case provides useful considerations of the meaning of the term "avoidance transaction" for the purposes of the general anti-avoidance rule ("GAAR") in section 245 of the *Income Tax Act* (the "Act") and of the interpretation of certain provisions of the Act specifically relevant to credit unions.

Aside from the taxpayer, another 40 credit unions in British Columbia will be grateful that the FCA found against the Crown; these credit unions had identical assessments held in abeyance pending the outcome of this test case. It is not yet known whether the Crown will seek leave to appeal to the Supreme Court of Canada.

Facts

Spruce Credit Union ("Spruce") is one member of a large network of credit unions providing financial services to its members in British Columbia. Two separate provincially owned entities were responsible for insuring the deposits of B.C. credit unions over the relevant period: the Credit Union Deposit Insurance Corporation ("CUDIC") and the Stabilization Central Credit Union of British Columbia ("STAB"). Under the relevant provincial law, CUDIC is required to maintain an insurance fund guaranteeing deposits and non-equity shares in the event of a default or failure of a credit union. STAB performed an oversight function in the credit union marketplace, and each B.C. credit union was required to be a member of STAB and hold such number of Class A shares of STAB as determined by the STAB board of directors. Both agencies were primarily funded by assessments of the provincial credit unions.

For many years, STAB and CUDIC had jointly maintained the deposit insurance protection fund that was ultimately CUDIC's statutory obligation to maintain. In 2003, the provincial agency responsible for overseeing STAB and CUDIC determined that CUDIC was required to maintain exclusive control over a significantly higher proportion of the protection fund; this required that funds currently held by STAB be transferred to CUDIC. After considering alternatives, it was decided that CUDIC would assess the member credit unions the amount in aggregate necessary to meet the fund requirement, and that STAB would pay to the credit unions a dividend on its Class A shares that was roughly equal to the assessment. Two dividends were in fact declared and paid: Dividend A, from STAB's "aggregate cumulative investment income", and Dividend B, from STAB's "aggregate cumulative assessment income".

Under the rules governing credit unions in the Act, Spruce (and presumably all the other affected credit unions) paid its assessment to CUDIC and claimed a deduction for the payment under subsection 137.1(11) of the Act, which provides that a "member institution" (which Spruce was) can deduct premiums or assessments made to deposit insurance corporations in the year (which CUDIC was). Spruce also deducted the dividend in computing its income pursuant to the dividend-received deduction in subsection 112(1) of the Act.

The Canada Revenue Agency ("CRA") reassessed Spruce, denying the subsection 112(1) deduction in respect of Dividend B. Dividend A was not reassessed. In the CRA's view, paragraph 137.1(10)(*a*) required Spruce to include the amount received as Dividend B in income as an "allocation in proportion to any premiums or assessments" that Spruce had paid to STAB. The CRA also assessed Spruce using the GAAR.

Tax Court of Canada

At the lower court, the judge held in favour of the taxpayer, finding that neither subsection 137.1(10) of the Act nor the GAAR were applicable. According to the Tax Court judge's reasons, the amount of Dividend B did not satisfy the "proportionate to assessments" test, as Spruce's aggregate amount of STAB's assessments, being 0.26%, did not match the amounts returned to Spruce by way of Dividend B, which amounted to 0.23% of the aggregate amount of STAB assessments. The credit unions held shares in STAB in proportion to their *asset size*, which had recently been rebalanced, and not in proportion to assessments received. As such, the strict wording of subsection 137.1(10) was not met, and Dividend B was instead governed by the ordinary rules in the Act pertaining to intercorporate dividends, namely the subsection 112(1) deduction.

The Tax Court also considered the application of the GAAR to deny the subsection 112(1) deduction. The Tax Court judge found that there was no transaction that was undertaken primarily for a tax purpose; in the parlance of the GAAR, there was no "avoidance transaction" and therefore the GAAR could not apply. Importantly, the Tax Court judge determined that the decision to return the funds to Spruce (and the other member credit unions) by way of dividend and not a return of assessments, for example, was not a transaction.

Federal Court of Appeal

The Crown appealed the Tax Court's decision to the FCA.

The FCA first considered whether subsection 137.1(10) of the Act applied to Dividend B. The Court noted that the rules surrounding the taxation of credit unions provide member institutions with a deduction for premiums paid in the year, and require the institutions to include any allocations in proportion to those assessments as income when received. Since Dividend B was paid from STAB's aggregate cumulative assessment account, it was assumed that Spruce and the other credit unions received a deduction when these amounts were paid to STAB. Presumably, this was the Minister's objection to the entire planning — the taxpayer received a deduction for premiums paid, but when returned as a dividend, there was no ultimate income inclusion because of the subsection 112(1) deduction *and* the subsequent assessment paid to CUDIC was deductible for the credit unions. Thus, there was an element of "double dipping" to the transactions.

