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It is with pleasure and excitement that McInnes Cooper assumes sole editorship duties for *Tax Hyperion*, following almost seven successful and fun years of co-editing with Grant Thornton LLP. During this period we worked closely and enjoyably with Grant Thornton's David Blom, CA, TEP, who now leads that firm's Calgary presence, as well as Karen Yull, CA, MBA, a tax principal in their Mississauga office. We most sincerely express our thanks and appreciation to David, Karen and colleagues for their valued contributions to *Tax Hyperion* on a regular basis. Indeed, we want that not to stop, and will encourage them to continue to contribute as and when they can. We will as well be inviting contributions from other respected tax advisors across the country — both legal and accounting tax professionals.

This new look for *Tax Hyperion* coincides with our editorship change (and complements our own firm's branding). Our publisher, Carswell, a division of Thomson Reuters Canada Limited, is to be congratulated for developing this refreshed design. As we move forward as sole editor, we affirm our commitment to providing *Tax Hyperion* subscribers with current, informed and thoughtful Canadian tax commentary. And, as always, we will welcome email and telephone feedback from readers, to help us to ensure continuance of a fully quality-driven product.

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NEW STOCK OPTION RULES: TIPS AND TRAPS

Significant amendments to the stock option rules proposed in Budget 2010 were enacted by S.C. 2010, c. 25 (Bill C-47) on December 15, 2010; this article provides tips and trips related to those new rules.

Employer Election to Forgo Option Cash-Out Payment Deduction

For transactions occurring after March 4, 2010 (including option cash-out payments made in respect of options issued before March 4, 2010), the 50 percent security option deduction under paragraph 110(1)(d) is only available where either an employee exercises their options by acquiring securities, or an employee exercises a right to receive cash for their options and the employer files an election under subsection 110(1.1) to forego a deduction in respect of the cash-out payment. Canada Revenue Agency (CRA) has stated that the filing requirements for electing under subsection 110(1.1) are considered met if an employer completes box 86 of an applicable employee's T4 for the year in which the option benefit related to the cash-out payment is reported (see CRA's website: cra-arc.gc.ca/gncy/bdgt/2010/mplystckptns-eng.html).

The following is highlighted respecting the election available under subsection 110(1.1):

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- An employer that files an election in respect of an option cash-out payment must renounce the deduction of all related amounts, including, for example, a make-whole payment made to a foreign parent corporation;
- The election applies separately to each employee (*i.e.*, the election is not a global election);
- An employer can file an election in respect of one or more employees who receive option cash-out payments;
- The election must be made in respect of all of a particular employee's options issued under a particular agreement (preamble to subsection 110(1.1) and paragraph 110(1.1)(a)). Thus, if an employer deducts an option cash-out payment made after March 4, 2010 to a particular employee in respect of options issued under a particular agreement, the employer cannot file an election under subsection 110(1.1) in respect of a subsequent cash-out payment made to the same employee in respect of options issued under the same agreement; and
- It appears that an election under subsection 110(1.1) does not have to apply to all option agreements an employee has entered into with a particular employer (*i.e.*, it appears that the election applies separately to different option agreements).

Withholding from Option Benefits

Generally applicable after 2010, subsection 153(1.01) was added to "clarify" that a stock option benefit is to be considered remuneration paid as a bonus for the purposes of determining withholding tax requirements. The withholding obligation does not apply in respect of a stock option benefit realized on the disposition of securities of a Canadian-controlled private corporation (CCPC) acquired by an arm's length employee (paragraph 153(1.01)(b)). Also, in determining required withholdings, the 50 percent security option deduction can be taken into account, as can the deduction available when securities acquired under an option agreement are donated to a charity (paragraphs 153(1.01)(a) and (c)). However, CRA is no longer permitted to allow an employer to exercise discretion and reduce withholdings on the basis that a stock option benefit is a non-cash benefit (subsection 153(1.31)). Formerly, CRA permitted employers to unilaterally exercise their discretion to reduce withholdings when it was demonstrated that full withholdings would result in an employee having little or no cash remuneration.

The new withholding rules do not apply with respect to benefits arising from rights granted before 2011 to a taxpayer under an option agreement that was entered into before March 4, 2010 and that included, at that time, a written condition prohibiting the taxpayer from disposing of the securities acquired under the agreement for a period of time after exercise. Based on the application rules to Bill C-47, it appears the prohibition from selling the shares must be contained in the option agreement for the grandfathering relief to be available.

