Tax Topics®

June 12, 2014
Number 2205

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Wolters Kluwer CCH

CONNECTING LEGAL FEES TO BUSINESS INCOME — CHANGE OR *STATUS QUO* FOR DEDUCTIONS?

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It is perhaps not surprising that we are still dealing with cases on the boundaries between deductible and non-deductible expenses, particularly when we are dealing with something like legal fees being sought as deductions against income. After all, it can be an important characterization to make when the deduction has the essential effect of shifting at least some of the burden of legal expenses from the litigant to the rest of us as taxpayers. But what is a bit surprising is how the courts have found ways to define the boundary. Two recent decisions of the Tax Court of Canada provide consistent and relatively clear guidance on the issue.

Both *Ironside v. Canada*, [2013] T.C.J. No. 298, 2014 DTC 1002 (TCC), and *Gouveia v. Canada*, [2013] T.C.J. No. 353, 2014 DTC 1035 (TCC), involve taxpayers who faced securities-related prosecutions arising from positions as directors and officers of companies. Both had left their respective employments and were, in the years in which deductions of legal fees were claimed, engaged in "new" businesses — Ironside as a chartered accountant and Gouveia as a consultant. Both argued that the expenses they incurred to defend themselves from the charges against them were necessary business expenses because they were incurred to protect against the risk the business might be shut down (in Ironside's case, if he lost his registration as a chartered accountant) or at least would lose revenue through damage to reputation if convicted (in both cases).

The basic test for deduction of legal fees, at least in the general cases not relying on one of the *Income Tax Act*'s (the "Act's") several provisions for specific deduction, is that the legal fees incurred in respect of a particular business or property must fit within the general rules that follow from subsection 9(1) of the Act and be part of the determination of "profit from that business or property for the year". Further, consistent with all other such business expenses, legal fees are subject to the restrictions of subsection 18(1) of the Act, and must have been incurred for the purpose of gaining or producing income from that business or property and not be on account of capital. Those tests, as the Supreme Court noted in *Symes v. The Queen*, [1993] S.C.J. No. 131, 94 DTC 6001, have really not been improved upon or added to by decades of judicial interpretation. On that basis, one might have thought the results in the two recent cases would be quite simple to predict — simply answer the question "Were the legal expenses by Ironside/Gouveia incurred for the purpose of earning income from a business or property?"

That would be premature, however, because the Supreme Court went on to describe several distinct factors to be considered by the Court to assist in applying the general principle to what would undoubtedly be a broad spectrum of facts.

First, would similar businesses "normally" incur a similar expense? This implies, if not explicitly requires, an "objective" analysis of all of the circumstances, rather than accepting the evidence of the taxpayer as to the purpose that was intended. But despite apparent simplicity, this factor raises other questions, such as "Who or what is 'similar'?" and "What is 'normal'?" In any event, the result based on this case might be expected to go in favour of the taxpayers, since one would expect that other accountants, in the case of *Ironside*, would normally be willing to pay legal fees to defend against an action that had every likelihood of costing them their registration and therefore their livelihood. That would also be premature.

The second factor also likely supports the taxpayers in these two cases — whether the deduction is ordinarily allowed as a business expense by accountants. That is a fascinating nod to the accounting profession's collective wisdom in these matters, but more importantly, it seems somewhat circular since presumably accountants would ordinarily allow expenses that were incurred for the qualifying purpose. But regardless, applied to *Ironside* and *Gouveia*, one might have thought that the expenses were incurred to protect the current income stream, and hence, would be allowed as business expenses. Again, that would be premature.

The final factor the Supreme Court included was whether an expense would have been incurred even if the person was not carrying on the business against which it was deducted, or in other words "Would the need exist apart from the business?", a so-called "but for" test. That is much more difficult to apply where, as in these cases, there is clearly more than one reason for the expense; there are personal considerations, wealth preservation considerations, and yes, income considerations. No doubt all three came into play for both Ironside and Gouveia. The question, one supposes, is whether or not having more than one purpose takes one outside of "incurred for the purpose of gaining or producing income from a business or property".

