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Volume 22, Number 1, January 2022

Editor's Note

This is my first issue as content editor of *Tax for the Owner-Manager*. I am honoured to be entrusted with this role by the Foundation, and I will do my best to maintain the high standards set by my eminent predecessor, Tom McDonnell.

It is the members of the tax community who have made *Tax for the Owner-Manager* successful. I invite you to submit articles for publication. I invite you to send me a list of topics that you would like to see addressed. And I invite you to write to me if you disagree with, or otherwise wish to share a comment on, something you read in this newsletter. With your input, *Tax for the Owner-Manager* will continue to succeed.

I look forward to engaging with you.

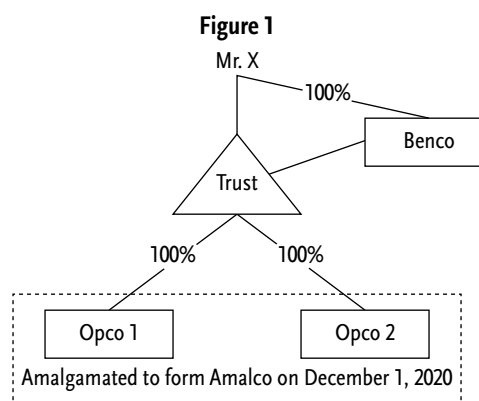
Joan E. Jung

Application of Part IV Tax to Amalgamations of Companies Owned by Trusts with Corporate Beneficiaries

The CRA has a longstanding position on how subsection 104(19) of the Act should be interpreted with respect to the timing of the dividend received by a trust and allocated to a corporate beneficiary. The CRA's position, in particular, is that the dividend is considered to be received as a dividend at the end of the trust's taxation year in which the trust received the divi-

dend, such that the dividend payer and the corporate beneficiary need to be connected at that time in order for part IV tax not to apply to the dividend. This position has been confirmed in a number of CRA views: document nos. 2012-0465131E5 (January 14, 2013), 2016-0647621E5 (June 3, 2016), and 2018-075759117 (April 30, 2019). This position may be justified in scenarios involving the sale of the shares of the dividend payer corporation (as described in document no. 2016-0647621E5), but it may pose technical difficulties for transactions that do not involve such a sale.

Consider, for example, the following scenario (shown in the accompanying figure), in which two Canadian-controlled private corporations (Opco 1 and Opco 2) are owned by a trust that is resident in Canada; Mr. X is a sole trustee of the trust, a beneficiary of the trust, and the sole shareholder of Benco, which is also a beneficiary of the trust. On November 30, 2020, Opco 1 pays a dividend to the trust, and the trust immediately transfers the funds to Benco. Opco 1 does not receive any dividend refund for the taxation year in which it paid the dividend. Then, on December 1 of the same year, Opco 1 and Opco 2 amalgamate to form Amalco.



On December 31, the dividend paid to the trust by Opco 1 on November 30 meets the conditions of subsection 104(19), and the amount of the dividend is deemed to be a dividend received by Benco.

Next, it must be determined whether part IV tax applies to the dividend deemed to be received by Benco. Paragraph 87(2)(a) states that the entity formed by amalgamation shall be deemed to be a new corporation for the purposes of the Act. Therefore, the analysis for part IV tax must be performed specifically for Opco 1, as the dividend payer, and not for Amalco. Pursuant to paragraph 186(1)(a), the dividend is exempt from part IV tax if the dividend payer and the dividend recipient are connected. The term "connected" is defined in subsection 186(4). The corporations are considered connected if (1) the recipient

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corporation owns more than 10 percent of the voting rights of the payer and also owns shares representing more than 10 percent of the value of the payer corporation; or (2) the payer corporation is controlled by the recipient corporation or persons not dealing at arm's length with the recipient corporation (at the time). On the basis of the CRA position set out above, the tests, in the case of our scenario, must be satisfied at the year-end of the trust, or December 31. Given that Benco has no direct ownership of Opco 1, the "more than 10 percent direct ownership" criterion cannot be met. Thus, in order for Benco to be considered connected to Opco 1, Opco 1 must be controlled by Benco. The term "control" is modified for the purposes of part IV by subsection 186(2). In particular, subsection 186(2) deems the corporation to be controlled by the other corporation if more than 50 percent of the issued share capital (having full voting rights) belongs to the persons with whom the other corporation does not deal at arm's length. In this case, on the dividend payment date (November 30), all outstanding shares of Opco 1 are owned by the trust. Benco is considered not to deal at arm's length with the trust pursuant to paragraph 251(1)(b). Therefore, pursuant to subsection 186(2), Opco 1 is controlled by Benco, and thus Opco 1 and Benco are connected on November 30. However, given that on December 31 (which is the date on which the connected status needs to be determined, according to the CRA position described above), Opco 1 no longer exists, Benco and Opco 1 cannot be considered connected on December 31.

It should be noted that a number of provisions in section 87 deem the new corporation that is formed by amalgamation to be the same corporation as the predecessor corporation. One such deeming provision, which applies to part IV, is subsection 87(2.11). This subsection applies to cases of vertical amalgamation, when a new corporation is formed by the amalgamation of a particular corporation and one or more of its "subsidiary wholly-owned corporations" (as defined in subsection 87(1.4)). Under this provision, the new corporation is deemed to be the same corporation and a continuation of the particular corporation for the purposes of applying part IV "in respect of the particular corporation." Part IV includes subsections 186(2) and 186(4), which define the term "connected." Thus, one might argue that for the purposes of the definition of the term "connected," the deeming rule in subsection 87(2.11) means that the amalgamated company should be considered the same corporation, and that therefore the corporate beneficiary receiving the dividend from the predecessor corporation may be provided some relief from part IV tax. On the other hand, the phrase "applying . . . Part IV . . . in respect of the particular corporation" in subsection 87(2.11) may be interpreted to mean that the deeming rule applies strictly to the application of part IV tax of the amalgamated entity, with the result that the deeming provision would not apply to the corporate beneficiary of the trust that receives the dividend from a predecessor corporation. To determine which of these interpretations is

correct, further guidance will be required from the CRA on how to interpret the deeming provision subsection 87(2.11).

