The Joint Committee on Taxation of
The Canadian Bar Association
and
Chartered Professional Accountants of Canada

Chartered Professional Accountants of Canada, 277 Wellington St. W., Toronto Ontario, M5V3H2
The Canadian Bar Association, 500-865 Carling Avenue Ottawa, Ontario K1S 5S8

June 16, 2014

Renée Shields
Manager
Income Tax Technical Publications Section
Income Tax Rulings Directorate
Canada Revenue Agency
17th floor - 320 Queen Street
Ottawa, ON K1A 0L5

Via email folios@cra-arc.gc.ca

Dear Ms. Shields:

Re: Income Tax Folio S1-F5-C1 (Related persons and dealing at arm's length)

This letter is from the CBA/CPA Joint Committee on Taxation. We write to suggest four changes to the above-named Folio, which was released for comment on May 2, 2014. The Folio is divided into two parts, the first dealing with related persons and the second with unrelated persons.

1) At the end of the first part, after paragraph 1.29 but before paragraph 1.30, we suggest that the following paragraphs be added:

> **Control of corporations through partnerships**
>
> 1.29A Where a partnership owns a majority of the voting shares of a corporation or otherwise has *de jure* control of a corporation, the issue may arise as to whether the partnership is related to the corporation. If that issue arises in a context in which

subsection 96(1) applies or has relevance, then the partnership is treated as if it were a separate person resident in Canada that owns those shares or that has *de jure* control of the corporation. For that purpose, the partnership and the corporation will be deemed to be related.

1.29B Where subsection 96(1) does not apply or have any relevance, then one or more of the partners of the partnership may control and therefore be related to the corporation. This will depend on the terms of the partnership agreement and any other rights and obligations that govern which of the partners have the right to vote the shares or exercise *de jure* control over the corporation. Usually, in a limited partnership, it is the general partner that has the right to vote the shares owned by the limited partnership; in that situation the general partner would control and therefore be related to the corporation. If there is more than one general partner and they form a related group, then the rules set out above for groups will apply as between that group and the corporation (see paragraphs 1.17 and 1.20 of the Folio).

2) In the second part of the Folio, after paragraph 1.38 but before paragraph 1.39, we suggest that the following paragraph be added:

1.38A While the courts have articulated these three tests, they constitute essentially just one test that may be summarized as follows: is there control of one party by the other? What the three tests are intended to determine is the existence of a relationship between persons who are parties to a given transaction where one of the parties exercises over the other an influence such that this other party is no longer free to participate in the transaction in an independent manner[1].

3) Paragraph 1.39 currently states:

1.39 The courts have held that when one person (or a group of persons) is, in fact, the bargaining agent, or the mind by which the bargaining is directed, on behalf of both (or all) parties to a transaction, then the parties cannot be dealing at arm's length. **The courts have expanded this principle to include the concept of acting in concert with respect to an element of common interest. Therefore, even when there are two distinct parties (or minds) to a transaction, but these parties act in a highly interdependent manner (in respect of a transaction of mutual interest), then it can be assumed that the parties are acting in concert and therefore are not dealing with each other at arm's length**. *When a common purpose exists, a transaction is not necessarily anon-arm's-length one when different interests (or independent parties) are also*

[1] As authority for this suggestion, see *Gestion Yvan Drouin Inc. v. The Queen*, 2001 DTC 72 (TCC) at paragraph 74.

> *present*. In this context, different interests are considered to exist when each party has an independent interest from the other parties to a transaction, notwithstanding the fact that each party may have the same purpose, such as economic gain. [emphasis added]

4) We suggest that the bold-faced sentences are incorrect or at least mis-leading. Furthermore, they are contradicted by the sentence in italics. The bold-faced sentences suggest that two parties with differing minds will be acting at non-arm's length with each other merely because they act in an interdependent manner to effect a transaction of mutual interest. But the second sentence says that this factor will not result in the parties dealing at non-arm's length with each other. Those sentences cannot both be correct.