To answer that question, the Tax Court has refined the discussion somewhat, and identifies and discusses a "connectivity" test — is the expense actually (and sufficiently) "connected" to the income it is supposedly intended to earn? And this is the relatively new and nuanced approach that is important; the Court went on essentially to hold that where the expense arose from conduct that was not itself related to the business from which the income was to be earned, the required connection did not exist. Because Ironside had to pay lawyers to defend him in respect of conduct in his former corporate life and not his accounting practice, he could not deduct those legal expenses against his current accounting income.

There is a certain harsh logic to this approach, but in the case of legal fees in particular, one might ask whether this is unduly restrictive. More to the point, one might ask from what part of either determining business income for purposes of subsection 9(1) or the restriction in paragraph 18(1)(*a*) that those expenses be "incurred for the purpose of gaining or producing income from a business or property" the restriction or requirement for connectivity arises? Regardless of such musings (and subject to the decision of the Federal Court of Appeal in *Gouveia*, appeal filed on January 13, 2014), as a result of these two decisions, the test has become somewhat more precise, and we have a better understanding of where the line may be drawn.

Finally, it seems difficult to envision planning around this requirement, as legal fees are typically incurred in "real time" and, for the most part, one can expect the sorts of defence costs raised by Ironside or Gouveia to be incurred sometime after the situation that gave rise to the need to incur them has passed. In advising clients with respect to deductibility, care should be taken in light of these cases.

A number of tax lawyers from Dentons Canada LLP write commentary for CCH's Canadian Tax Reporter *and sit on its Editorial Board as well as on the Editorial Board for CCH's Canadian* Income Tax Act with Regulations, Annotated. *Dentons Canada lawyers also write the commentary for CCH's* Federal Tax Practice *reporter and the summaries for CCH's* Window on Canadian Tax. *Dentons Canada lawyers wrote the commentary for* Canada–U.S. Tax Treaty: A Practical Interpretation *and have authored other books published by CCH:* Canadian Transfer Pricing *(2nd Edition, 2011);* Federal Tax Practice; Charities, Non-Profits, and Philanthropy Under the Income Tax Act; *and* Corporation Capital Tax in Canada. *Tony Schweitzer, a Tax Partner with the Toronto office of Denton's Canada LLP and a member of the Editorial Board of CCH's* Canadian Tax Reporter*, is the editor of the firm's regular monthly feature articles appearing in* Tax Topics.

QUEBEC BUDGET

On June 4, 2014, the Government of Quebec tabled its post-election 2014 Budget. While the Budget contained no changes to personal tax rates, it did propose several new measures, including an amendment such that retirement income splitting for the 2014 taxation year would only be allowed between spouses where the person whose retirement income was being split was 65 or older before the end of the taxation year. In addition to proposing a loan program to help assist seniors with the payment of property taxes, the Budget also proposed the following changes to personal tax credits and subsidies:

- seniors over the age of 70 with annual incomes under $40,000 will be eligible for a new refundable tax credit of up to $40, where amounts are paid after June 4, 2014 for programs to enhance their well-being;
- the tax credit for experienced workers will apply to the first $4,000 (previously $3,000) of income over $5,000 for the 2015 taxation year; and
- the $7/day rate of daycare subsidization is to be indexed starting with an increase to $7.30/day per child on October 1, 2014.

The Budget proposes reducing the small business tax rate for small companies that engage more than 25% of their activity toward manufacturing and processing and have paid-up capital of $10 million or less; the reductions would be up to 2% and up to 4% for income earned after June 4, 2014 and April 1, 2015, respectively (the rate currently stands at 8% on the first $500,000 of income). Depending on size, location, income, and level of manufacturing, an additional deduction of up to 6% of gross income was proposed for remote manufacturing small and medium-sized enterprises ("SMEs") with paid-up capital less than $15 million. As well, a partial reduction to the health services fund was proposed for natural and applied science sector SMEs with payrolls between $1 million and $5 million, and the use of tax-free reserves was proposed to cover the costs for Quebec ship owners who award contracts for new ships or for maintenance to Quebec shipyards. In addition to proposing a 20% decrease to several refundable corporate tax credits for qualifying expenditures incurred after June 4, 2014 or for contracts made after June 3, 2014, the Budget also proposed the elimination, delayed implementation, or scaling back of several other tax credits (including certain SR&ED and manufacturing and processing credits).