The Crown argued that "allocation" for the purposes of section 137.1 can refer to something less than the member institution's original assessment. The Crown also continued its argument (heard, but not decided in the Tax Court) that section 137.1 of the Act is a "complete code" as regards the taxation of premiums and assessments made and refunded to credit unions. However, the FCA did not accept this reasoning. In its view, because Dividend B was at law and in fact a dividend from a taxable Canadian corporation, and because the dividend was paid in proportion to the member institutions' *shareholdings* and not their assessments or premiums, subsection 137.1(10) simply had no application to the facts.

The FCA also addressed the Crown's argument that the GAAR should be applied to deny Spruce the ability to claim the subsection 112(1) deduction. As noted by the Court, there are three elements necessary for the GAAR to be applicable: (1) there must be a tax benefit; (2) one of the transactions or events giving rise to the tax benefit must be an avoidance transaction; and (3) the tax benefit must result in an abuse or misuse of the object, spirit, or purpose of the provisions relied on by the taxpayer.

Spruce had conceded that it obtained a tax benefit by virtue of claiming the subsection 112(1) deduction. At the Tax Court, the judge held that there was no avoidance transaction and therefore the abuse or misuse analysis was not necessary. The Crown argued that the Tax Court judge's reasoning was flawed in that the Tax Court had held that it was "inappropriate to consider whether the taxpayer chose the particular transaction among alternatives primarily based on tax considerations". In the Crown's view, the FCA decision in *MacKay* (2008 DTC 6238) requires the Court to consider whether the non-tax objective could have been obtained without the particular impugned transaction or through an alternative transaction. The Crown also argued that the Tax Court was incorrect in holding that tax considerations can play a primary role in a taxpayer's choice among several structuring options without necessarily making any particular transaction or event in the series primarily tax-motivated.

The Crown relied heavily on the fact that STAB had paid the dividends at a time when it appears (although not explicitly stated in the Court's reasons) that the Class A STAB shares were "taxable preferred shares" and had later petitioned the Supreme Court of British Columbia to retroactively amend the share terms to avoid a significant tax under Part VI.1 of the Act. In statements made to that court, STAB had indicated that the "dominant consideration" in structuring the transactions was to minimize adverse tax considerations of the member institutions.

The FCA rejected the Crown's reasoning as regards the GAAR. The Court found that when determining whether a particular transaction is an avoidance transaction, the existence of an alternative transaction that may have attracted additional tax is but one factor to consider. The very existence of such alternative transaction is not, in and of itself, determinative that there has been an avoidance transaction. The fact that this alternative transaction exists is only one consideration in determining whether any transaction in a series is an avoidance transaction. In this author's view, this must be correct. As noted by the FCA in its reasons, to contend otherwise would be to undermine the long-standing *Duke of Westminster* principle in Canadian tax law that taxpayers are free to organize their affairs in a manner to pay the least amount of tax within the bounds of the law. The Supreme Court of Canada has affirmed the validity of the *Duke of Westminster* principle in numerous GAAR decisions.

It is not entirely clear what the principled distinction is between this decision and that in *MacKay,* where the FCA found an avoidance transaction, overturning the lower court decision. It may be that in this case, there was a regulatory regime in place that needed to be accommodated and that necessitated moving money around from STAB to CUDIC, whereas *MacKay* involved arguably gratuitous tax-motivated planning based on a voluntary acquisition of certain real property. However, in neither case is this distinction particularly clear. The presence of an accommodating party in *MacKay* may have also played a role. Unfortunately, it may simply be a matter of the FCA finding that the *Spruce Credit Union* transactions "smelled" better than the motivations of certain of the steps in *MacKay*.

It is hoped that future GAAR decisions in which the presence of an avoidance transaction is at issue, or perhaps an appeal of the *Spruce Credit Union* decision to the Supreme Court of Canada, will help resolve this uncertainty.

