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• DISPUTE RESOLUTION IN TAX LAW •

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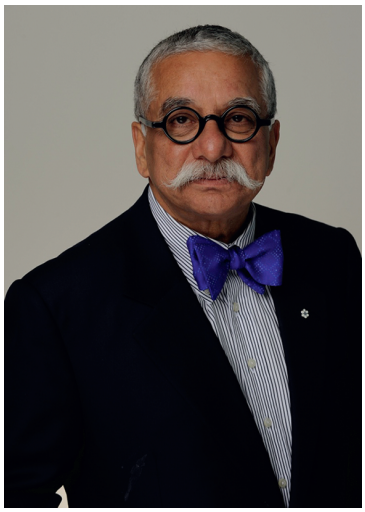

Vern Krishna CM

• In This Issue •

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A basic feature of the Canadian income tax system is that it relies on taxpayers to self-assess their income annually on a prescribed form and in a prescribed manner. Voluntary compliance and self-assessment are the foundation of the administrative structure of the Act.

The term "voluntary" is a misnomer. The tax system has powerful inducements, civil penalties, and criminal sanctions to encourage taxpayers to fully disclose their income. The Canada Revenue Agency ("CRA") can impose monetary penalties, make third-party demands for disclosure of information, garnish income, seize property, and prosecute through the criminal process.

So you have just received your notice of assessment in the dreaded brown envelope from the CRA. You open it with trepidation to learn that the CRA has reassessed your taxes from three years ago. They claim that the gain that you declared in good faith on the sale of your rental property as a capital gain is, in their view, an income amount. Hence, they have doubled the gain from the sale of the property, and would like you to pay an additional $50,000 in tax. What should you do? The first thing to do is to stop hyper ventilating and bring your blood pressure down to a respectable level.

Next, immediately remit the taxes demanded to stop the clock on accumulating interest charges.

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The CRA charges interest on any amounts owing back to the date of the original tax year. The interest is calculated at 5 per cent [2016 rates] on a daily compounding basis, and is not deductible for tax purposes. Thus, the 5 per cent payable is an after-tax cost, which in today's market is an exorbitant cost. By the time you receive the reassessment, there would be nearly three years of accumulated interest charges payable on your account, and you would already owe about $58,000.

The second step is to immediately file an Objection with a Tax Service Office (or electronically) that sets out in general terms the reasons, and relevant facts, for your tax filing position. As a general rule, you have 90 days from the date of sending of the assessment to file your Objection. In exceptional circumstances, you can get an extension from the Minister if she considers the extension "just and equitable". The words "just and equitable" conjure up an impression of palm tree justice. In fact, the Minister and the Tax Court rarely grant extensions of time to file. Don't count on getting one easily. Do it immediately.

The CRA is required to respond and consider your Objection "with all due dispatch". You will receive a standard response in about eight weeks telling you that they have your Objection, and you will be contacted by an appeals officer. It may take as long as ten to twelve months (or longer) for someone to contact you and ask for further details. This is the beginning of a long relationship that you will have with the appeals officer, a CRA employee who will evaluate the CRA's own assessment. This is known as independent administrative review in tax law! During the delay you should cultivate patience, which is why you should pay the tax claimed immediately to avoid accumulating interest charges. Delay works to the government's advantage through daily compounding of interest on any outstanding taxes back to the date of the original filing.

Another option that you can consider is to file an appeal to the Tax Court 90 days after you file your Objection if you have not, as is likely, heard back from the Minister with all due dispatch. At this juncture there are new rules and costs to consider.

If the amount under dispute is $25,000 or less, you can elect the "Informal Procedure", which is a less formal procedural route, and a mildly less intimidating route for self-represented individuals who are not trained in the formal litigation nuances of the judicial system. The advantage of this route is that the entire trial procedure can be completed in less than a year.

If the amount in dispute is more than $25,000, you are stuck with the General Procedures of the Tax Court, which are steeped in legal formalism, best left to legal counsel who will represent you. The process is long, adversarial, subject to stringent rules of disclosures, discoveries, and expensive. A complex tax case moving along at a steady clip can last a dozen years, which is another reason to pay the amount of taxes claimed immediately. $50,000 accumulating interest at 5 per cent will be equal to about $90,000 in twelve years. The $40,000 accumulated interest will not be deductible for tax purposes.

