TCC ruling stresses 'reasonable' agreements

By DONALEE MOULTON

Settlement agreements are not etched in stone even when the signatories are a taxpayer and the Canada Revenue Agency, the Tax Court of Canada clarified in a recent ruling that ordered the CRA to reassess the taxpayer under the terms of the settlement as interpreted by the court.

"The decision reinforces a taxpayer's right to have a settlement result in a reassessment that makes sense," said Larry Nevsky, an associate with Dentons law firm in Toronto.

Settlement agreements often are considered to be out-of-court contracts and the belief is that anything goes as long as the parties agree. The TCC's decision confirms otherwise, noted Peter Baek, a tax partner with the Toronto law firm Fogler, Rubinoff and co-counsel for the appellant. "The decision says if you want an enforceable agreement, it has to be in accordance with the law. Here the government admitted it couldn't win if the case went to court."

In *Bolton Steel Tube Co. v. Canada* [2014] T.C.J. No. 74, the CRA in 2007 reassessed the pipe manufacturing company for the four taxation years from 1994 to 1997, determining it had failed to report income in each of these years. For the 1996 taxation year, the CRA determined the company's income should be increased by $602,998, bringing its reported revenue for that year to $1.863 million.

Bolton appealed and during examinations for discovery, the CRA acknowledged its original reassessment was incorrect and the 1996 income increase was $403,219. The company made an offer to settle based on that amount.

"The CRA without having any prior discussion just accepted it based on what we later discovered was a mistaken belief," said Ross MacDougall, also with Fogler, Rubinoff and co-counsel for the appellant.

That belief translated into an additional $403,219 being added to the $1.863 million the CRA had originally assessed Bolton Steel as earning in 1996, bringing the total amount under consideration to more than $2.2 million. The calculation was not acceptable to the tax court, which vacated the CRA's original reassessment for the year in question and returned the issue to the minister of national revenue for reconsideration.

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"There is no factual or legal basis to support the Respondent's contention that the Appellant's income for the 1996 taxation year could be $2,266,291," Justice Diane Campbell wrote in her 16-page decision. "The Respondent's argument that: 'the Appellant offered more, so we accepted it' is without merit and it is precisely that which the Minister is precluded from doing in settling tax disputes."

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Justice Campbell's decision clarifies the grounds under which a settlement agreement will be varied: the terms must be reasonable. This foundation holds even when the tax agreement itself appears open to interpretation.

"The judge found in favour of the taxpayer even though the language was ambiguous. The facts point clearly in one direction," said MacDougall. "The key is the settlement has to be reasonable. What a person believes an agreement means is actually irrelevant."

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The decision has important implications for tax professionals working on settlement agreements on behalf of their clients. First, there is the issue of clarity. "The decision reinforces the importance that a taxpayer needs to ensure the settlement language is precise and unambiguous," noted Nevsky.

Although the agency would not speak about the case "by virtue of the confidentiality provisions of the *Income Tax Act*," CRA spokesperson Philippe Brideau in Ottawa told *The Bottom Line*, "The implication of the decision is that all parties will be required to verify each other's understanding of the specific results of a proposed settlement agreement before being finalized."

The motion before the court, he added, "arose from a misunderstanding between the parties about the terms of a settlement agreement that had been reached earlier in respect of tax reassessments."

MacDougall believes hectic work schedules within the federal government may be to blame, at least in part. "My experience is that Department of Justice lawyers have heavy caseloads. In this case, there was clearly a disconnect between how their side internally interpreted the settlement with the facts of the case. It may be a lesson they have to be careful with these settlement agreements as well. They need to be carefully considered."

Communication and confirmation would have solved the issue and saved a trip to court, he noted. "Had they explained their reasoning, then the agreement wouldn't have been accepted."

That reasoning, the Tax Court of Canada makes clear, must always be compliant with tax and other law. "This case reinforces the fact that the result has to be something that could be reached if the law was applied," noted Baek.

Accountants, lawyers, and taxpayers may change their approach to settlement agreements as a result and prepare a formal statement or recital, he said. "You might want to put information into a recital to ensure it is in accordance with the law and to spell out the context. I can see that happening."

Interpreting a contract

In a recent decision from the Tax Court of Canada regarding a CRA settlement agreement, Justice Diane Campbell turned to an earlier decision from the Ontario Court of Appeal to clarify and reaffirm how contracts, including settlement agreements, should be interpreted in this country. According to *3869130 Canada Inc. (c.o.b. I.C.B. Distribution 2001) v I.C.B. Distribution Inc*. [2008] O.J. No. 1947, four rules must be followed:

- The contract must be interpreted as a whole in a manner that gives meaning to all of its terms and avoids an interpretation that would render one or more of the conditions ineffective.
- The intention of the parties must be determined in accordance with the language they have used and based upon the "cardinal presumption" that they have actually intended what they have said.
- The facts must be relied upon to reach a conclusion, without reference to the subjective intention of the parties, to the extent there is any ambiguity in the contract.
- Sound commercial principles and a good business sense have to be used. A commercial absurdity must be avoided.

FASB nears the U.S. GAAP-based finish line

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The IASB worked closely with the FASB throughout the development of IFRS 9, says the standard's background material, but "although every effort has been made to come to a converged solution, ultimately these efforts have been unsuccessful."

The lack of convergence troubles Mezon, who said it will have a detrimental impact on some of Canada's banks.

"The Toronto-Dominion Bank and the Bank of Montreal, for example, have large retail operations in the U.S.," she said. "They will have to compute their loan-loss provisions for their U.S. subsidiaries under two methods — one for U.S. GAAP for regulatory reporting requirements in the U.S., and one under IFRS for their consolidated reporting. That's a problem from an operational perspective and there is a cost to those banks."

Mezon said Canada is fortunate to have a robust banking system and that financial institutions were able to work through the credit crisis without any bailouts. "What they're concerned about now is the same as with any other IFRS. When is the rest of the world going to adopt IFRS 9? Are they going to have to adopt it before anybody else? What's it going to mean? They are going to have to get their arms around the standard and figure out how to implement it. The proof will be in the implementation details."

Meanwhile, the FASB is completing its proposed "current expected credit loss" model, explained spokesman John Pappas, "which would require companies to reflect on day one when they put a loan on the balance sheet any losses they expect to incur over the lifetime of the loan, even if the loan is fully performing." The FASB plans to issue a final standard by the end of 2014.

Pappas noted the FASB also is completing its approach to classification and measurement of financial instruments, "which will include improvements to existing U.S. GAAP. That standard also is expected to be issued at the end of the year."

Hoogervorst said in a July 31 speech at the Singapore Accountancy Convention that "it's a pity the FASB decided to stick to current American practices [on this standard] and leave the converged position. Convergence would have allowed the U.S. to make the ultimate jump to IFRS. But nobody can force it to do so; if it wants to stick with U.S. GAAP, that's its choice. But IFRS moves on — we have a large part of the world to take care of."

A spokesperson for the Canadian Bankers Association said the CBA had not yet had a chance to consult with members on the standard, and would not be able to provide comment at this time.