

In our view this report is just a first step, albeit a major one. There will be further study and the big question in our minds is whether this will emerge as a major election issue in 2019 with costs, not principles, being the issue in debate.

## Margin Trading, Short Selling and My Client-Broker Agreement: What You See is Not What You Get

David Sohmer

I recently had occasion to read the "Client Account Agreements" which I had entered into when I opened an account with my stock broker several years ago. The following provision caught my eye:

You acknowledge that securities held in your margin account that are not fully paid or are not excess margin securities may, to the extent permitted by applicable law, be loaned to us or loaned to others and we have no obligation to retain under our possession and control a like amount of securities.

The provision led me on a fascinating odyssey. I started with the description of short sale transactions in the Federal Court of Appeal decision in *Hayes v. R.*<sup>1</sup>

A short sale of shares is a sale of shares that the seller does not own. The shares are said to be "borrowed". That means that the sale is facilitated by entering into an agreement with a broker who will permit the sale of shares belonging to another person (who may be the broker or a customer of the broker).

I had never understood the legal principles underlying short selling transactions, and found the answer in the Prefatory Notes to Revised Article 8 of the United States Uniform Commercial Code (about which more later):

Perhaps the best way to understand securities lending is to note that the word "loan" in securities lending transactions is used in the sense it carries in loans of money, as distinguished from loans of specific identifiable chattels. Someone who lends money does not retain any property interest in the money that is handed over to the borrower. To use civil law terminology, securities lending is *mutuum* rather than *commodatum*.

In order to facilitate short selling transactions, the *Income Tax Act* overrides the legal principles otherwise applicable

to the lender and the broker's account statements reflect the tax fiction.

In the case of a short sale arrangement to which section 260 of the Act applies, the lender is deemed not to have disposed of the shares for purposes of the Act pursuant to subsection 260(2). The borrower, however, is considered to have acquired the shares and the consideration paid to the lender is the obligation of the borrower to deliver identical shares to the lender at some time in the future. While a question of fact, it is arguable that the value of this consideration is equal to the fair market value at the time the shares are acquired.<sup>2</sup>

The statutory creation of phantom shares is not surprising in a statute which contains numerous "deeming" provisions. What may be a surprise to investors is that they own security entitlements rather than shares. Security entitlements were invented by the drafters of Revised UCC Article 8, which has been adopted in securities transfer legislation by each of the Canadian provinces.<sup>3</sup> The Official Comment to UCC 8-501 describes a security entitlement as follows:

1. Part 5 rules apply to security entitlements, and Section 8-501(b) provides that a person has a security entitlement when a financial asset has been credited to a "securities account". . . . A securities account is a consensual arrangement in which the intermediary undertakes to treat the customer as entitled to exercise the rights that comprise the financial asset.
4. Persons who hold securities through brokers or custodians have security entitlements that are governed by Part 5, rather than being treated as the direct holders of securities.
5. Securities in the Article 8 sense, are fungible interests or obligations which are intended to be tradable. The concept of security entitlement under Part 5 is quite different. A security entitlement is the package of rights that a person has against the person's own intermediary with respect to the positions carried in the person's securities account. That package of rights is not, as such, something that is traded. When a customer sells a security that she had held through a securities account, her security entitlement is terminated; when she buys a security that she will hold through her securities account, she acquires a security entitlement.

<sup>2</sup> CRA Views 2010-0364991E5, Transaction in securities, November 1, 2010.

<sup>3</sup> The security entitlement system is intended to provide a legal framework for the indirect holding system whereby the direct holder of publicly-traded stock is a central securities depository and trades are effected by entries in the book accounts of financial intermediaries. The central depository in Canada is the Canadian Depository for Securities Limited and in the U.S. it is The Depository Trust Company. The central depository credits shares by book entry to the accounts of its broker/dealer shareholders and they in turn credit the accounts of other financial intermediaries and so on down the chain until the account of the investor is credited.

<sup>1</sup> 2005 FCA 227, [2005] 3 C.T.C. 241 at para. 4.

In a paper entitled "Attributes of Ownership", the authors describe the concept of a security entitlement as follows:

Thus the person purchasing 100 shares of Microsoft purchases a securities entitlement, not the stock itself. Securities entitlements are an invention of the Article 8 drafters and do not conform to common law contract or property systems. Instead the meaning of the term is "to be found less in any specific definition than in the matrix of rules that use the term. . . The most important component of that matrix of rules is the set of five duties Article 8 imposes on a securities intermediary with respect to entitlement holders."<sup>4</sup>

The provisions of the *Income Tax Act* implicitly assume that transactions in securities are governed by common and civil law contract and property principles. Furthermore the Supreme Court of Canada has held that the economic realities of a situation cannot be used to recharacterize a taxpayer's *bona fide* legal relationships, absent a finding of sham.<sup>5</sup> Whether or not the courts can stretch the language of the Act to accommodate the security entitlement system remains to be seen.<sup>6</sup> It is likely that the Act will eventually be amended with retroactive effect to deem a security entitlement with respect to a share to be a share.