5) In *The Queen v. McLarty*[2] the Court held that even when two parties enter into a tax-driven deal, they will be dealing at arm's length if they look after their separate interests and are not under each other's influence[3]. This principle had already been adopted in the earlier case of *Lenester Sales Ltd. and Sushi Sales Ltd v. The Queen*[4] where the TCC said:

> To say that every time two independent business persons in pursuit of [their] own business interests work together to achieve a mutual beneficial commercial objective means that they are "acting in concert" and are, therefore, not at arm's length would mean that no business relationships would ever be at arm's length.[5]

6) The same thought was expressed in *H.T. Hoy Holdings Ltd.* v. *The Queen*[6], where the Court said: "The existence of a common goal should not be equated with having a common interest."

---

2 2008 DTC 6354 (SCC) at paragraph 63, aff'ing 2005 DTC 217 (TCC) at paragraphs 57-60 and rev'ing 2006 DTC 6340 (FCA).

3 See also *The Queen v. Remai Estate*, 2009 DTC 5188 (FCA) at paragraphs 31-49. In that case an uncle and his nephew, who were obviously close family relations(although not "related" as defined in section 251, were found to be dealing with each other at arm's length in the context of a tax-driven transaction designed to achieve a charitable tax credit for the uncle, even though the nephew worked for the uncle. This is a very strong example of two parties found to be dealing at arm's length with each other even where they wanted to achieve the same tax outcome.

4 2003 DTC 997 (TCC), aff'd 2004 DTC 6461 (FCA).

5 Note that this case and *McCoy* were decided after *RMM* and therefore, presumably, state the current view of the law.

6 97 DTC 1180 (TCC) at 1182.

7) One case has suggested that two persons may be dealing with each other at arm's length as far as the *terms* of their commercial arrangement goes, but then not deal with each other at arm's length as far as the *implementation* of that commercial arrangement goes. See *RMM Canadian Enterprises Inc. and Equilease Corporation v. The Queen*[7]:

> What, then, is the situation here? We have a corporation that uses another corporation to participate in what is essentially a plan to achieve a particular fiscal result. Does the very act of participation make the relationship non-arm's length? Admittedly there was clearly arm's length bargaining about the return that RMM would realize on the transaction. During those negotiations there was no element of control between EC and RMM, and RMM was separately advised. At that stage EC and RMM were at arm's length. However, once the deal was settled, and as it evolved through the sale, the payment of the funds, the premature payment of the guaranteed amount, the endorsement of the refund cheques by RMM to EC and the virtual disappearance of RMM from the scene once it had served its purpose, it became clear RMM had no independent role. If one adopts the "common mind" theory of non-arm's-length relationships it is perfectly clear that only one mind was involved, that which was the controlling mind of EC. The same result is achieved if one applies the "acting in concert" theory. RMM and EC were in my view not at arm's length in carrying out the transaction, including the sale. Accordingly section 212.1 applies in any event. It must be borne in mind that in Canada the focus is on the relationship between persons. The concept seems to be somewhat different in the United States, where the focus is on whether the transaction is at arm's length, that is to say whether the transaction is one that arm's length persons would enter into.

8) However, this passage has been criticized[8], first, for being contrary to the decision in *McNichol v. The Queen*[9], and second, for applying the arm's length test to the end of the transaction rather than to its beginning.

9) In *R. Daren Baxter v. Her Majesty the Queen*[10] the TCC said:

> [51] On the basis of the foregoing, I have concluded, regarding the Cundil decision, supra, that there being no common mind dictating the terms of the bargain on both sides of the transaction, the parties were not acting in concert. The element of de facto control mentioned in that case is irrelevant here. The

---

7 97 DTC 302 (TCC) at 311,

8 See *Stack*, "Arm's Length as a Question of Fact", 97 CR 16:1 at p.16:12.

9 97 DTC 111 (TCC), which was followed in *McMullen v. The Queen*, 2007 DTC 286 (TCC) at paragraph 28 and *Brouillette v. The Queen*, 2005 DTC 1004 (TCC) at paragraph 48.

