

Quarterly legal newsletter intended for accounting, management and finance professionals

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THE 2014 FEDERAL BUDGET PLAN SOUNDS THE DEATH KNELL FOR TWO FAMILY TAX PLANNING MEASURES MUCH APPRECIATED BY ENTREPRENEURS AND SOME PROFESSIONALS

Martin Bédard
mbedard@lavery.ca

INCOME SPLITTING THROUGH A TRUST OR PARTNERSHIP

First, the 2014 Federal Budget Plan (the "Budget") ends the possibilities for splitting the income of trusts and partnerships in respect of business and rental income attributed to a minor child.

Such income will henceforth be considered as being part of the split income of the trust or partnership and taxed at the marginal rate.

As described in the Budget, the conditions of application of this new measure are as follows:

- ▶ the income is derived from a source that is a business or a rental property; and
- ▶ a person related to the minor
 - ▶ is actively engaged on a regular basis in the activities of the trust or partnership to earn income from any business or rental property, or
 - ▶ has, in the case of a partnership, an interest in the partnership (whether held directly or through another partnership)

The structures affected by these new measures could be used by professionals conducting their activities through a partnership of which their minor children or a trust established for their benefit were members. Such structures allowed for directly or indirectly allocating a portion of the income of the partnership to the minor child and thus benefit from progressive tax rates.

As of 2014, the rules governing split income will apply to these structures, which will no longer offer a tax benefit. However, it is still possible to split such income with related persons who have reached the age of majority.

POST-MORTEM INCOME SPLITTING: THE TESTAMENTARY TRUST

The Budget also puts an end to the progressive tax rates applicable to a testamentary trust, a measure which was announced in the 2013 Federal Budget Plan.

Up to now, testamentary trusts were allowing their beneficiaries to benefit from several progressive tax rates. Among the tax planning possibilities associated with the availability of such progressive tax rates were the use of numerous testamentary trusts,



the postponement of the completion of the administration of an estate for tax purposes or the avoidance of the Old Age Security Recovery Tax.

Testamentary trusts will henceforth be uniformly taxed at their marginal tax rates.

However, progressive tax rates will remain applicable in the following two cases: (i) for the thirty-six (36) first months of an estate which is a testamentary trust and (ii) in the case of a trust whose beneficiaries are eligible for the federal disability tax credit.

The Budget also provides that the tax year-end of testamentary trusts must henceforth be December 31 of each year starting December 31, 2015.

These measures will apply to taxation years 2016 and following. ◀

THE EXPERT AND THE COURT

Dominique Vallières
dvallieres@lavery.ca

In the context of litigation, lawyers frequently require the testimony of experts, particularly accountants. Well presented, this evidence may have a decisive influence on the outcome of a trial. In the contrary situation, a debate on the quality of the expert or the weight to be given to his or her testimony may occur. This is why we review in this bulletin the role, qualification and credibility of the expert.

THE ROLE OF THE EXPERT

The role of the expert is to express an opinion based on his or her scientific, economic or other knowledge, which exceeds that of the judge and without which it is impossible to draw from the facts the correct conclusions. In other words, when the judge is able by himself to understand the facts and draw the correct inferences, an expert is neither necessary nor admissible. For example, the calculation of the gross profits from a contract, which only constitute a mathematical operation, will not require a particular expertise and an accountant called upon to testify on that matter will be at best considered as an ordinary witness. The role of the expert is to enlighten the Court in as objective or impartial a manner as possible.

THE QUALIFICATION OF THE EXPERT

To express his or her opinion, the expert must first be recognized as such by the Court. The expert will therefore be first examined respecting his or her training and experience. If the expert qualification is contested, and

the Court considers that the expert is insufficiently qualified, it may refuse to hear him or her. The qualifications of the expert must be related to the matters about which he or she testifies.

The training of the witness and his or her practical experience, will be considered. Although either may be enough, a really convincing expert will generally have solid training and experience, failing which, even if the Court accepts to hear him or her, less weight may be given to his or her testimony.