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<sup>4</sup> Reid Thompson & David A. Weisbach, *Attributes of Ownership*, (Coase-Sander Institute For Law & Economics, Working Paper No. 621, 2012 at pg. 32).

<sup>5</sup> *Shell Canada v. R.*, [1999] 3 S.C.R. 622, [1999] 4 C.T.C. 313.

<sup>6</sup> For example: Is a security entitlement with respect to a share of a non-resident corporation specified foreign property which must be reported on a T1135? Is the termination of a security entitlement a disposition (it is not a share nor a right to receive an amount)? The waters become even more muddy when dealing with jurisdictions where the securities entitlement model does not apply. For an excellent review of the non-tax issues see "Cross-border issues of securities: European efforts to support securities markets with a coherent legal framework" published by the Directorate-General For Internal Policies of the European Parliament: Dated May 2011.

## CRA Reports on Real Estate Audit Activity

The CRA has issued a report<sup>1</sup> which deals with its efforts to stem tax abuses related to the real estate markets in

<sup>1</sup> <https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/compliance/does-canada-revenue-agency-address-non-compliance-real-estate-sector.html>.

Vancouver and Toronto which is of course part of an overall multi-jurisdictional attempt to cool housing prices.

The Agency uses a combination of advanced risk-assessment tools, analytics, leads, and third-party data to detect and address non-compliance. The CRA audits the files of taxpayers that it identifies as being high risk.

The real estate sector is one of many sectors that the CRA addresses through its risk-based method. Audits related to real estate occur regularly across the country, including in regions of Canada where economic factors may increase the risk of non-compliance. In 2015 for instance, the CRA doubled its level of effort focused on the real estate sector in British Columbia. The CRA has also started a review of 500 high dollar value real estate transactions in British Columbia in 2015 to uncover any tax issues that may not have already been identified.

There are five main areas of concern:

- questionable source of funds
- property flipping
- unreported goods and services tax/harmonized sales tax (GST/HST) on the sale of a new or substantially-renovated property / GST/HST new housing rebate
- unreported capital gains
- unreported worldwide income

The paper goes on to "explain" each of these areas of concern:

The source of funds used to buy or maintain Canadian properties could be an unreported source that was never taxed, either in Canada or another country. In certain circumstances, a large down payment on a home, or a property that is expensive to maintain, may indicate any of the following:

- Unreported income, if the lifestyle of the buyer is not compatible with the income reported;
- Tax evasion;
- Purchase of real estate by a low-income person hiding a wealthy buyer.

The CRA can establish correlations between a taxpayer's reported income and their lifestyle. The acquisition of expensive assets, such as a high-end home, without an obvious income source, can be an indicator of potential unreported income earned from legal or illegal sources.

People, including real estate agents, who buy and resell homes in a short period for a profit are engaged in property flipping.

The CRA acquires and analyzes third-party data and has found that some flips are not being reported or are being reported incorrectly. The profits from flipping real estate are generally considered to be fully taxable as business income. The facts of each case determine whether such profits should be reported as business income or as a capital gain.

Generally, the builder of a new or substantially-renovated home must charge and collect GST/HST when the home is sold and report that tax to the CRA. The CRA uses various analytical techniques to identify builders who are not complying.

The sale of a property for an amount greater than its cost generally leads to a capital gain. In most cases, capital gains are taxable and must be reported to the CRA. Whether the capital gain is taxable or not can vary depending on whether the property is a principal residence, or whether the seller of the property is a resident or non-resident of Canada.

Residents of Canada have to report their **worldwide** income to the CRA. Non-residents only have to report their **Canadian-source** income, unless a tax treaty provides otherwise. An individual's residency status is therefore essential in determining what income must be reported.

What we found of particular interest is the audit results as reported by the CRA.

The CRA continuously evaluates risk as it relates to non-compliance. Resources are dedicated accordingly, and they can shift in relation to risks that develop.

Results of audit activities related to real estate in Ontario from April 2015 to December 2017		
Programs	Number of files completed	Audit assessments
Income tax	2,520	\$37.7 million
GST/HST	1,218	\$81.3 million
GST/HST New Housing and New Residential Rental Property Rebates	19,577	\$258.7 million
<b>Total</b>	<b>23,295</b>	<b>\$377.7 million</b>
Results of audit activities related to real estate in British Columbia from April 2015 to December 2017		
Programs	Number of files completed	Audit assessments
Income tax	665	\$63.7 million
GST	880	\$62.3 million
GST New Housing and New Residential Rental Property Rebates	3,406	\$14.0 million
<b>Total</b>	<b>4,951</b>	<b>\$140.0 million</b>

The CRA will apply a penalty equal to 50% of the additional tax payable if a taxpayer knowingly makes a false statement

when filing a return. During the period of April 2015 to December 2017, the CRA applied 1,254 penalties, totaling \$38.6 million. The highest penalty was almost \$2.5 million.