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STANDING COMMITTEE ON FINANCE ANNOUNCES PRE-BUDGET CONSULTATION PROCESS

On June 6, 2014, the House of Commons Standing Committee on Finance (the "Committee") invited Canadians to participate in its pre-budget consultation process, and requested that stakeholders share their priorities for the upcoming 2015 federal Budget. The closing date for written submissions, which are not to exceed 2,000 words in length (including an executive summary), is August 6, 2014. Input and requests to appear before the Committee can be submitted via email to finapbc-cpb@parl.gc.ca.

PRESCRIBED INTEREST RATES — THIRD QUARTER OF 2014

The prescribed interest rates for the third quarter of 2014 were released by the Canada Revenue Agency on June 12, 2014. Except for corporate taxpayers' rates for interest on pertinent loans and indebtedness (which will be 4.93%), the rates have not changed from the second quarter of 2014 and are noted below.

- 1% to calculate a deemed interest taxable benefit on subsidized employee and shareholder loans;
- 1% on refunds of income tax overpayments paid to corporate taxpayers;
- 3% on refunds of income tax overpayments paid to non-corporate taxpayers; and
- 5% on payments of overdue income taxes, insufficient income tax instalments, unremitted employee source deductions, CPP contributions or EI premiums, and unpaid penalties.

These rates will be in effect from July 1, 2014 to September 30, 2014.

A listing of the prescribed interest rates for each quarter, dating back to 2000, is reproduced at ¶300 and under "Quick Links" in the *Canadian Tax Reporter* on DVD and online.

RECENT CASES

Insurer ordered to pay Minister cash surrender value of insurance policies owned by tax debtor

The third party, Projexia Conseil Inc. ("PC Inc."), was the owner and sole beneficiary of 11 policies (the "Policies") issued by the appellant, London Life Assurance Company ("London Life"). On October 13, 2011, the Minister registered a certificate under section 223 of the *Income Tax Act* (the "Act") certifying that PC Inc. owed tax of $1,255,298.28. On August 15, 2012, a Prothonotary of the Federal Court issued a final order seizing all amounts owing under the Policies by London Life to PC Inc. up to the sum of $1,255,298.28. In the Prothonotary's view, (a) the cash surrender value of the Policies fell outside the purview of the exemption from seizure provisions of articles 2457 and 2458 of the *Quebec Civil Code*; (b) insurance policies and the rights to surrender them are subject to seizure, and this right to surrender is not a personal right such as to prevent the seizure being effected by the Minister; and (c) the seizure by the Minister of the cash surrender value of the Policies in the present proceedings did not require a prior written request from PC Inc., since the seizure itself was the equivalent of a written request. In dismissing London Life's application to set aside the Prothonotary's final order of seizure (2013 DTC 5093), a single judge of the Federal Court concluded, in part, that (a) PC Inc. had not opposed the Prothonotary's final order and had not contested the Minister's right, on its behalf, to collect the cash surrender value of the Policies; (b) having suffered no prejudice, London Life could not be heard to put forward arguments on PC Inc.'s behalf, because London Life did not have the legal status to do so and because it was required to pay out the cash surrender value of the Policies on PC Inc.'s instructions in any event; and (c) under article 1627 of the *Quebec Civil Code,* the Minister was entitled to exercise the rights under the Policies which PC Inc. had failed to exercise and was not required to seize the Policies themselves prior to exercising the surrender rights. London Life appealed to the Federal Court of Appeal.

London Life's appeal was dismissed. The parties agreed that the policy rights under the Policies, including the right to surrender them, were subject to seizure. In addition, London Life was unable to show any need to interfere at the appellate level with the Federal Court judge's decision. To conclude otherwise would be tantamount to finding that the right to surrender the Policies was a right attaching personally to PC Inc. alone, which was contrary to the position taken by the Supreme Court in the *Malenfant* case ([1999] 3 SCR 375).

¶48,771, *London Life Assurance Company*, 2014 DTC 5055

Taxpayer disallowed dependant tax credit claimed for his children as he made support payments for them

The taxpayer lived apart from his spouse and had joint custody of his two children. Relying on subsection 118(5) of the *Income Tax Act*, the Minister disallowed the dependant tax credit claimed by the taxpayer for 2010 and 2011 in respect of his two children on the ground that he was making support payments for those children. On appeal to the Tax Court of Canada, the taxpayer argued that his former spouse was making a form of support payment to him with respect to the two children because she had imputed income that had been factored into the support amount that he was required to pay, and that subsection 118(5) was unfair since taxpayers in his position should be permitted the dependant tax credit.