While the Budget proposed harmonization with many of the 2014 federal Budget proposals, certain items (including the increase in the maximum amount of expenditures eligible for the adoption expense tax credit, the extension of the mineral exploration tax credit, and certain consequential amendments arising from the elimination of graduated rate taxation for certain trusts and estates) were not among the measures proposed for harmonization. Budget documents, along with CCH commentary, are posted on the provincial News Tracker on CCH Online and are also available in the *Quebec Tax Reporter* online and on DVD.

RECENT CASES

Taxpayer not liable for gross negligence penalty for failing to report dividend from corporation operating his law firm

The taxpayer, a lawyer, was a shareholder in a law firm operating his law practice ("Avocats Inc."). On January 29, 2008, the taxpayer incorporated a holding corporation ("Cantin Inc.") and during February 2008 it became a shareholder in Avocats Inc., replacing the taxpayer. In January 2008, Avocats Inc. paid a dividend to its shareholders out of its undistributed profits, and the taxpayer's share of this dividend was $65,750. A T-5 for this amount was issued by Avocats Inc. to the taxpayer in his name but it was not reported on his tax return for 2008. On reassessment, the Minister included the $65,750 in the taxpayer's income and imposed a penalty for gross negligence in the amount of $5,292.72 under subsection 163(2) of the *Income Tax Act* (the "Act"). On appeal to the Tax Court of Canada, the taxpayer contested only the exigibility of the penalty.

The taxpayer's appeal was allowed. Gross negligence entails more than a simple lack of prudence. It involves significant negligence accompanied by deliberate action coupled with an indifference with respect to the Act (see *Venne v. The Queen*, 84 DTC 6247). Wilful blindness, which is another concept often applied to taxpayers, occurs when a taxpayer

knows or ought to know that he or she is bound to make inquiries, but refuses to do so (see *Panini v. The Queen*, 2006 DTC 6450). In the present proceedings, the taxpayer was honest, well-educated, and not lacking in integrity, and his prior tax compliance history had been unblemished. Although there was a significant discrepancy between his reported income for 2008 and the income he ought to have reported for that year, his income had previously varied by as much as $100,000 from year to year. As a result, his failure to notice the absence of the $65,750 in his 2008 return was easily explained by the fact that he honestly believed that it had been or should have been paid to Cantin Inc. rather than to himself directly. He was, therefore, negligent, but had not demonstrated wilful blindness or gross negligence. In a gross negligence analysis, any benefit of the doubt must be decided in favour of the taxpayer because subsection 163(2) is a penal statutory provision (see *Farm Business Consultants Inc. v. Canada*, [1994] ACI 760). In light of the foregoing findings, the taxpayer was not liable for the subsection 163(2) penalty, and the Minister was ordered to reassess accordingly.

¶48,764, *Cantin*, 2014 DTC 1113

Arrangement rescinding previous issue of corporate shares was retroactive tax planning, so not approved