There are two other rules that taxpayers should be aware of in tax disputes. First, the CRA's assessment is presumed to be correct, unless the taxpayer can demolish its underlying assumptions of fact. The presumption of validity of an assessment is the single most significant rule for taxpayers. The Act deems an assessment to be valid and binding on the taxpayer, even if it contains an error or defect, or the CRA incorrectly calculates or improperly issues it. This is a formidable presumption — a form of reverse onus burden. Hence, it is imperative that the taxpayer maintain full, complete, and detailed records in support of his or her filing position. The CRA does not need to prove anything after it issues its assessment, which gives them a considerable advantage in tax litigation. The CRA can sit on its hands. The taxpayer must "demolish" the assessment.

Second, if the taxpayer eventually overcomes the presumption of correctness and wins, he or she will be refunded the full amount paid ($50,000 in the above example) plus interest at 3 per cent, which will be fully taxable as income. Thus, the government will take back approximately one half of what it gives you. The difference between the government's 5 per cent after tax interest and the taxpayer's 3 per cent pre-tax income is known as hedging in sophisticated financial circles.

The notion that the tax system is a purely voluntary structure is deceptively appealing. To be sure, no one is compelled to comply with the *Income Tax Act*, just as members of the armed forces can ignore the orders of their commanding officer on the battlefield. In tax law, the sanctions are less severe and include protracted civil litigation, forfeiture of property, criminal prosecution, and eventual incarceration.

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• PROPOSED GST/HST AMENDMENTS RELATING TO PENSION PLANS •

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On July 22, 2016 (the Announcement Date), the Department of Finance released a package of draft legislative amendments that includes proposed changes to the existing GST/HST rules under the *Excise Tax Act* (the ETA) relating to pension plans.[1] Most of these changes concern pension plan structures that include a "master pension entity," which is newly defined to be a corporation or trust described in paragraph 149(1)(o.2) or (o.4) of the *Income Tax Act*, one or more shares or units of which are owned by a "pension entity" of the pension plan, as defined in subsection 123(1) of the ETA.[2]

The proposed changes will, in effect, extend the existing deemed supply rules[3] and rebate[4] provisions applicable to plan-related expenses incurred in respect of pension entities to apply, in a similar manner, to such expenses incurred in respect of master pension entities as well. The main aspects of these proposed amendments are summarized below. All statutory references below are to provisions of the ETA unless otherwise specified.

NEW DEEMED SUPPLIES IN RESPECT OF ACTIVITIES RELATING TO MASTER PENSION ENTITIES

Under the existing deemed supply rules in section 172.1, a GST/HST-registered participating employer in respect of a pension plan is deemed at the end of each fiscal year to make supplies of most taxable property and services acquired by the employer during the year, and in-house resources of the employer consumed or used in the year, for purposes relating to the pension plan. The employer is then liable to self-assess and remit GST/HST on the value of these deemed supplies, as determined under the ETA. In turn, the relevant pension entity is generally deemed to have paid that tax for purposes of claiming a partial rebate. In particular, existing subsections 172.1(5) and (6) deem the employer to make, at the end of the fiscal year, supplies of property or services that are determined to have been, during the year, actually supplied by the employer, or consumed or used by the employer in making actual supplies, to a pension entity. Proposed new subsections 172.1(5.1) and (6.1) contain parallel deeming rules in respect of property and services determined to have been supplied, or consumed or used in making supplies, by a participating employer of a pension plan to a master pension entity of the plan.

In addition, the deemed supply rule under existing subsection 172.1(7), which generally applies to all other property and services that are consumed or used during the year by the employer in the course of "pension activities" (as defined in the ETA), is proposed to be amended so as not to apply in respect of pension activities that relate exclusively to the establishment, management or administration of a master pension entity or the management or administration of assets held by a master pension entity. Instead, a new parallel deeming provision, under proposed subsection 172.1(7.1), will apply in respect of such pension activities relating exclusively to a master pension entity.

The GST/HST that will be required to be self-assessed by a participating employer on the new deemed supplies in respect of a master pension entity

will be calculated in much the same manner as is the GST/HST on deemed supplies under the existing rules of section 172.1, except that one additional factor, referred to as the "master pension factor," will have to be taken into account. As newly defined in subsection 123(1), the master pension factor in respect of a master pension entity generally is the percentage of the total value of all units/shares of the master pension entity that is represented by units/shares held by pension entities.