In either interpretation, the deeming rule applies only to vertical amalgamations, not to the amalgamation of the two sister companies owned by the trust. Thus, in the case of the scenario shown above, Opco 1, in the absence of any other deeming provisions, ceases to exist on the date of amalgamation and thus cannot be considered connected to Benco on December 31, when the trust makes the designation pursuant to subsection 104(19).

Therefore, given that Opco 1 and Benco are not connected on December 31, the dividend paid by Opco 1 to the trust prior to amalgamation and then allocated by the trust to Benco is subject to part IV tax. This scenario results in the potential application of part IV tax if there is no change of ownership and the structure is at all times controlled and beneficially owned by the same person (Mr. X). It is unclear, from the published CRA views, whether such a result was contemplated. For greater clarity on this question, further interpretation will be required from the CRA regarding the timing of the determination of the connected status of corporations in structures with trusts and corporate beneficiaries.

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Changing the Analysis for a Typical Spinout

At the CRA round table at the Canadian Tax Foundation's 2020 annual conference, the CRA addressed a series of questions related to the allocation of safe income in a paragraph 55(3)(a) reorganization, and introduced some new terms to the tax lexicon—"direct safe income" (DSI) and "indirect safe income" (ISI). At the same event, the CRA also expressed concerns about the "misalignment" of ACB, notwithstanding that the transfers complied with subsection 51(1), 85(1), or 86(1), as the case may be (see CRA document nos. 2020-0860991C6, October 27, 2020 and 2020-0861031C6, October 27, 2020). In this article, I also refer to CRA document no. 2021-0889611E5, May 28, 2021 ("the 2021 CRA document"), in which the CRA elaborated on its position regarding a multi-tier spinout fact situation. To my knowledge, the allocation of safe income and the potential for "misalignment" have not previously been issues in a typical paragraph 55(3)(a) spinout.

It is challenging to describe the new CRA administrative positions without numerical examples, but I attempt to do so in this article. In what follows, the “distributing corporation” (DC) is the corporation that seeks to spin out a property (“the spin property”), and the “transferee corporation” (TC) is the corporation to which the spin property is transferred. The shareholder of DC is the taxpayer. The CRA round table questions consider

- 1) the ACB of the spin property; and
- 2) the ACB of the shares (typically, preferred shares created in the course of the spinout) of DC that are transferred to TC.

Such DC preferred shares are usually cross-redeemed and cancelled, although the mechanics of the spinout should result in the taxpayer holding TC shares with ACB matching that of the cancelled DC preferred shares. The creation of the DC preferred shares is usually a subsection 51(1), 85(1), or 86(1) transaction, and these provisions differ from one another in the way they allocate the pre-reorganization ACB of DC shares held by the taxpayer to the newly created DC preferred shares: the allocation is either pro rata, based on the FMV of new DC preferred shares in relation to the pre-existing exchanged shares, or it is simply based on the FMV of the new DC preferred shares. As described below, the CRA added DSI/ISI into the analysis, too. Leaving aside the safe income matter, the apparent misalignment that, in the CRA’s view, leads to an undue increase of ACB becomes somewhat evident when we compare

- x) the aggregate ACB of DC shares held by the taxpayer pre-reorganization; and
- y) the aggregate ACB of the remaining DC shares held by the taxpayer post-reorganization, plus the ACB of the spin property (on the assumption that TC, to which the spin property was transferred, is thereafter wound up, such that the taxpayer directly holds the spin property).

The use of standard share-exchange methodology to create the DC preferred shares means that the aggregate ACB of the remaining DC shares held by the taxpayer post-reorganization should be equal to the aggregate ACB of all DC shares held by the taxpayer pre-reorganization less the ACB of DC preferred shares that are created and cancelled in the course of the spinout. In the CRA’s view, if an insufficient amount of the DC shares’ pre-existing ACB is eliminated in the course of the reorganization (because of the cross-redemption), the result could be an increase in the aggregate ACB of the shares or property held by the taxpayer—that is, in terms of the comparison set out above, (y) would be greater than (x). In the fact situation presented in the CRA round table questions, which seemed to be a standard paragraph 55(3)(a) reorganization, the CRA stated that because of the misalignment, it would not rule favourably and, furthermore, would consider the applica-

tion of GAAR because of what would be, in the CRA’s view, an undue increase of ACB in the hands of the taxpayer.

A worrying aspect of the CRA documents discussed above is the role of safe income, which has not previously been a concern with respect to a standard paragraph 55(3)(a) spinout. The CRA provided a formula for calculating the amount of DC’s safe income that would transfer to TC in the spinout reorganization and the amount that would be retained by DC. Under this formula, the amount is generally pro rata to the cost amount of property transferred or retained. Safe income can be capitalized into ACB, and the CRA factored this possibility into the hypothetical misalignment analysis described above. In other words, the comparison was made after a hypothetical safe income capitalization at all levels.

The CRA documents discussed above seem to suggest that simply creating for the spinout, by means of subsection 51(1) or 86(1), DC preferred shares that have an aggregate redemption and retraction amount equal to the FMV of the spin property may not result in a sufficient elimination of ACB. This is because the additional ACB that may be created by the capitalization of safe income is not taken into account. In order to avoid the misalignment issue identified by the CRA, it appears that the sum of

- 1) the ACB of the DC preferred shares (which will be cross-redeemed and cancelled) and
- 2) the DSI/ISI transferred to TC

should be at least equal to the ACB of the spin property (including, where the spin property is shares, safe income that can be capitalized). Determining the “correct” amount of the ACB of the DC shares to eliminate (which could make it possible to preserve some ACB) requires knowledge of DC’s safe income. Creating the “correct” amount of ACB to be eliminated may require streaming, which could require the combined application of paragraph 85(1)(g) and subsection 86(1) in the creation of the necessary DC preferred shares.

In the 2021 CRA document, the CRA was asked whether a representation regarding the safe income of each corporation is a prerequisite to a favourable ruling. The CRA stated that “an estimate of such safe income is always necessary to fully assess the situation being ruled upon since it represents one of the key elements in the appreciation of such situation.” The CRA also stated that a comment would be added to rulings “regarding the allocation of safe income that is required on a tax-free reorganization.” The exact wording of the comment was not provided. The CRA cautioned that the full elimination of the ACB of the DC shares held by the taxpayer (that is, through the use of an internal subsection 85(1) transaction to create the DC preferred shares) “does not necessarily address the misalignment of ACB, especially where the corporations involved have a significant amount of safe income that was not capitalized.” Although it is not desirable to unnecessarily forgo

ACB, one questions whether the CRA formula for the allocation of safe income to TC will sufficiently address that issue.