The applicant partnership, FRPDI LP, which was the sole shareholder of the corporate applicant, Graymar, acquired a marine contractor business. A substantial portion of the purchase price was funded at arm's length with debt provided by a syndicate led by CIBC. Because the marine business did not fare well, negotiations ensued with CIBC, resulting in a debt restructuring agreement (the "2010 Debt Restructuring") under which the partners of FRPDI LP would contribute an additional $10 million of partnership capital to reduce the debt owed to the lending syndicate. The 2010 Debt Restructuring concluded with an increased subscription by FRPDI LP of $14,390,921 in Graymar's common shares and a corresponding increase in debt in the form of a $14,390,921 shareholder's loan owed to Graymar by FRPDI LP. Through inadvertence, FRPDI LP failed to repay this loan by December 31, 2011 (i.e., at the end of the taxation year following the year in which the loan was made). This prompted the CRA to reassess FRPDI LP's direct partners and others under the unpaid shareholder loan income inclusion provisions of subsection 15(2) of the *Income Tax Act*. These reassessments prompted FRPDI LP and Graymar to apply for retroactive approval of an arrangement (the "Arrangement") under which $14,390,921 of Graymar's capital would be returned to FRPDI LP in respect of Graymar's issued common shares (by way of a directors' resolution by Graymar's Board), and that $14,390,921 would be set off against the $14,390,921 shareholder's loan owing to Graymar by FRPDI LP.

The application was dismissed. Despite the respondent Attorney General's argument to the contrary, the Tax Court of Canada did not have sole authority to evaluate the operation of the *Income Tax Act* in this case, inasmuch as the Alberta Court of Queen's Bench also has jurisdiction to interpret provisions of the *Income Tax Act* if necessary to decide issues that are properly before it (see *783783 Alberta Ltd. v. Canada (AG)*, 2010 DTC 5125). Additionally, section 244 of the *Business Corporations Act* (the "Act"), which deals with the rectification of corporate registers where persons' names have been wrongly recorded, was of no assistance to the applicants in this case. Nor was it appropriate or necessary for the court to invoke its inherent jurisdiction to grant the relief being sought in this case where an alternative statutory mechanism for approving arrangements already existed under section 193 of the Act. For that section to apply, however, the applicants had to demonstrate that they had satisfied the statutory procedural requirements of the section (which all parties agreed that they had), that they were acting in good faith with respect to the purpose of the 2010 Debt Restructuring (which was undisputed), and that the Arrangement was fair and reasonable. A fair and reasonable arrangement has a valid business purpose and resolves the objections of those whose legal rights are being arranged. In addition, both the applicants and the Attorney General agreed that it was necessary to determine whether the Arrangement had a valid legal purpose and that this determination depended, in turn, upon whether the applicants were entitled to rectification. Rectification requires, however, that the original documentation be shown not to accord with the parties' true intention (see, for example, *McPeake v. Canada (AG)*, 2012 DTC 5042). Conversely, in the present proceedings, the applicants could not show that the omission from the 2010 Debt Restructuring of a provision requiring the repayment of FRPDI LP's shareholder's loan was an error that obstructed their true original intentions underlying the 2010 Debt Restructuring. The Arrangement, therefore, was merely an attempt at retroactive tax planning through rectification — which courts discourage — and could not be approved.

¶48,767, *Graymar Equipment (2008) Inc.*, 2014 DTC 5051

Applicant provided no arguable case for appeal and no explanation for delay

The taxpayer was seeking an order extending the time to appeal a Tax Court judgment. The judgment was pronounced orally on October 3, 2013, with the taxpayer receiving a copy on October 8. Within the 30-day appeal period, the taxpayer completed a notice of appeal form and mistakenly sent it to the Tax Court. He was informed by the respondent's counsel in November that the proper appeal venue was the Federal Court of Appeal ("FCA"). On January 3, 2014, the Registry of the FCA advised the taxpayer that he would have to apply for an extension of time to appeal; on January 17, 2014, the Registry advised the taxpayer of the proper procedure to follow.

The motion was dismissed. An order extending time to appeal will be granted if the taxpayer shows a continuing intent to appeal, provides an arguable case for appeal, and offers a reasonable explanation for the delay. While the taxpayer displayed an intention to appeal, he did not meet the other criteria. He failed to provide a notice of appeal that would be filed if the extension were to be granted. The material he submitted did not comply with the proper rules and did not set out the grounds of appeal, so the material filed did not clearly show there was even an arguable case for his appeal. Up to a certain point, one could argue that the delay was due to lack of knowledge on the part of the taxpayer. However, by January 17, 2014, the taxpayer was given all the necessary information and yet he waited another 57 days before seeking an extension of time. No explanation was given for this delay.