10 2006 DTC 2642 (TCC), rev'd on another point 2007 DTC 5199 (FCA).

> fact that the parties considered that they had entered into a mutually beneficial relationship when, at the same time, they were pursuing their own individual interests and were free, without either of them being controlled by the other, to enter or not enter into that relationship means they were dealing with each other at arm's length as a matter of fact.

10) Other cases make the same point. See *McCoy v. The Queen*[11] where the Court said:

> To say that the parties acted in concert is not meaningful in this context. All it means is that both parties wanted to get the deal done. If that is the sort of "acting in concert" that results in parties to a transaction not dealing at arm's length then no business transaction between independent persons would ever be at arm's length.

11) See similarly *Swiss Bank Corporation v. Minister of National Revenue*[12]:

> To this I would add that where several parties--whether natural persons or corporations or a combination of the two--act in concert, and in the same interest, to direct or dictate the conduct of another, in my opinion the "mind" that directs may be that of the combination as a whole acting in concert or that of any of them in carrying out particular parts or functions of what the common object involves. Moreover as I see it no distinction is to be made for this purpose between persons who act for themselves in exercising control over another and those who, however numerous, act through a representative. On the other hand if one of several parties involved in a transaction acts in or represents a different interest from the others the fact that the common purpose may be to so direct the acts of another as to achieve a particular result will not by itself serve to disqualify the transaction as one between parties dealing at arm's length. The Sheldon's Engineering case [supra], as I see it, is an instance of this.

12) On balance, while there is some very limited authority for saying that agreeing to implement a particular transaction in a particular way is sufficient to make the parties deal with each other at non-arm's length, the clear weight of authority is that that is not enough: one party must be under the control of or act at the direction of or have no separate interests from the other party. Therefore, we suggest that paragraph 1.39 be re-written as follows:

---

[11] 2003 DTC 660 at paragraph 70, additional reasons at 2003 DTC 1559 (TCC).

[12] 71 DTC 5235 (Ex. Ct.) at 5241, aff'd 72 DTC 6470 (SCC). The SCC based its decision on the fact that the parties had "no separate interests".

> 1.39 The courts have held that when one person (or a group of persons) is, in fact, the bargaining agent, or the mind by which the bargaining is directed, on behalf of both (or all) parties to a transaction, then the parties are not dealing with each other at arm's length. The "common mind" can apply to the terms of a transaction, or the manner of its implementation, or both. However, two parties will not be viewed as dealing with each other at non-arm's length merely because they desire to achieve a common goal, such as economic gain, or to implement a transaction of mutual interest, or to implement a transaction in a common way. The facts must show that one party was under the control of the other in the sense that the other person directed the bargaining for both parties and that they did not have independent interests in respect of either the terms of the transaction or the manner in which it was implemented.

13) Under "Partnerships", starting at paragraph 1.42, we suggest that the following paragraph be added immediately after paragraph 1.44 and before paragraph 1.45:

> 1.44A Where it is necessary to determine if a person who is not a partner and a partnership are dealing at arm's length, the determination is to be made at the partnership and not the partner level. The issue of arm's length is a question to be decided on the basis of the relationship of the directing minds of the person and the partnership at the relevant time[13].

We trust that you will find our comments helpful and would be pleased to discuss them with you at your convenience should you so desire.

Yours very truly,

Janice Russell
Chair, Taxation Committee
Chartered Professional Accountants of Canada

Mitchell Sherman
Chair, Taxation Section
Canadian Bar Association

Cc:

- Mickey Sarazin, Director General, Canada Revenue Agency
- Gabe Hayos, Vice President, Taxation , CPA Canada

[13] See *Peter Brown v. The Queen*, 2003 DTC 5298 (FCA) at paragraph 23.