In a related development, British Columbia's government is cracking down on tax evasion in the condominium market and is giving municipalities more control over rental housing as it looks for ways to ease the housing crunch.

Finance Minister Carole James said legislation introduced on April 24 would require developers to collect and report buyer information on the purchase and sale of condos before they are built to ensure the proper amount of tax is paid.

The prices of so-called presale condominiums are inflated by people who buy and sell the properties without ever living in them or paying capital gains tax, she said.

"This is a key step to stopping people from using presale condos as a quick, lucrative investment," James said. "It's also to stop them from driving prices up for British Columbians trying to get into the housing market."

She said the government will share the presale data it collects with the Canada Revenue Agency to monitor taxes.

## PBO Costs a Federal Guaranteed Income Program

The Parliamentary Budget Office at the request of Tory Finance Critic Pierre Poilievre prepared a cost estimate of establishing a guaranteed annual income (GAI) program at the national level.<sup>1</sup>

The following is an edited excerpt of the Executive Summary. Insofar as we are aware a national GAI is not part of the Liberal government's platform.

As a first step in addressing this question, PBO provided a baseline of the actual federal support for low-income Canadians and vulnerable groups in a previous report released on 21 November 2017. In this report, PBO takes the policy parameters of Ontario's basic income pilot project and applies them across the country to estimate the cost of a guaranteed basic income (GBI).

<sup>1</sup> [http://www.pbo-dpb.gc.ca/web/default/files/Documents/Reports/2018/Basic%20Income/Basic\\_Income\\_Costing\\_EN\\_Final.pdf](http://www.pbo-dpb.gc.ca/web/default/files/Documents/Reports/2018/Basic%20Income/Basic_Income_Costing_EN_Final.pdf).

The Ontario Government announced in its 2016 budget that it would test a basic income program. In April 2017, it launched a three-year pilot project in Hamilton, Brantford, Brant County, Lindsay and Thunder Bay and the surrounding area. Recipients started to receive monthly deposits in November 2017.

According to the Ontario Basic Income Pilot, participants must be aged 18 to 64, living on low income. Payments are based on 75 per cent of Statistics Canada's low-income measure (LIM). Single individuals will receive \$16,989 less 50 per cent of any earned income; couples will receive \$24,027 less 50 per cent of any combined earned income.

People with a disability will receive an additional \$500 per month (or \$6,000 per year). The payments replace Ontario Works and the Ontario Disability Support Program. The Canada Child Benefits (CCB) and the Ontario Child Benefit (OCB) will be maintained as guaranteed security incomes for children.

Overall, as shown in Summary Table 1, the annual gross cost of expanding the Ontario Basic Income Pilot across the country would amount to an estimated \$76.0 billion in 2018-2019. By 2022-2023, it would reach nearly \$79.5 billion.

#### Summary Table 1 – Gross cost of a Guaranteed Basic Income (\$ millions)

	2018-19	2019-20	2020-21	2021-22	2022-23
Basic cost	72,822	73,496	74,172	75,039	75,992
Supplement cost for disability	3,194	3,265	3,336	3,405	3,471
Total GBI cost	76,017	76,761	77,508	78,444	79,463

Based on our previous report on the federal support for low-income individuals and groups, PBO identified \$32.9 billion as federal support for the category of people defined by our benchmark model.

If this amount were deducted from the total estimated GBI cost of \$76.0 billion in 2018-2019, the net cost of a federally implemented GBI would be \$43.1 billion.

However, the GBI could take the form of a combined federal-provincial basic income system managed by an intergovernmental fiscal arrangement. This would replace some provincial transfers for low-income individuals and families, including many non-refundable and refundable tax credits, thereby reducing its net cost.

Furthermore, GBI costs may appear large at the aggregate level. However, the following table shows that more than 7.5 million people would benefit from the basic cost of GBI. Thus, on a per capita basis, the annual cost would range between \$9,421 and \$10,169 for the period 2018-2023.

#### Summary Table 2—Cost of a Guaranteed Basic Income per capita

	2018-19	2019-20	2020-21	2021-22	2022-23
Basic cost of GBI (\$ millions)	72,822	73,496	74,172	75,039	75,992
Number of potential recipients (000)	7,730	7,657	7,587	7,528	7,473
Basic cost per capita (\$)	9,421	9,598	9,776	9,968	10,169

These estimates represent pre-behavioral (static) costs. We do not take behavioral reactions to the GBI into consideration. For example, some studies show that a guaranteed minimum income could have a negative impact on labour force participation and hours worked.