THE WEIGHT GIVEN TO HIS OR HER OPINION

As is the case with any other witness, the Court will have to assess the credibility of the expert, particularly in the presence of contradictory opinions. The Court may review the seriousness of the steps taken by the experts. It will give more weight to the opinion of a witness who directly noted the facts and reviewed the data than to the opinion of another witness who only relied on what he or she has been told. A mostly theoretical opinion or an opinion which only describes principles will also be given less weight. It is important for the witness to explain why the particular facts of the case allow for drawing a particular conclusion. Furthermore, in the presence of diverging schools of thought on a particular item, the Court appreciates that the expert considers them and explains why one should be favoured over the other in the situation at hand. Dogmatism, the absence of justification and the out of hand dismissal of a recognized approach will also generally be negatively perceived.

This is consistent with the very basis of the role of the expert, which is to impartially and objectively enlighten the Court. The Court will want to ensure that the expert keeps the required distance and independence to issue a credible opinion. If the Court perceives that the expert is taking sides or "pleads the case" of the party who retained his or her services, his or her credibility will suffer. Thus, even though it is admissible, the testimony of the expert and his or her conduct will be more closely scrutinized if it is demonstrated, for instance, that he or she is employed by a party or expressed in the past an opinion on similar issues.

Although this situation is rarer, the Court could even refuse to hear the witness if it is convinced that he or she will be unable to be impartial. Such may be the case when the expert personally advocates in favour of the position defended by a party or the fact that he or she was personally involved in similar litigation. The animosity or the closeness which may exist between the expert and a party may also negatively affect the expert. In this respect, it is important for the expert to be transparent to the party who retains his or her services.

CONCLUSION

The really useful expert is the one whose conduct may be summarized by these three words: competence, thoroughness and objectivity. ◀

YOU SIGNED A CONTRACT FOR SERVICES... WITH AN EMPLOYEE? HOW TO PROPERLY IDENTIFY THE RELATIONSHIP BETWEEN THE PARTIES AND WHAT ARE THE CONSEQUENCES OF A WRONG CATEGORIZATION?

Valérie Korozs
vkorozs@lavery.ca

Martin Bédard
mbedard@lavery.ca

The Court of Appeal of Québec recently issued an interesting decision on this subject in the *Bermex international inc. v. L'Agence du revenu du Québec* case¹ ("**Bermex**").

It must be noted that regardless of the fact that the parties have described their agreement as a contract for services or an agreement with a self-employed person, a court is not in any way bound by such a description.

The courts have developed certain criteria for analyzing the legal status of a person in order to determine whether that person is an employee or a self-employed person. Among these criteria, the relationship of subordination, that is, whether a person works under the direction or control of another person, has always been decisive.

What about when a person is not, strictly speaking, "under the direction or control of another person",² due to the fact that he or she runs the business? This is the question the Court of Appeal had to answer in the *Bermex* case.

The Court adopted a broad interpretation of the concept of the subordination relationship by considering the degree of integration of the worker into the company, a criterion derived from the common law.

THE FACTS

Following a tax audit of four companies, the Agence du revenu du Québec (the "**Agency**") concluded that Mr. Darveau, their main director and officer, did not have the status of a self-employed person but rather that of an

employee. Accordingly, the Agency was of the view that the management fees paid to Mr. Darveau had to be considered employment income and therefore, had to be included in the companies' payroll.

The four companies targeted challenged the Agency's assessments before the Court of Québec but to no avail.

THE DECISION OF THE COURT OF APPEAL

Just like the trial judge, the Court of Appeal concluded that the intent of the parties to enter into a service contract was not clear from the evidence in the case.

The fact that Mr. Darveau was a shareholder of the appellant corporations allowed him some freedom of action, giving the impression that he acted as a self-employed person. It is not surprising that as an officer, Mr. Darveau managed his own schedule, work and compensation nor is it surprising that he was not under the direct supervision of another authority. This freedom resulted from his status as an officer and not from the contract for services upon which he was relying.