The proposed new deemed supply rules in respect of master pension entities generally apply to fiscal years of a participating employer beginning on or after the Announcement Date. However, it should be noted that there is also a proposed retroactive amendment to existing subsection 172.1(7), which is in addition to the above-noted prospective amendment to that subsection. For fiscal years that begin on or after September 23, 2009 (when the existing deemed supply rules were first introduced) but before the Announcement Date, subsection 172.1(7) is proposed to be amended so as not to apply to any property or service that is consumed or used by the relevant participating employer in the course of the establishment, management or administration of a master pension entity of the plan or the management or administration of assets in respect of the plan that are held by such a master pension entity. This retroactive amendment corrects for an unintended consequence that could have arisen where a participating employer was considered to have made both an actual supply, pursuant to the general rules of the ETA, and a deemed supply, pursuant to the pre-amended wording of subsection 172.1(7), of the same property or service in respect of the master pension entity. In that circumstance, the employer would not have been able to rely on either the tax-adjustment note mechanism under section 232.01 or the nil-consideration election under section 157 to avoid the resulting double tax, since the latter relieving mechanisms did not, prior to the current amendments, apply in respect of supplies deemed to be made in respect of pension activities relating to master pension entities.

Given that the above-noted retroactive amendment to subsection 172.1(7) will have the effect of "unravelling" the consequences that otherwise flowed from the application, during the retroactive period, of that subsection to deemed supplies in respect of master pension entities, it could lead to reassessments of amounts in respect of such deemed supplies that were included in computing the net tax of a participating employer and possibly also included in determining the corresponding rebate amount under section 261.01 or the net tax deduction available to participating employers in respect of the "transfer" to them of the corresponding rebate entitlement. The net effect of all such reassessments should be a refund of the unrecovered portion of the tax that was, by virtue of the retroactive amendment, not required to have been self-assessed by the participating employer in the first instance. To deal with situations where such reassessments would otherwise not be made (for example, if they would otherwise be statute-barred), a special transitional rule is provided that would, subject to certain conditions, allow for such reassessments to be made upon the request of the participating employer. If a participating employer wishes to make this request, it will have to do so in writing to the Minister of National Revenue within one year after the day on which the Act enacting the retroactive amendment to subsection 172.1(7) receives royal assent.

NEW "NIL-CONSIDERATION" ELECTION

Based on the CRA's current administrative interpretations, in certain circumstances it may be determined that a participating employer makes actual taxable supplies of property or services for consideration to a master pension entity, pursuant to the general rules of the ETA (*i.e.*, outside of the special deeming rules under section 172.1). There normally would also be a deemed supply of the same property or service under the rules of section 172.1, as amended. In that case, to avoid the double taxation that would otherwise result, the employer may resort to the tax adjustment note mechanism under section 232.01,

which will be extended to apply to the tax on the new deemed supplies in respect of master pension entities. Alternatively, the employer and relevant master pension entity will be able to make a joint election, under proposed new subsection 157(2.1), to treat actual supplies considered to be made by the employer to the master pension entity as having been made for nil consideration. This proposed new election is similar to the existing one available in respect of actual supplies considered to be made by a participating employer to a pension entity.

While in many circumstances it remains a contentious question as to whether, according to the general rules of the ETA, a participating employer does, in fact, make such actual supplies, for greater certainty, it will, in most cases, be advisable for a participating employer to make this new election (on a without prejudice basis). The new nil-consideration election provision applies to supplies made on or after the Announcement Date. Like the existing election in respect of pension entities, the new nil-consideration election will be effective as of the first day of the fiscal year of the participating employer specified in the election form, which must be filed with the Canada Revenue Agency on or before the effective date, or on such later day as may, on request, be allowed.

REBATE FOR TAX ON NEW DEEMED SUPPLIES IN RESPECT OF MASTER PENSION ENTITY

The GST/HST on the new deemed supplies in respect of master pension entities will generally be eligible for the 33 per cent rebate under section 261.01. The rebate for this tax will be claimed by the "specified pension entity" of the pension plan (as defined in existing subsection 172.1(4)), which will be the pension entity that will be deemed, for purposes of the rebate, to have paid the tax on the new deemed supplies in respect of master pension entities of the plan. In addition, the related rules under the ETA that provide for an election to "transfer" all or part of the rebate amount to qualifying employers in respect of a pension plan are proposed to be amended to apply to the rebate for the tax on the new deemed supplies in respect of master pension entities of the plan.

NEW ELECTION TO CLAIM REBATE FOR GST/HST INCURRED BY MASTER PENSION ENTITY ON ACTUAL SUPPLIES

Pursuant to proposed new section 172.2, the rebate and related rules under section 261.01 will also generally apply to GST/HST that is paid or becomes payable by a master pension entity in respect of actual supplies that are determined to be made to the master pension entity based on the general rules of the ETA (*i.e.*, otherwise than pursuant to the special deeming rules noted above). For this purpose, such GST/HST will be deemed to be paid by the applicable pension entity that is the "designated pension entity," as newly defined. Where there is more than one pension entity of a pension plan, the master pension entity that has incurred the GST/HST in question must jointly elect with one of the pension entities to have that pension entity be the "designated pension entity," failing which the rebate and related rules will not apply to the GST/HST incurred in respect of actual supplies made to the master pension entity.