The CRA documents referred to in this article have introduced new ways of analyzing a typical spinout reorganization, and practitioners should be aware of this change. It appears that, in order to plan in accordance with the CRA's administrative views, safe income estimates are now required. Respectfully, it is debatable whether this requirement is supported by the legislation.

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The Interaction Between the Subsection 82(3) Election and TOSI

A recent technical interpretation (document no. 2020-085608117, August 23, 2021) issued by the CRA examines the interaction between subsection 82(3) and section 120.4 of the ITA. This TI may be of interest both for the narrow technical question that it raises and for its guidance on how the tax on split income (TOSI) regime may interact with other provisions of the ITA.

Subsection 82(3) is designed to optimize the benefit of the married or common-law partnership status tax credit ("the spousal credit") in paragraph 118(1)(a). Provided that certain conditions are met, the spousal credit provides a tax credit to a spouse or common-law partner ("the electing spouse") who supports his or her spouse or common-law partner ("the recipient spouse"). The spousal credit declines in amount as the net income of the recipient spouse increases, and it is completely eliminated when that net income reaches a legislated maximum.

Under subsection 82(3), if the electing spouse makes the election, all taxable dividends received in a year by the recipient spouse from taxable Canadian corporations under paragraphs 82(1)(a) and (a.1) are deemed to have been received by the electing spouse and not by the recipient spouse. This election is available, however, only if the spousal credit of the electing spouse would be increased. In summary, subsection 82(3) is designed to minimize the effect of the net-income phaseout in the spousal credit.

The TOSI regime in section 120.4 adds an extra layer of complexity to the effect of subsection 82(3), because the TOSI regime denies the benefit of bracketed rates and tax credits to dividend income that is "split income" (as defined in subsection 120.4(1)) to the recipient spouse or, if the subsection 82(3) election is made, to the electing spouse. Accordingly, the application of TOSI to dividend income could affect the decision whether to make the election and could undermine the potential effectiveness of the election under subsection 82(3). Subparagraph 120.4(1)(a)(i) of the definition of "split income" includes in split income the taxable dividends that an individ-

ual received on shares of a corporation (subject to certain exclusions not relevant to the scenarios discussed in this article).

The CRA was asked to opine on whether an ordering rule governs the application of these two legislative schemes (the subsection 82(3) election and TOSI) and then to illustrate, with hypotheticals, how these sets of rules would work. The CRA concluded that, although no ordering rule in the ITA governs the interaction of subsection 82(3) and section 120.4, the text of the provisions indicates that subsection 82(3) should take precedence over section 120.4 and should be applied first. The CRA also stated that GAAR should not apply.

Accordingly, in the CRA's view, the correct method of applying the two provisions is to allocate receipt of the dividends in accordance with subsection 82(3) and then apply the TOSI regime.

The CRA examined three hypothetical examples in order to illustrate the TOSI analysis when subsection 82(3) is applied. In each example, the CRA commented on (1) how TOSI would apply to the dividends received by the recipient spouse if no election had been made, and (2) how it would apply, if the election had been made, to the dividends deemed received by the electing spouse.

First Hypothetical

The first hypothetical dealt with a recipient spouse who owned shares with less than 10 percent of the votes and FMV of all of the shares of a corporation and was not actively engaged in the business of that corporation. The electing spouse owned no shares in the corporation but was actively engaged in its business.

The CRA concluded that if no subsection 82(3) election had been made, the taxable dividends received by the recipient spouse from the corporation would not have been an "excluded amount" (as defined in subsection 120.4(1)) to the recipient spouse and would, therefore, have been split income subject to TOSI.

The CRA concluded that if the subsection 82(3) election had been made, the election would have converted taxable dividends subject to TOSI in the hands of the recipient spouse into an income inclusion that was an excluded amount to the electing spouse. In the CRA's view, one examines the application of TOSI on the basis of the share ownership and personal circumstances of the electing spouse, not the recipient spouse. In this hypothetical, the taxable dividends deemed received by the electing spouse were an excluded amount because the electing spouse had been actively engaged in the business of the corporation.

Second Hypothetical

In the second hypothetical considered by the CRA, the recipient spouse owned shares with less than 10 percent of the votes and FMV of all of the shares of a corporation controlled by his

or her mother-in-law (who was actively engaged in the business of the corporation). The electing spouse owned no shares in that corporation. Neither spouse was actively engaged in the business of the corporation.

The CRA concluded that if no subsection 82(3) election had been made, the taxable dividends received by the recipient spouse from the corporation (1) would have been received from a “related business” (as defined in subsection 120.4(1)) in respect of the recipient spouse, (2) would not be an excluded amount to the recipient spouse, and, accordingly, (3) would have been split income subject to TOSI. If the subsection 82(3) election had been made, the deemed dividends received by the electing spouse would not be an excluded amount because the dividend is not from an “excluded business” (as defined in subsection 120.4(1)) or from “excluded shares” (as defined in subsection 120.4(1)) and would also, therefore, be split income subject to TOSI.

Third Hypothetical

The third hypothetical dealt with a corporation in which the recipient spouse, the electing spouse, and the brother of one of the spouses were each shareholders owning shares of a separate class of shares in a corporation. The recipient spouse, the electing spouse, and the brother, respectively, owned shares with 5 percent, 20 percent, and 75 percent of the votes and FMV of all of the shares of the relevant corporation. Only the brother, however, was actively engaged in the business of the corporation.

In the CRA’s view, if no subsection 82(3) election had been made, the dividends received by the recipient spouse would have been split income subject to TOSI (by virtue of no relevant carve-outs being applicable).

The CRA accepted that the effect of making the subsection 82(3) election would have been to treat the electing spouse as having received the dividends on the shares he or she actually owned (that is, shares representing 20 percent of the votes and value of the corporation). The dividends would, therefore, be the electing spouse’s income from excluded shares and not subject to TOSI. In the CRA’s view, in other words, dividends that are reallocated pursuant to subsection 82(3) should be regarded, for the purposes of the TOSI regime, as being received by the electing spouse on the shares actually owned by the electing spouse, not on the shares owned by the recipient spouse. Put simply, subsection 82(3) reallocates the dividends, but it does not provide for a deeming rule that puts the electing spouse in the shoes of the recipient spouse as far as shareholdings are concerned.