¶48,768, *Doray*, 2014 DTC 5052

Minister permitted to issue inconsistent assessments against two taxpayers until underlying matter resolved

The taxpayer appealed a Tax Court order dismissing the taxpayer's motion to strike the Crown's reply to a notice of appeal against a reassessment issued under the *Income Tax Act* (the "Act") for 2001. In that year, the taxpayer had settled a spousal trust and later transferred corporate shares to the trust. Those shares were redeemed soon after, which gave rise to a deemed dividend to the trust for which the trust paid tax. The Minister took the position that the trust was a sham and that the dividend was taxable to the taxpayer and not the trust. The taxpayer argued, on the motion, that the Minister's reply was a collateral attack on the assessment of the trust's tax liability for 2001, which, under subsection 152(8) of the Act, was valid and binding on all parties including the Minister, unless that assessment was varied or vacated, or the trust was reassessed.

The taxpayer's appeal was dismissed. It was not plain and obvious that the reassessment under appeal was an impermissible collateral attack by the Minister on the initial assessment of the trust. The Court had previously held that where the facts are in dispute, the Minister may issue inconsistent assessments pending the resolution of the dispute. The Minister was not, therefore, precluded from reassessing the taxpayer despite the trust having filed and paid tax on the deemed dividend in 2001.

¶48,769, *McAdams*, 2014 DTC 5053

Materials obtained under warrant ordered returned to taxpayer

The Canada Revenue Agency ("CRA") executed a search warrant at the respondent's house, where it seized materials that it sealed and delivered to the B.C. Sheriff Services in Victoria. The respondent claimed solicitor-client privilege over the documents. The CRA filed an application to the Court for an order directing the Court Registry to release the warrant materials to it. The respondent filed a cross-application seeking a ruling or declaration that only those portions of the warrant material that fell within the scope of the warrant and were not protected by solicitor-client privilege be disclosed to the CRA.

The documents were to be divided based on whether privilege applied. There were a number of documents that were outside of the scope of the warrant, some that were simply indiscernible, and several documents that were protected by solicitor-client privilege. The remaining documents were within the scope of the warrant and not protected. Accordingly, the Court Registry was instructed to release the allowable documents to counsel for the CRA while the remainder were returned to counsel for the respondent.

¶48,770, *J.G.C., also known as G.C., also known as J.C.*, 2014 DTC 5054

Taxpayer entitled to order setting aside prior default judgment dismissing his appeal

The taxpayer initially appealed reassessments for 1994 and 1995 dated June 20, 2008, disallowing the deduction of partnership losses and certain carrying charges. On February 27, 2012, the Tax Court mailed a notice of status hearing for April 3, 2012 to the taxpayer's former address. The taxpayer failed to appear for that hearing, so his appeal was dismissed by an order dated April 10, 2012 (the "Default Judgment"), but he only became aware of this upon contacting the Minister's counsel on or about September 7, 2012. On November 1, 2013, he moved for an order setting aside the Default Judgment and extending the time to apply for such order.

The taxpayer's motion was granted. The factors to consider in granting extensions of time to appeal include a continuing intention to pursue the appeal, an appeal with some merit, no prejudice to the party responding to the application for the extension, and a reasonable explanation for the delay in bringing the application. The taxpayer's case met the foregoing criteria. Additionally, the taxpayer truly believed that his appeal was being held in abeyance pending the outcome of other appeals. He also believed, albeit mistakenly, that he had provided notice of his new address to the Court. Although his delay in this case was of significance, the question of whether he might suffer prejudice if his motion were not granted had to be given a great deal more weight. He had done virtually everything expected of him in relation to keeping the Court advised of his address and was not intentionally avoiding any notice of matters about his appeal. He was, therefore, entitled to both the extension of time being sought as well as to the actual order setting aside the Default Judgment.

¶48,772, *Izumi*, 2014 DTC 1114

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