SLFI STATUS OF A MASTER PENSION ENTITY OF A PENSION PLAN AND THE PENSION ENTITIES OF THE PLAN

The status, as a "selected listed financial institution" ("SLFI") or "qualifying small investment plan" ("QSIP"), of a pension entity or master pension entity will continue to be determined according to the existing rules of the ETA and related regulations. Under those rules, the SLFI and QSIP status of a master pension entity of a pension plan should not be affected by the new deemed supplies in respect of the master pension entity. However, the status of the pension entities of the plan as SLFIs or QSIPs may be affected by the new deemed supplies, since the GST/HST on the deemed supplies is included in the relevant threshold calculations of the pension entities. As a result, a pension entity that qualifies as

a QSIP under the existing rules, may lose that status after taking into account the new deemed supplies in respect of master pension entities of the relevant pension plan.

QUESTIONABLE RESTRICTION ON WHICH MASTER TRUSTS WILL QUALIFY AS MASTER PENSION ENTITIES

As noted above, under the proposed amendments, a "master pension entity," in the case of a trust, is defined as one that is described in paragraph 149(1)(o.4) of the *Income Tax Act*, which is a trust that satisfies two conditions, namely: (1) it is prescribed for purposes of that paragraph to be a master trust; and (2) it has elected to be treated as tax-exempt for income tax purposes (the ITA Election). It is questionable why the latter condition should exist to limit the scope of the definition of master pension entity for GST/HST purposes. There are various reasons why the ITA Election might not be made in respect of a master trust that would otherwise fit within paragraph 149(1)(o.4) of the *Income Tax Act*. For example, the trustee might choose not to make the ITA Election simply because all of the income of the trust is distributed at the end of each taxation year such that there is no need to elect for tax-exempt status. It is not clear what relevance the making of the ITA Election has to the purposes underlying the proposed new GST/HST rules relating to master pension entities. As currently drafted, the definition of master pension entity would leave out many master trusts for no apparent policy reason. We believe that the ITA Election condition, as currently proposed, is unduly restrictive and should be re-thought.

OTHER TECHNICAL CHANGES TO THE GST/HST RULES RELATING TO PENSION PLANS

The set of proposed GST/HST amendments relating to pension plans also includes some technical amendments that do not necessarily have to do with master pension entities. Generally, these technical amendments clarify the existing rules or fill gaps in the legislation and, as such, are in some cases relieving in nature and tightening in other cases. Some are strictly prospective, while others are retroactive with specified exceptions.

CONCLUSION

There is both good and bad news in this set of proposed GST/HST amendments relating to pension plans. On the positive side, there are, as described above, some technical relieving amendments that will correct some long-standing deficiencies in the legislation. As well, the new rules pertaining to master pension entities should result in less disparity of treatment under the ETA as between different pension plan structures. However, on the negative side, nothing has been done to simplify the GST/HST rules relating to pension plans. To the contrary, the proposed amendments make what were already very complex rules all the more complicated. The above brief summary skims the surface of the amendments. The old adage, "the devil is in the details" certainly applies here. Participating employers and other affected parties are strongly encouraged to work with their advisors in closely examining all of the draft amendments to determine the effect that the amendments will have in their particular circumstances and identify actions that may need to be taken, such as the filing of the new elections that are provided for under the amended rules and re-evaluating the SLFI status of pension entities after taking into account the effect of the new deemed supply rules in respect of activities relating to master pension entities.

The Department of Finance has invited interested parties to submit comments on the proposed amendments before the end of August. If you wish to make a submission, but do not believe that you can meet that deadline, we recommend that you advise the department of your intention and of the date by which you expect to make your submission.

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customs and related cross-border matters, including all aspects of the GST and HST.]

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1 For this purpose, the term "pension plan" continues to have the meaning set out in subsection 123(1) of the ETA. The definition encompasses most registered pension plans and pooled registered pension plans, within the meaning of the *Income Tax Act* and the regulations thereunder.

2 Pension entities include trusts governed by pension plans and certain corporations that are incorporated and operated either solely for the administration of pension plans or for that purpose and the purpose of acting as trustees of, or administering, trusts governed by certain retirement compensation arrangements (as defined in subsection 248(1) of the *Income Tax Act*).

3 The existing deemed supply rules, and the related existing "nil-consideration" election and tax-adjustment note provisions, are contained in sections 172.1, 157, and 232.01, respectively.

4 The existing pension plan rebate is provided for under section 261.01.