Concluding Comments

This TI provides helpful insight into the complexity of applying distinct regimes within the ITA when they interact with one

another. In this case, the methodology advanced by the CRA seems reasonable and pragmatic, but it seems to involve an assumption—specifically, an assumption that dividends deemed received by the electing spouse pursuant to subsection 82(3) will be received on the shares actually owned by the electing spouse (not those of the recipient spouse). This assumption, while practical, does not flow obviously from the text of the two sets of provisions. The CRA, in this circumstance, developed an approach that it found to be consistent with the policy goals of the TOSI regime (by not enabling the taxpayer to do indirectly, via the subsection 82(3) election, what he or she could not do by taking the relevant dividends directly).

Whether the policy rationale for these provisions justifies the assumption relied on by the CRA in this TI is an interpretive question with no easy answer. We note that in CRA document no. 2006-0183851E5 (May 30, 2007), the CRA took a similar position on the interaction between subsection 83(2) and paragraph 84.1(1)(b).

Given the interpretive uncertainty when it comes to determining the interaction between tax provisions that do not form part of a common legislative scheme, caution is in order: the position ultimately taken by courts can be quite unpredictable.

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Paragraph 118.1(13)(c): Consideration Plays a Critical Role in Donation Tax Credits

Section 118.1 of the Act provides a donation tax credit to taxpayers who have made a gift to a registered charity or a qualified donee. Subsection 118.1(13), however, limits the credit on certain donations of private company shares. A recent case, *Odette* (2021 TCC 65), illustrates that the gifting must be executed in meticulous accordance with paragraph 118.1(13)(c) in order for the donor to receive the credit.

In *Odette*, the estate donated shares of a private company (Edmette), which were non-qualifying securities, to a private foundation with which the estate did not deal at arm’s length. Shortly thereafter, but in the same 2013 taxation year, the shares were purchased for cancellation in exchange for a promissory note from Edmette for \$17.7 million. The promissory note was repaid in cash by Edmette over an eight-month period in 2014. The foundation issued a charitable donation receipt for income tax purposes for the 2013 taxation year, but the minister disallowed the donation tax credit on the grounds that paragraph 118.1(13)(c) would deem the value of the gift to be nil.

Subsection 118.1(3) provides a tax credit based on the total gifts made by an individual or a trust in a taxation year. Generally speaking, “total gifts” means total charitable gifts made in a taxation year to a qualified donee such as a registered charity. But when an individual makes a gift of a non-qualifying security, which is not an excepted gift, paragraph 118.1(13)(a) deems the gift not to have been made. “Non-qualifying security” of an individual is defined in subsection 118.1(18) to include shares of a corporation with which the individual or the estate does not deal at arm’s length immediately after the gifting. “Excepted gift” is defined in subsection 118.1(19) to be a gift of a security (1) that is a share, (2) the donee of which is not a private foundation, and (3) the donor of which deals at arm’s length with the donee. In *Odette*, the estate did not deal at arm’s length with either the corporation (Edmette) or the donee, which was a private foundation. The gift, accordingly, was a non-qualifying security of the estate, and the gift was not an excepted gift. For that reason, pursuant to paragraph 118.1(13)(a), the gift would be deemed not to have been made.

However, if the security ceases to be a non-qualifying security within 60 months of the making of the gift or if the donee disposes of the gift within that 60-month period, the individual is deemed by paragraph 118.1(13)(b) or (c) to have made the gift and may still be able to claim a charitable donation tax credit. In *Odette*, the gifted security did not cease to be a non-qualifying security, and thus paragraph 118.1(13)(b) did not apply. Because the donee disposed of the security within 60 months, the estate was deemed, under paragraph 118.1(13)(c), to have made a gift to the donee of property at the time of the disposition, and the FMV of that property was deemed to be the lesser of the FMV of any consideration (other than a non-qualifying security of any person) received by the donee for the disposition and the FMV of the security that would otherwise have been included in a calculation of the estate’s total charitable gifts for the taxation year.

In other words, the relief would be limited if the donee disposed of the security for consideration that is a non-qualifying security of any person. Such non-qualifying security includes an obligation of any person with which the estate does not deal at arm’s length. In *Odette*, the private foundation disposed of the security back to the corporation for a promissory note payable by that corporation. Since the corporation did not deal at arm’s length with the estate, that promissory note, too, would be considered a non-qualifying security. Given that the private foundation received only a non-qualifying security as the consideration for the disposition of the security, the “lesser of” rule in paragraph 118.1(13)(c) effectively resulted in the FMV of the gifted property being nil. For that reason, the minister denied the donation tax credits.

The appellant argued that the phrase “any consideration” in paragraph 118.1(13)(c) should be interpreted as including both promissory notes and the corresponding cash payments. The promissory note and corresponding cash payments were

part and parcel of the consideration received, and the deemed value of the gift should be substantially higher. The appellant took the position that a broad interpretation of “any consideration” would respect Parliament’s intention to encourage charitable giving and would be harmonious with the legislation as a whole.

Undertaking a thorough contextual analysis of the term “consideration,” the court went beyond the term itself and considered, in addition, the terms “received” and “at the time of disposition,” and the parenthetical exclusion “(other than a non-qualifying security of any person).” The court explained that consideration is subject to a timing limitation: the consideration must be received at the time of the disposition. In this case, the foundation did not receive the cash payments until approximately eight months after the disposition. If the legislation was intended to include consideration received outside the time frame of the deemed gift, clear language would have been used to express this intent. The fact that the term “consideration” in paragraph 118.1(13)(c) is subject to many limitations and qualifications indicates that the consideration in *Odette* could not be both the promissory note and the corresponding cash payments.

Furthermore, the parenthetical exclusion further limits the scope of “consideration” by providing that, in order to fall into this redemptive provision, the consideration cannot be a non-qualifying security. Therefore, the term “consideration,” in paragraph 118.1(13)(c), should be narrowly and strictly interpreted. The provision expressly contemplates that the consideration must be received at the time of disposition and that it cannot be a non-qualifying security. The provision does permit taxpayers to claim the credit if, within the prescribed time, the charity disposes of the non-qualifying security to a third party in an arm’s-length transaction. The price paid by the third party for the security can be taken to be its FMV. Without a transaction with a third party, it would be difficult to determine the FMV. It would be contrary to the legislation’s intention to allow a donation tax credit if a non-qualifying security is disposed of for another non-qualifying security.