Thus, individuals who decide to cut working hours in response to the GBI would find that their earned income declines, while their GBI rises. Also, the decline in hours worked would result in less income tax revenue for the federal and provincial governments.

Take it for what it is worth. . . and if you are truly interested, read the full report on the website of the Parliamentary Budget Office.

**Ontario:** As most readers are likely aware, Ontario has been running a pilot project to test the concept of a guaranteed annual income.

Doug Ford's Progressive Conservatives support Ontario's basic income pilot project, a three-year experiment to determine whether regular, no-strings-attached payments improve health, education and housing outcomes for people living in poverty.

"We look forward to seeing the results," a party spokesperson said about the Liberal government initiative launched a year ago.

After a slow start due to disbelief among many that it was too good to be true, the project has reached its goal of enrolling 6,000 participants between the ages of 18 and 65 in Hamilton-Brant, Thunder Bay and Lindsay.

#### Employer Provided Social Events

The Tax Executive Institute has regular meetings and exchanges with the CRA about myriad topics which primarily concern business taxation.



On December 5-6, 2017, a delegation of Canadian Income Tax Committee members assembled in Ottawa, Ontario, for TEI's annual liaison meetings with representatives of the Canada Revenue Agency and Department of Finance. The Canada Revenue Agency and Department of Finance have issued their responses to TEI's liaison meeting... questions, which cover a range of important tax law, policy, and administration issues.

In mid-April, the CRA and TEI published a series of questions and answers.

We found one non-technical but potentially important administrative change worth noting.

During the 2016 TEI-CRA liaison meetings, the CRA verbally agreed to recommend a 50-dollar increase to the allowable non-taxable limit for employer-provided social events (i.e., from \$100 to \$150).

The TEI in December 2017 asked whether this recommendation been made and approved. If so, when will the change be announced? Will the new limit be effective for 2017 taxation years?

## CRA RESPONSE

Beginning in 2018, the threshold for reporting employee benefits derived from employer sponsored social events will be increased to **\$150**. All other aspects of the current CRA administrative policy remain the same.

Obviously this change will be very much welcomed by both employers and employees. We don't know when and how the change will be publicized but readers who advise businesses and who are not involved with the TEI should make a note of this positive change in administrative policy.

## Form and Function

*Adam Aptowitz*

A recent decision of the Tax Court illustrates a concept whose importance is only matched by the universality to which it is ignored. The case of *Lichtman*<sup>1</sup> involved a number of Orthodox Rabbis teaching at an Orthodox Jewish school in Vancouver. The Rabbis claimed what is known as the "Clergy Residence Deduction" and ultimately lost their case. However, in a surprisingly lengthy decision the principle to take from this case is universal and

simple. Namely that legal documents should match the underlying factual relationships.

The Clergy Residence Deduction allows for a religiously ordained individual who is ministering to a congregation to deduct residence expenses from his or her income. Historically, this relates to the time when ministers had parsonages and were required to live near the congregation and often used their homes to aid in the ministering.

The Rabbis in question taught at an elementary school. In the context of their duties, these Rabbis provided counselling when necessary and conducted daily prayer services with the children in the school. From the perspective of these Rabbis, much of the work that they did was similar to the work that they would do with adults in any Orthodox Jewish congregation.

It would seem, notwithstanding a full 72-page decision, the most persuasive evidence was that the Rabbis' contracts referred to them as teachers, and that they had the same duties as other teachers. As previous decisions found that teachers do not minister to a congregation these Rabbis were caught. In fact, the contracts that they signed were contracts typical of other teachers as well, who would not necessarily qualify as Rabbis of Orthodox Jewish congregations, lending further credence to the view that they were not ministering to a congregation.

The context of the evidence reviewed in Justice Campbell's decision makes it clear that the contracts signed by the school and the teacher may not have been fully reflective of the activities undertaken by these individuals. It seems that the Rabbis in question, to their mind, were somewhere closer to Rabbis providing the typical services to a congregation, including the fact that Rabbis and other religious leaders often engage in teaching in the context of their ministering duties. The fact that the contracts referred to these individuals as teachers was, at least in their minds if not the judge's, an irrelevant factor.

The lesson to be drawn from this decision is one that can be applied to all areas of law. Legal documents describing relationships or stating a particular matter (such as board minutes) must be accurate and fulsome in their explanation of the situation. It can be tremendously harmful to rely on precedent documents or vague statements. Tax, in particular, applies the law to the situations as described in the documents between the various parties. In this case, the tax authority and the courts applied the law based on the documents provided and the evidence, such as it was,

<sup>1</sup> *Lichtman v. R.*, 2017 TCC 252, 2017 CarswellNat 7304.