Highlights of Recent Tax-Related Cases

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Topics to Discuss

1. Introduction:
2. *Wheaton Precious Metals* Cases
3. *Gagliese* Case
4. *Landbouwbedrijf* Case
5. *Kau* Case

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Wheaton Precious Metals Tax Cases

- The Canadian public company previously known as Silver Wheaton is in the business of providing financing to mining companies in return for a share of their production (a so-called “streaming company”)
- The CRA audited Wheaton and its wholly-owned Cayman subsidiary for the period 2010-2015, and reassessed on the basis that Wheaton had violated the Transfer Pricing Rules
- As a result, the Cayman income of $715 million was attributed to the Canadian parent, which was assessed for $310 million of taxes, interest and penalties

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Wheaton Precious Metals Tax Cases…cont'd

- Wheaton made timely disclosures of the CRA proposals and actual reassessments, but management stated that the audit was not expected to have a material adverse effect on the company, and that the company's financial statements were in compliance with the International Financial Reporting Standards
- Immediately following the disclosure, the stock price fell about 20%
- Shareholder class actions were commenced in civil courts both in the U.S. and in Canada, seeking punitive damages of $10 million, among other things

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Wheaton Precious Metals Tax Cases…cont'd

- Wheaton's Annual Information Form filed with the OSC proclaimed that the "Corporation's profit is derived from its subsidiary, Silver Wheaton Cayman, which is incorporated and operated in the Cayman Islands, the Corporation's profits bear no income tax".

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This is like waiving a red flag in front of the CRA bull

Wheaton Precious Metals Tax Cases…cont'd

- The allegations in the cases are that the Cayman company had inadequate substance to be able to conduct the business from which it claimed to be generating profits for itself as opposed to for its parent company in Canada
- The plaintiffs allege that Wheaton violated securities laws by failing to disclose material adverse facts about the company's business, operations, prospects and performance

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Wheaton Precious Metals Tax Cases…cont'd

- The IFRS apparently requires a company to record as an uncertain tax-position liability in its financial statements an estimate of the obligations if it was "more likely than not" that the CRA audit would result in additional taxes
- In addition, the plaintiffs allege that management made false and negligent misrepresentations about the severity of the reassessments, inducing shareholders to buy its stock at inflated prices

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Wheaton Precious Metals Tax Cases…cont'd

- What lessons can be learned from these cases ?
  - Compliance with the Transfer Pricing Rules is critical for any company with international operations
  - Public disclosure about tax minimization must be managed with an expectation that the CRA will read it and react
  - Even if the company believes it has a good defensible position, it must be conservative and realistic in representing the risks to the public
  - Tax issues are no longer a private matter for public companies

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Rocco Gagliese Productions Inc. v. The Queen

When a company earns royalties, can it still claim the small business deduction from carrying on an active business ?

- Rocco Gagliese is a writer, performer and recorder of music for television programs; in fact he won an Emmy Award for his music
- He incorporated a company of which he was the sole shareholder, director and officer through which to produce his music and obtain limited liability protection

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Rocco Gagliese Productions Inc. v. The Queen...cont'd

- He assigned to his corporation his rights to receive revenue in respect of the music he composed, performed or recorded
- When this revenue was received as "royalties" from the collecting agent SOCAN (the Society of Composers, Authors and Music Publishers), the CRA denied the corporation the small business deduction on the basis that it earned income from property (copyright in the music) and not from an active business (the provision of services)

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Rocco Gagliese Productions Inc. v. The Queen...cont'd

- The Tax Court noted that this issue has come before the court because the CRA revoked its previous published position, which stated:
- *Although royalty income is generally from a source that is property, where it can be established that the royalty income is related to an active business carried on by the recipient corporation, or the recipient corporation is in the business of originating property from which the royalties are received, such income will be considered to be income from an active business. Therefore, if a company is in the business of composing music, the income it earns with respect to its copyrighted music would generally be considered active business income*.

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Rocco Gagliese Productions Inc. v. The Queen...cont'd

- The Court found on the facts that Mr. Gagliese validly assigned to his corporation the rights to receive revenue from the music he wrote, performed or recorded
- Counsel for the taxpayer corporation argued that the corporation in fact carried on an active business, and that in any event it did not fall within the definition of an "investment business" which requires the principal purpose of the corporation to be the earning of income from property, which was not the case here

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Rocco Gagliese Productions Inc. v. The Queen...cont'd

- Counsel for the Crown argued that the court must be bound by the legal character of the revenue: *royalties* come from the use of property
- However the Court found that the principal purpose of the corporation's business was to earn income from Mr. Gagliese's daily activities of originating and recording music tracks for individual television episodes
- Accordingly, it was carrying on an active business from providing services and, thus, was entitled to claim the small business deduction

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Rocco Gagliese Productions Inc. v. The Queen...cont'd

- What we can learn from this case is that while the legal character of a payment is important, it will not govern the taxability, if the taxpayer can show that value was created from an activity that differed from the label that was assigned to the payment
- In addition, we are reminded that interpretations put forward by the CRA or withdrawn by them do not constitute the law, but only their views, which may be overturned by a court where the evidence is clearly in the taxpayer's favour

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Landbouwbedrijf Backx B.V. v. The Queen

When a Dutch company realizes a capital gain from the sale of partnership interest in a Canadian farm, can it be liable for tax as a resident of Canada?