Interestingly, the court commented that the donor was not impoverished and the charity was not enriched when, in fact, the opposite was the case, although these events occurred at a distance of a few months from the foundation’s disposition of shares. Whether a donation credit is allowed seems to boil down to a timing issue. Had the foundation received cash consideration upon the redemption of the shares, the donation credit would have been allowed. It was unfortunate that the estate was denied the donation tax credit on the basis of a technical failure to comply with the rules.

Fortunately, the CRA provided some relief at the 2021 APFF round table (question 14). According to the CRA, the word “consideration” must be given the broad meaning generally accepted in the jurisprudence, and thus should not be limited to “proceeds of disposition” as defined in section 54. On that

basis, the CRA is of the view that for the purposes of paragraph 118.1(13)(c), the consideration received by the qualified donee for the disposition of non-qualifying securities may include the portion of such consideration that is a deemed dividend received by the qualified donee, pursuant to subsection 84(3), on the redemption of shares. It is unclear, however, whether the question contemplated a redemption price paid by promissory note and, where that is the case, whether the deemed dividend characterization therefore overrides the legal form of the consideration, with the result that the non-qualifying security is considered to have been disposed of for consideration that was a deemed dividend rather than for consideration that was a non-qualifying security. The CRA's discussion of this round table question may be welcome news where the foundation receives a deemed dividend. However, pending clarification, a conservative course of action may be not to redeem the gifted shares until there is sufficient cash for the redemption proceeds.

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Charitable Gifts by Will: New Rules Create Arrears Interest Consequences

In 2014, the government announced changes to the Income Tax Act's treatment of charitable gifts made by will. The objective of these amendments was to provide greater flexibility for an estate: under the old rules, the estate could not use any of a testator's donation tax credits. Under the new rules, charitable planning remains an important part of estate planning, because any gift made by a graduated rate estate (GRE) determined without reference to the 36-month limitation ("the modified GRE") can be included in the computation of the individual's total charitable gifts if the modified GRE makes the gift no more than 60 months after the individual's death. Despite the welcome flexibility, delaying or deferring a gift may trigger arrears interest consequences under subsections 161(1) and (7).

Background: Charitable Gifts Under the Old and New Rules

Before January 1, 2016, subsection 118.1(5) provided that when an individual taxpayer made a gift by will, the gift was deemed to have been made immediately before the individual died. Under the old rules, a taxable estate could not use any of the testator's remaining donation tax credits. Essentially, those tax credits would be lost if they could not be used by the testator or the testator's spouse or common-law partner. Under the new rules, applicable to deaths occurring on or after January 1, 2016, subsection 118.1(5) provides that (1) the estate makes the gift and (2) the gift is made at the time the property was trans-

ferred to the charity. The estate can then deduct the charitable tax credits in computing its own tax payable for the year of the gift or, provided that the gift was made by a modified GRE, in computing its tax returns for the years in which it was a GRE (that is, applying the 36-month limitation), or it can carry back the tax credits to the testator's return for the year of death or the immediately previous year.

Computing Arrears Interest

Subsection 161(1) establishes the arrears interest payable by a taxpayer. In short, arrears interest is payable on the difference between a taxpayer's taxes payable and the total of all amounts paid on account of those taxes.

Subsection 161(7) provides that, for the purposes of computing interest under subsection 161(1), tax payable is to be computed without taking into consideration, among other things, deductions under section 118.1 in respect of a gift made in a subsequent year. In other words, arrears interest is payable from the balance-due date of the taxation year until the date the charitable gift is made in a subsequent taxation year. In *Connaught Laboratories Ltd. v. The Queen* (94 DTC 6697 (FCTD)), the FCTD confirmed that the purpose of subsection 161(7) is to discourage a taxpayer from not paying taxes in circumstances where the taxpayer expects to incur a loss in a subsequent taxation year. The CRA subsequently acknowledged this purpose and cited *Connaught Laboratories* in technical interpretation 2009-031378117, April 14, 2009.

An Example of Applying Subsection 161(7) to Charitable Gifts by Will

Assume that a testator dies owning non-cash property that has unrealized gains, some of which will be donated to charities by will. Ultimately, little to no taxes will be payable by the testator in their final taxation year because of the donation tax credits that can be carried back to that year. However, it takes time to value the donated properties.

Under subsection 70(5), the unrealized gains are deemed to be realized on death. As a result, the testator initially has taxes payable in their final taxation year. There may not be enough liquidity to satisfy that tax liability, and thus it may remain unpaid after the taxpayer's balance-due day. Thus, under subsection 161(1), arrears interest payable begins to accrue on the outstanding liability.

When donations are finally made and carried back to the terminal return, the estate is still left with arrears interest payable because of subsection 161(7). That liability may interfere with a trustee's ability to obtain a clearance certificate.

Context and Purpose of Subsection 161(7)

Contextually, subparagraph 161(7)(a)(iv.2) provides that for the purposes of computing arrears interest, tax payable for the year is computed without reference to a capital loss carryback

under subsection 164(6). However, subsection 164(6) applies only when the GRE has disposed of the capital property in the estate's first taxation year. Any arrears interest will be relatively minimal as a result. The time frame for making a gift under subsection 118.1(5.1) is now 60 months, which means that a greater amount of arrears interest could be payable.

The consequences for arrears interest appear to be inconsistent with both the purpose of the 2016 amendments and the purpose of subsection 161(7). Deaths that occurred before 2016 had no consequences for arrears interest because the testator was deemed to have made the gift immediately before death. The estate may have interest payable, now, where no interest would have existed before. The 2016 amendments were intended to promote flexibility for the estate, but this flexibility may have come at the cost of an increase in arrears interest. Furthermore, subsection 161(7) is intended to discourage taxpayers from not paying taxes in circumstances where the taxpayer expects to incur a loss or to have large donation tax credits in a subsequent year. No evidence exists that Parliament intended subsection 161(7) to apply to charitable gifts by will.