The taxpayer's appeal was dismissed. The "set-off" type of argument put forward by the taxpayer was specifically rejected in *Verones v. The Queen* (2013 DTC 5061). In addition, fairness and policy considerations relating to tax legislation are the prerogative of parliament and not the courts, so the taxpayer's argument based on the fairness of subsection 118(5) was untenable and misplaced. The Minister's assessments were affirmed accordingly.

¶48,773, *Sauve*, 2014 DTC 1115

In civil tax appeal, Minister not bound by agreed facts arrived at in prior criminal plea bargaining proceedings

The individual taxpayers, L and G, were the directors and shareholders of the corporate taxpayer (the "Corporation"). All three taxpayers were charged with tax evasion under the *Income Tax Act* (the "ITA") relating to 2002 to 2007. L and the Corporation pleaded guilty based on an Agreed Statement of Facts (the "Agreed Facts"), and the charge against G was withdrawn. The Minister subsequently reassessed the Corporation under the *Excise Tax Act* (the "ETA") for its reporting periods from October 1, 2002 to September 30, 2007, and also reassessed all three taxpayers under the ITA for 2002 to 2007. In their notices of appeal to the Tax Court of Canada, all three taxpayers argued that the Minister's reassessments, which were for amounts in excess of those established in the Agreed Facts, had to be consistent with the Agreed Facts. They moved under section 58 of the *Tax Court of Canada Rules* for a determination, as a question of law, whether, for purposes of their appeals to the Tax Court from those reassessments, the Minister was bound in the reassessments by the Agreed Facts arrived at during the plea bargaining process. The Minister's position was that an analysis of the case law indicated that (a) issue estoppel does not apply where a prior criminal conviction arises from a plea bargain as opposed to an actual trial with judicial findings of fact; and (b) prior convictions in criminal proceedings resulting from plea bargains do not determine the relevant facts and issues in a subsequent tax appeal, although they may factor into a civil tax proceeding.

The taxpayers' motion was dismissed. Courts are reluctant to apply the doctrines of issue estoppel or abuse of process to relieve taxpayers from having to prove facts allegedly determined in a prior criminal proceeding. Admittedly, issue estoppel may be applied to prevent a party from relitigating an issue when that same issue has been determined in prior proceedings in another court. In the present proceedings, however, the Agreed Facts addressed only the income tax appeals for some of the Corporation's and L's taxation years involved in the Minister's reassessments. But they did not address G's income tax matters, the matters involved in the Corporation's GST appeal, or L's and the Corporation's other taxation years involved in those reassessments. Restricting the Minister in this civil proceeding to the Agreed Facts established during the course of a plea bargain arrived at in the previous criminal proceedings would constitute an abuse of process. Also, to permit all three taxpayers to introduce evidence in support of their request for a determination of a question of law at this stage in the proceedings would be inappropriate, since this motion is not a substitute for a trial.

¶48,774, *McIntyre*, 2014 DTC 1116

Taxpayer's claim she was supported by then-fiancé credible, and reassessments vacated

The taxpayer was appealing reassessments of her 2003 and 2004 income tax returns. She had reported income of about $4,600 and $24,000 for those years, which was initially accepted, but she was subsequently audited as there was a significant difference between her expenses and her reported income. The taxpayer was sent a questionnaire to verify non-taxable revenues and later a request for supplementary financial information. She gave incomplete information, although she did indicate that she was being supported by her then-fiancé, G. She would not provide contact information for G and then she became difficult to contact. Using a cash flow method, Revenu Québec issued reassessments in 2007 to add $24,000 and $16,000 to her income, which was somewhat reduced after a notice of objection was filed. The taxpayer argued that she was being supported by G and the income she reported was accurate.

The appeal was allowed. Revenu Québec properly used the cash flow method to determine the taxpayer's income as the taxpayer failed to provide proper information regarding her total income and expenses. The taxpayer has the onus of rebutting the assumptions of Revenu Québec, which can be done by documentation or testimony. As no documents were provided, the issue came down to the credibility of the witnesses. The taxpayer claimed she was living common law with G in 2003 and 2004 and was supported by him. Although she initially refused to disclose his name, the taxpayer did eventually provide that information. G was a reluctant witness and only testified after being arrested for failing to respond to a subpoena. He was not sympathetic to the taxpayer, but he did corroborate that he was the main support for the taxpayer despite his hostility towards her. Although there were some credibility issues for the taxpayer (including the fact that she was hard to reach and filed returns as a single person), it was more likely than not that she lived with G, that he supported her, and that the income she reported reflected her total income.

¶48,776, *Daimsis*, 2014 DTC 1118

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