- The corporate taxpayer ("LB") is a limited liability company incorporated under the laws of the Netherlands
- It disposed of its partnership interest in an Ontario farm, and the CRA assessed the capital gain under Part I as though it was a Canadian resident and also under Part XIV (branch tax) as though it was a non-resident

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Landbouwbedrijf Backx B.V. v. The Queen...cont'd

- The original Dutch resident shareholders and directors of LB were Michiel Backx and his wife, Marian Backx
- When the Backx immigrated to Canada they formed a 51/49 partnership with LB to acquire the Ontario farm
- The Backx resigned as directors of LB in favour of Marian's sister, but remained as shareholders
- They also established an Ontario corporation, Backx Dairy Farms Limited ("BD"), to which LB transferred its 49% interest in the farm partnership for proceeds of $4.5 million, paid by a note, resulting in a capital gain of $1.7 million

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Landbouwbedrijf Backx B.V. v. The Queen...cont'd

- The memorandum of agreement approving the transaction was signed by Marian's sister on behalf of LB
- BL followed the procedure under s.116 of the ITA disclosing the transaction and claiming the capital gain was tax exempt as being "treaty-protected property" under the ITA and the Canada-Netherlands Tax Treaty, on the basis that the farm partnership carried on a business and the capital gain realized on the transfer of the partnership interest was only taxable in the Netherlands

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Landbouwbedrijf Backx B.V. v. The Queen...cont'd

- The Tax Court found that all the instructions for buying and selling the Ontario farm property came from the Backx in Canada, and that Marian's sister in the Netherlands was a mere nominee who carried out clerical and administrative functions on behalf of the Backx
- Marian's sister admitted that she had no experience in farming and no prior business experience. She accepted the title of director to assist her sister and brother-in-law, and received remuneration of €500 per year
- Moreover, the correspondence among the Backx, their Canadian and their Dutch advisors disclosed that the Backx assumed effective and independent control of LB- indeed most of the correspondence was not copied to Marian's sister

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Landbouwbedrijf Backx B.V. v. The Queen...cont'd

- In analysing whether LB was a resident of Canada, the Court adopted the long-standing central management and control test (See the decision of the Supreme Court of Canada in *Garron Family Trust (Trustee of) v. R.)*
- While central management and control is usually found to reside in the Board of Directors, if significant management decisions are taken by a person who is not a director, the place where that person resides or operates may be determined to be the residence of the corporation
- The Court found that LB had not ceased to be a resident of the Netherlands; accordingly, it was a dual resident, in which case the "competent authorities" under the Treaty not the Court must resolve the conflict

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Landbouwbedrijf Backx B.V. v. The Queen…cont'd

- What we learn from this case is that even with expert tax advice in both Canada and the Netherlands, it is possible to overlook the fundamental facts on how a corporation actually operates and the resulting tax risks
- One always needs to go back to "basics"
- In any cross-border transaction, one must be clear on where the parties are resident for tax purposes based on the actual facts, not just on the tax plan proposed by the advisors

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Anibal Kau v. The Queen

When does a purchaser of real property from a vendor satisfy the test of making "reasonable inquiry" as to whether the vendor is a non-resident ?

- The taxpayer, Anibal Kau ("Kau") purchased a Toronto condominium unit from a vendor with a California address for service
- No application was made for a section 116 clearance certificate from the CRA

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Anibal Kau v. The Queen…cont'd

- The dispute arose from the assessment of the purchaser of 25% of the purchase price on the basis that the purchaser did not make "reasonable inquiry…to believe that the non-resident person was not resident in Canada"
- The Court carefully examined the evidence presented by the parties to determine whether the taxpayer met the statutory test
- Leading up to the closing, the taxpayer visited the condo and determined that the vendor did not live there, a tenant did, and that it was an investment property for the vendor
- In addition, the taxpayer's lawyer found that the vendor's address for service was in California

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Anibal Kau v. The Queen…cont'd

- The vendor in front of a California notary declared (but did not solemnly swear) in an affidavit: "I am not a non-resident of Canada…"
- The taxpayer himself did not make enquiry as to the residency of the vendor; he did however hire a real estate lawyer to act for him, which presumably includes avoiding tax liability under the ITA
- The Court found that the lawyer knew about the California address for service for the vendor, the possession of the condo by a tenant not the vendor, the so-called "affidavit" – these should have been viewed as "red flags" to the lawyer to make further inquiries and dig deeper into the apparent facts

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Anibal Kau v. The Queen…cont'd

- It was incumbent on the lawyer in these circumstances to make additional inquiries, such as asking for the permanent residential address of the vendor, not just the address for service, and for a copy of the vendor's driving license
- These and other inquiries might have led the lawyer to conclude that the taxpayer ought not to rely on the vendor's documents, and instead not close without the clearance certificate

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Anibal Kau v. The Queen…cont'd

What can we learn from this case ?

- Even in apparently conventional purchase and sale transactions, the tax risks must be carefully evaluated
- Appropriate steps must be taken to mitigate such risks by examining the statutory exculpatory language, and using common sense and the perspective of how a court might look at the conduct of the taxpayer years after the event
- What needs to be done will always be dictated by the context of the law and the particular facts, but the approach to risk mitigation in the tax minefield should have the highest priority

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Questions?

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