Administrative Relief and Other Options

The CRA has provided some administrative relief. Guide T4011 provides that the trustee, in preparing the final return for a deceased taxpayer, can include charitable gifts made by will even though the gifts will be made later. The taxes payable on the final return will be reduced and no arrears interest will accrue. The CRA requests that the following documents be included to support the donation:

- the will;
- a letter to the recipient charitable organization from the estate, advising of the gift and including a description of the property and an estimate of its value;
- a letter from the charitable organization acknowledging the gift and stating that it will accept the gift; and
- a letter from the legal representative stating that (1) the estate is a GRE, (2) the estate intends to make the gift within 60 months after death, (3) the amount of the gift on the final return will not be claimed in any other return of any estate of the deceased, and (4) the value of the future gift can be reasonably ascertained and supported.

A few other options are available to trustees if the CRA does not provide this administrative relief. The first option would be to pay the tax liability on assessment of the final taxation year. Upon carrying back the charitable gifts, the estate receives a refund. Full payment may not be possible in all cases, however, especially if the property giving rise to the taxable capital gains is illiquid. Security could be provided too, if feasible, but that could be costly. Finally, an estate may also seek interest relief under subsection 220(3.1). Such an application for relief

would likely be based on the fact that the arrears interest arose in circumstances beyond the taxpayer's control.

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Stop-Loss Grandfathering Exceptions Under Subsections 112(3)-(3.32): Pre-Existing Insurance Rule

The stop-loss rules in subsections 112(3) to (3.32) of the Act apply to share dispositions and may reduce the loss on the sale of a share by the amount of tax-free dividends received on the share. If shares are redeemed following the death of an individual and corporate-owned insurance is used to fund the redemption price, the stop-loss rules may prevent the full loss from being carried back by the estate to offset the gain in the taxpayer's terminal return. However, exceptions are available to alleviate the hardship caused by subsections 112(3) to (3.32). These exceptions, which are not found in the Act, are based on transitional rules that date from the coming into force of subsections 112(3) to (3.32).

The grandfathering exceptions—available for the 2000 and subsequent taxation years—are found in the Income Tax Amendments Act, 1997, SC 1998, c. 19, section 131 (“the 1997 amendments act”), as amended by the Income Tax Amendments Act, 2000, SC 2001, c. 17, section 251 (“the 2000 amendments act”). These two acts, which were published July 31, 1998 and June 14, 2001, respectively, are in the *Canada Gazette*, Part III: Acts of Parliament. Given how much time has since passed, a refresher on the grandfathering exceptions may be helpful.

Three of the original five grandfathering exceptions required a disposition before 1997 and are no longer available. The other two, which can be referred to as the “pre-existing agreement rule” and the “pre-existing insurance rule,” are found in paragraph 131(11)(a) and paragraph 131(11)(b) of the 1997 amendments act, respectively, as amended by the 2000 amendments act.

Pre-Existing Agreement Rule

The pre-existing agreement rule applies to a disposition that occurs pursuant to an agreement in writing made before April 27, 1995. What constitutes an “agreement,” while relatively straightforward, may be open to interpretation.

Pre-Existing Insurance Rule

The balance of this article relates to the pre-existing insurance rule. This rule is the more complicated of the two rules, and it applies when insurance proceeds are used to redeem shares. It

requires that certain criteria have been met on April 26, 1995 and that different criteria be met on the date of redemption. The criteria for April 26, 1995 are as follows:

- the share was owned by an individual (other than a trust) or by a trust under which an individual (other than a trust) was a beneficiary;
- a corporation, or a partnership of which a corporation is a member, was a beneficiary of a life insurance policy that insured the individual or the individual's spouse; and
- a main purpose of the life insurance policy was to fund a redemption, acquisition, or cancellation of the share by the corporation that issued the share.

While these three criteria take into account the share owner and the beneficiary of the insurance policy on April 26, 1995, the rule's remaining criteria concern the identity of the owner on the ultimate redemption date. Specifically, the disposition must be made by

- the individual or the individual's spouse or common-law partner;
- the estate of the individual or of the individual's spouse or common-law partner within the estate's first taxation year;
- the particular trust that owned the shares on April 26, 1995, if it is a post-1971 spousal or common-law partner trust or a pre-1972 spousal or common-law partner trust, provided that the disposition is made within the first three taxation years of that trust following the death of the individual's spouse; or
- a spousal trust, an alter ego trust, or a joint spousal or common-law partner trust, provided that the disposition is made within the first three taxation years of that trust following the death of the individual or the individual's spouse, as the case may be.

It should be noted that the persons listed here are not expressly limited to the individual or trust that owned the shares on April 26, 1995. Notably, the redemption criteria effectively allow for share transfers between April 26, 1995 and the ultimate redemption date, although the possible transferees are limited to the spouse, the individual's estate, the spouse's estate, certain life interest structures, and spousal or common-law partner trusts (inter vivos or testamentary).

Example

Consider, for example, spouses Blair and Alex. Blair owned 100 common shares of Cco on April 26, 1995. On Blair's death, the shares passed to Alex pursuant to Blair's will. Alex has recently died. On April 26, 1995, Cco was the beneficiary of a life insurance policy covering Alex and Blair, the main purpose of which was to fund a redemption of the shares.

If Cco redeems the shares now held by Alex's estate within the first year of the estate, the second requirement listed above is satisfied. The ultimate redemption can be made by the estate of the individual who owned the shares on April 26, 1995, or by the estate of that individual's spouse.

Therefore, the pre-existing insurance rule applies. The stop-loss rules in subsections 112(3) to (3.32) will not prevent the loss on share redemption from being carried back by the estate and applied in Alex's terminal return to offset the gain on the disposition of the 100 common shares of Cco.

Changes to the Insurance Policy

Provided that the "main purpose" test was met on April 26, 1995, changes to the policy after April 26, 1995 may be possible. Such changes could include converting the policy to a universal life policy, replacing it with a new life insurance policy, increasing the death benefit, or adding a new life insurance policy with an additional death benefit. (See CRA document no. 2005-0124311E5, June 28, 2005.)

Share Exchange After April 26, 1995

Finally, because subsection 131(12) of the 1997 amendments act deems a share of the corporation acquired in exchange for another share in a transaction to which section 51, 85, 86, or 87 of the Act applies to be the same share as the other share, reorganizations after April 26, 1995 that rely on those provisions of the Act would not automatically disqualify the shares. Were it not for this relieving provision, the ownership requirements on April 26, 1995 could not be met if a share exchange occurred after April 26, 1995.