The Court of Appeal placed a particular emphasis on the fact that it was the appellant companies who assumed all risk of loss and who profited from the activities: [translation] "Yet, a company does not assume the errors of an external consultant".³ Mr. Darveau did not bring any [translation] "expertise requiring the intervention of an external person in an area that he knows better than anyone, he simply deals with the day-to-day problems of his companies, as he so acknowledges."⁴



CONCLUSION

According to the line of case law followed by the Court of Appeal in the *Bermex* case, one shall take criteria such as control, ownership of tools, expectation of profits and risks of loss, as well as integration into the company into consideration for the purpose of determining a person's status as a self-employed individual or an employee.

An erroneous categorization of the nature of the contract may have significant financial impacts on the company and the individual in question, both from a tax and labour law perspective. It is therefore essential to undertake a careful analysis of the true status of the person involved before the beginning of the contractual relationship. ◀

¹ 2013 QCCA 1379.

² Article 2085 of the *Civil Code of Québec*.

³ Para 59 of the Court of Appeal's judgment.

⁴ Para 60 of the Court of Appeal's judgment.

APPLICATION OF GAAR TO A CROSS-BORDER DEBT "CLEAN-UP" TRANSACTION: THE *PIÈCES AUTOMOBILES LECAVALIER INC.* CASE

Éric Gélinas
egelinas@lavery.ca

The Tax Court of Canada recently rendered a decision dealing with the general anti-avoidance rule ("GAAR") in the context of the elimination of a cross-border debt between Greenleaf Canada Acquisitions Inc. ("Greenleaf") and Ford US, its American parent company, prior to the sale of Greenleaf's shares, who owed the debt, to a third party. In the case under review, Ford US subscribed for additional Greenleaf shares and Greenleaf used the proceeds from the subscription to repay its debt to Ford US.

The purpose of the transactions in question was to avoid the application of section 80 of the *Income Tax Act* ("ITA") upon the forgiveness of a portion of the debt. Without the debt repayment, the rules pertaining to debt parking contained in paragraphs 80.01(6) to (8) ITA would have resulted in the application of section 80 ITA in such a way as to reduce Greenleaf's tax attributes and even add to its income the portion of the "forgiven amount" not being sheltered.

The Minister of National Revenue ("Minister") was of the view that GAAR applied to the "clean-up" transaction in such a way that Greenleaf had to realize a capital gain of

\$15 million on the forgiveness of the debt. Greenleaf's tax attributes were accordingly reduced and certain adjustments to its taxable income were made pursuant to section 80 ITA.

ANALYSIS OF THE COURT

From the outset, the taxpayer acknowledged that the transactions provided it with a tax benefit, namely, the preservation of Greenleaf's tax attributes through the avoidance of the provisions of section 80 ITA.

As to whether these transactions constituted "avoidance transactions", the taxpayer attempted, particularly through the testimony of the accounting expert, to prove that they had been carried out only for US tax and accounting purposes, and that they therefore had *bona fide* non-tax purposes and did not constitute avoidance transactions. The Court did not rely on this testimony because it constituted hearsay. Furthermore, the Court applied the negative inference doctrine since no representative of Ford US had testified and that the testimonies provided were deemed not to be credible.

With respect to the issue of abuse, the Court agreed with the Minister's argument to the effect that the "clean-up" transactions were abusive since they circumvented the purpose

and spirit of section 80 ITA: if the debt had not been repaid using the proceeds from the subscription, the rules governing debt parking would have applied and Greenleaf's tax attributes would have been reduced pursuant to section 80 ITA.

CONCLUSION

This decision is particularly important in a context of debt reorganization within a corporate group. The type of transactions discussed in the decision under review is frequently used. Practitioners will have to pay particular attention to the tax impact of such a transaction. When it is possible to do so, it will obviously be preferable to simply convert a debt into shares of the debtor corporation to the extent that paragraph 80(2)(g) ITA is applicable so that no forgiven amount will result from the conversion. ◀

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CONTACTS

MONTREAL – 1 Place Ville Marie
514 871-1522

QUEBEC CITY – 925 Grande Allée West
418 688-5000

SHERBROOKE – Cité du Parc
95 Jacques-Cartier Blvd. South
819 346-5058

TROIS-RIVIÈRES – 1500 Royale Street
819 373-7000

OTTAWA – 360 Albert Street
613 594-4936

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