Further Comments

Practitioners dealing with the pre-existing insurance rule should keep the 1997 amendments act and the 2000 amendments act close at hand. It may be useful to undertake a step-by-step analysis similar to the one shown above, even to the point of reproducing the 1997 amendments act, as amended by the 2000 amendments act, and inserting the names of the parties and shares as appropriate.

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Reassessment of Statute-Barred Taxation Years: Reasonable Care and Standards—Regina Mall Test

When a taxpayer's misrepresentation is attributable to neglect, carelessness, or wilful default, or involves a fraud, the CRA can reassess the tax return beyond the normal reassessment

period pursuant to subparagraph 152(4)(a)(i). Existing jurisprudence holds that this provision does not apply when a taxpayer can demonstrate on the facts that she acted in a prudent manner. The test in *Regina Shoppers Mall v. The Queen* ([1990] 2 CTC 183 (FC)) states that where the taxpayer's filing position is as thoughtful, deliberate, and careful as that of a wise and prudent person, there is no misrepresentation.

In *Hansen* (2020 TCC 102), the taxpayer (Mr. Hansen) was successful in defending against the minister's assertion that Hansen had made a misrepresentation, within the meaning of subparagraph 152(4)(a)(i), in his claiming of principal residence exemption (PRE) in his 2007, 2008, and 2009 returns in respect of the sale of three homes in these taxation years. The reassessment was issued after the normal reassessment period for each year. (We addressed, in the previous issue of this newsletter, the capital-versus-income question relating to the sale of successive homes: see "Principal Residence or Income Property? The Happy Valley Test.") In his defence, the taxpayer stated that he had sought professional advice after the sale of each home. The taxpayer's accountant gave evidence that he (the accountant) had considered the facts and the requirements of the Act before coming to a filing position. The taxpayer contended that his seeking the opinion and advice of a professional accountant after the sale of each home was prudent and diligent behaviour and that statute-barred years can be reopened only if (as was established in *Venne v. The Queen*, [1984] CTC 223 (FCTD)) it can be shown that a taxpayer not only made a misrepresentation but also failed to exercise reasonable care. On these grounds, the taxpayer argued that the minister was not justified in reopening the statute-barred 2007, 2008, and 2009 taxation years under subparagraph 152(4)(a)(i).

In determining issues under subparagraph 152(4)(a)(i), the TCC has frequently considered whether a taxpayer has been reasonable in reporting her income. When the court finds her to have been reasonable, it has found that statute-barred years cannot be assessed, regardless of whether the minister disagrees with the taxpayer's position. (See *Regina Shoppers Mall*, *Cameron v. The Queen*, 2011 TCC 107, and *Petric v. The Queen*, 2006 TCC 306.)

In deciding the issue of whether the minister correctly reopened Mr. Hansen's statute-barred years, D'Auray J focused on whether Mr. Hansen had thoughtfully, deliberately, and carefully assessed the situation, and whether he had a bona fide belief that his filing position was correct. In coming to her decision, D'Auray J considered the credibility of the Hansens' testimonies regarding why they purchased and sold each property, and regarding their discussions with their accountant about whether the PRE could be claimed.

Mr. Hansen testified that he and his spouse purchased the first three of the five homes in question with the intention of remaining there long term. Unfortunately, owing to several factors (substantiated by testimony), these homes proved

unsuitable; the Hansens feared for the safety of their young children. Two of the five properties had been custom-built at the direction of the Hansens, and all of the homes had been extensively finished according to the family's very specific tastes and requirements. As the Hansens testified, they had put substantial money and effort into customizing the properties to their liking because they had intended, in each case, to make the home their long-term residence.

The Hansens met with their accountant each year to prepare their taxes. Their accountant testified that he and Mr. Hansen discussed the reasons for the purchase and sale of each home, and whether each home qualified for the PRE. The accountant had considered the facts of each purchase. Because he genuinely believed that the Hansens were not engaged in house flipping, he advised them that they could claim the PRE on each property. The Crown provided no evidence to dispute this testimony.

The court found that the taxpayer had acted prudently and that his tax-filing position on the sale of all properties was reasonable, given his circumstances and the professional opinion of his accountant. The taxpayer had had an honestly held belief that his homes were all to be principal residences and that therefore they were exempt from taxation. The court held that when the minister disagrees with the taxpayer's filing position, the particular evidence for the difference of opinion should be considered. When the taxpayer takes a thoughtful, reasonable approach to reporting, the minister should not reopen statute-barred years for assessment under subparagraph 152(4)(a)(i). Therefore, the minister could not reassess Mr. Hansen for his 2007, 2008, and 2009 taxation years.

In our view, the *Hansen* decision is consistent with the four-part test established in *Aridi v. The Queen* (2013 TCC 74). Mr. Hansen was aware that there was a PRE and that if a standard was not met, the sale would be subject to tax, likely on income account. He sought an accountant's advice on his family's specific circumstances in relation to the purchase and sale of each house and on why he and his spouse qualified, in each case, for the exemption. It was never a matter of not knowing the tax rules. It was a matter of whether the real-life circumstances fit the rules.

It is notable that reliance on a professional accountant's advice at the time of filing may not be a panacea for any reassessment: the taxpayer is always responsible for checking the accuracy of the tax filing (see *Nesbitt v. R*, 96 DTC 6588 (FCA), aff'g 96 DTC 6045 (FCTD)). In accordance with several court rulings, the taxpayer must verify the accuracy of the information at the time of filing: see CRA document no. 2005-011324117 (February 2, 2005).

As for the application of the gross negligence penalty, the standard for imposing a penalty under subsection 163(2) is higher than the standard set out in subparagraph 152(4)(a)(i). If the court finds that the minister did not have the right to reopen the appellant's statute-barred years, it must likewise

find that the gross negligence penalty should not have been applied (see *Venne*).

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Cautionary Tale: CRA Interviews and Taxpayer Rights

The 2021 federal budget proposed that the broad CRA audit powers be expanded to allow the agency to compel oral interviews from an owner-manager and any other employee of the business. The CRA currently has the statutory authority, under the ITA and the ETA, to demand any document, record, or information from taxpayers and third parties. When those powers are exercised properly, taxpayers must comply, and they may be committing an offence if they do not. This puts taxpayers in a very awkward position. Faced with the CRA's potentially improper exercise of these powers, taxpayers are required both to know their rights and to seek legal representation to vindicate those rights.

This article reviews the current rules in this area; the proposed changes in the 2021 budget; some of the greater issues, problems, and traps that these changes entail; and some of the recourse options available to taxpayers.

Current Rules

Under the current rules in subsection 288(1) of the ETA and subsection 231.1(1) of the ITA, the CRA is authorized to inspect, audit, or examine all relevant documents, property, or processes of a person, and to require the owner-manager to answer "all proper questions" and provide "all reasonable assistance." What "reasonable assistance" or "proper questions" means has always been somewhat ambiguous.

Recently, the FCA denied the CRA the authority to force interviews on a taxpayer's employees; the court concluded that such power is not legislated under either subsection 231.1(1) of the ITA or subsection 288(1) of the ETA. (See *Cameco*, 2019 FCA 67.) This was a somewhat surprising decision, which led the CRA to update its policy (AD-19-02R). The CRA's new position is that it will continue to interview owner-managers and will reserve the right, if the owner-managers refuse to provide full answers, to "make inferences and assumptions and . . . assess on that basis."

Proposed New Rules

The Department of Finance, in keeping with the CRA's updated policy, appears to have moved to legislate the CRA's powers to conduct interviews. Under the proposed changes in the 2021 budget, the CRA will now be able to force interviews and compel answers from owner-managers and their employees, "orally or in writing, in any manner specified by the authorized persons."

Problems

Although these proposed changes appear to make it easier and quicker for the CRA to issue assessments and ensure tax compliance, experts in the area are foreseeing real problems for taxpayers, given the potential for the misapprehension of facts. The worry is that taxpayers and their employees lack tax sophistication and are unlikely to fully comprehend the CRA's questions. As a result, they may not respond appropriately to these questions, and this will be to the overall detriment of the taxpayer's business. What makes this even more worrying is that the CRA often has a preconceived mindset as it heads into these audits, and it uses these interviews simply to gain ammunition for a pending assessment.

In these situations (with the CRA using the interviews as a fishing expedition), even the slightest miscommunication on the taxpayer's part can lead to major audit conclusions and significantly adverse tax results. As we probably all know, the cost of overturning a wrong-headed assessment is sizable.

An illustration of this problem, perhaps, was *Canus* (2005 NSSC 283), a case in which the auditor relied on discredited information and a faulty methodology to arrive at an assessment that was objectively unsupportable. The CRA Appeals Division ultimately vacated the assessment, but the simple fact of the assessment led to a disclosure of the tax debt in the company's financial statements, a reduction in its available bank financing, and a significant impairment of Canus's ability to conduct its business. Canus tried to sue the CRA for causing this damage, but, like most plaintiffs in these cases, it was unsuccessful.

Recourse for Aggrieved Taxpayers

The administrative law in Canada does not allow any government institution to exercise its powers arbitrarily. Accordingly, the CRA's audit powers are subject to a taxpayer bill of rights (RC4417), which requires the CRA to maintain proper conduct throughout the course of audits, appeals, investigations, and collection matters—a list that would seem to include interviews. On the basis of procedural fairness, the law affords aggrieved taxpayers some options for recourse.

First, at an institutional level, taxpayers who face unfairness or bias can file complaints within the CRA or can request a file transfer. These disciplinary complaints are taken seriously,

provided that the taxpayer can prove the misconduct with evidence. Moreover, wrong advice from CRA officials can in some cases be grounds for requesting tax relief.

Second, when the audit escalates into a criminal investigation, taxpayers' rights that are protected by the Canadian Charter of Rights and Freedoms are honoured. In *Jarvis* (2002 SCC 73), the Supreme Court of Canada held that the powers under compliance audit could not be used for the purposes of investigating a criminal offence. This is in line with section 13 of the Charter, which provides every person with the right not to self-incriminate, meaning that a witness's testimony cannot be used against that witness in criminal matters. The CRA's findings from an audit interview are not admissible in a criminal prosecution against the taxpayer.

Finally, in rare tax litigation cases, the CRA's improper conduct can be a factor in awarding enhanced costs against the Crown. In *Hunter* (2002 CanLII 47033 (TCC)), for example, the CRA's failure to ask any substantive and highly relevant questions (which should have underpinned the assessment) was viewed as a reason to award increased costs against the Crown. Similarly, in *Lau* (2003 TCC 74), the CRA's meritless assessment against one of the taxpayers (which forced the taxpayers to defend themselves in court) was another significant factor in the court's award of increased costs against the Crown.

In our view, the CRA's negligence during an audit interview could also be grounds for a civil claim against the CRA for the tort of misfeasance of public office, negligence, or malicious prosecution. The issue of whether the CRA owes taxpayers any duty of care remains an underdeveloped area of law. Some recent jurisprudence (for example, *Leroux*, 2012 BCCA 63) appears to suggest that such a duty of care may exist but that it involves a high bar for negligence—requiring the taxpayer to show evidence of malice or unlawful conduct, which is usually extremely difficult to show.

Commentary: Is an Ounce of Prevention Worth a Pound of Cure?

As the law now stands, a taxpayer's prospects of a successful claim against the CRA are slim, but the probability of being misunderstood during an audit interview is high.

Not all interviews are likely to be negative; a knowledgeable and prepared employee can effectively present a business's affairs. In our experience, however, taxpayers usually devote insufficient resources to audit, which means that audit interviews often lead to haphazard results. Bad interviews lead to significant misunderstandings about the business's tax affairs, and that leads to bad (and usually large) notices of assessment. When a GST notice of assessment has been issued, the CRA is authorized to collect from the first day, and the notice of assessment can be undone only through lengthy and costly tax-appeal processes.

Fortunately, taxpayers can generally avoid all of this through the early engagement of tax counsel, who will ensure that potential witnesses are well prepared. It is in the interests of taxpayers to cooperate with the CRA, but such cooperation should be given through a controlled, prepared, and properly conducted interview, in which the relevant information is provided and questions are answered in a clear and succinct manner.

It is also worth noting that employees have their own individual rights and protections under the federal and provincial laws, including the right, in certain circumstances, to retain legal counsel, and the right to remain silent in the face of CRA questions. Employers should be mindful of honouring employees' rights while adhering to CRA demands.

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