There are several practical implications employers should consider in respect of satisfying withholding requirements in respect of option benefits.[1] Where it is not possible to increase withholdings from regular cash remuneration, an employer should considering amending their stock option plan (if necessary) to permit the employer to sell a portion of the securities issued on the exercise of stock options to fund withholding requirements. However, such a strategy may not be feasible in respect of private company shares of a non-CCPC in respect of which there is no active market for the shares. As an alternative, a stock option plan could require an option holder to pay to the employer, in addition to the exercise price, sufficient cash to permit the required tax remittance. Employees are likely to prefer the first alternative. Other considerations to keep in mind in respect of the option withholding rules include:

- An employee that immediately sells shares acquired under an option agreement to fund withholding obligations should consider filing a designation under subsection 7(1.31) to avoid the normal adjusted cost base averaging rules;
- Employers should consider amending option plans that impose restrictions respecting when shares acquired under an option agreement may be sold to take into account the potential requirement of an employee to sell securities to fund withholding requirements; and
- Employers should have procedures in place to meet withholding obligations when former employees exercise options that were granted while the individual was employed.

Special Elective Tax Treatment in Respect of Underwater Options

Where a capital loss is incurred on the disposition of a share acquired under an option agreement, the capital loss cannot be applied to offset the employment benefit realized on the acquisition or the disposition of the optioned security. However, as proposed in Budget 2010, section 180.01 was added effective March 4, 2010 to allow for special elective tax treatment to apply where an employee acquired securities under an option agreement and the securities acquired significantly declined in value. For the elective tax treatment to be available, a taxpayer must have elected to defer the option benefit realized on the acquisition of the security under former subsection 7(8). Furthermore, the securities acquired under the option agreement must be (or must have been) disposed of after 2000 and before 2015. Finally, if the taxpayer disposed of the securities before 2010, the taxpayer is required to file Form RC310: *Election for Special Relief for Tax Deferral Election on Employee Security Options*, on or before the filing-due date for the taxpayer's 2010 tax return (normally April 30, 2011). In any other case, Form RC310 is required to be filed on or before the filing-due date for the taxation year of the taxpayer in which the disposition of the securities occurred.

1 An employer that fails to meet withholding obligations may be liable for the tax owing, plus interest and penalties.

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Where Form RC310 is filed, a taxpayer generally replaces the deferred employee stock option benefit income inclusion with a deemed capital gain equal to the lesser of the stock option benefit and the capital loss incurred on the disposition of the optioned securities. Any unused allowable capital losses arising on the disposition can be used to offset the deemed capital gain. However, any proceeds received by the taxpayer on the disposition of the optioned securities is payable as a special tax. The special tax is equal to the proceeds received, except in the case of a taxpayer resident in Quebec at the end of the year, in which the tax is equal to two-thirds of the taxpayer's proceeds of disposition. The election will generally be beneficial if the optioned securities have declined in value to the extent that the proceeds of disposition in respect of the securities is insufficient to pay the tax that was deferred on the option benefit under former subsection 7(8). However, the election may not be beneficial if the capital loss realized on the disposition of the securities is (or has already been) partially or fully utilized to offset other capital gains. In such a case, any additional taxes payable on the deemed capital gain would need to be considered in determining whether filing the election would be beneficial. In Form RC310, the CRA states that if the application of the election under subsection 180.01(1) is not to the benefit of the individual filing the election, the CRA will not process the election and will advise the individual accordingly. An example of the application of section 180.01 is provided in CRA Guide T4013 under "Employee security options" (available on *Taxnet Pro*). Refer also to the *Canada Tax Service* commentary to section 180.01.

Bruce Russell, QC – *Partner, McInnes Cooper*

MORGUARD – DISCOVERY DENIED?

In the recent Tax Court decision of *Morguard Corp. v. R.*,[1] Justice V. Miller provided judicial insight into the matter of a party's selection of nominee for discovery examination purposes. As a rule of thumb, a corporate party will select as its discovery deponent an officer of the corporation having personal knowledge of the particular transaction or other matter of interest, and who being an officer is sufficiently senior to credibly bind for all purposes of the litigation the corporate party nominating him or her, and who would reasonably be able to inform himself/herself as to related matters not within his/her personal knowledge. For relevant questions that, despite personal knowledge and becoming informed, cannot be immediately answered, the party's counsel customarily will give undertakings to answer in writing. Typically only one deponent is examined on behalf of each party.

Morguard addresses a situation in which the taxpayer's nominee was unable to answer certain questions put by the Crown counsel, and *in lieu* thereof, undertakings were given to respond later in writing. The Crown was not content with this and so brought a motion to compel the appellant taxpayer to produce a certain other particular person as knowledgeable, for discovery examination on its behalf. Miller, J. was able to draw upon her experience as a former senior tax litigator for the Crown in disposing of this motion from the bench in October last year. The fact that these reasons for decision were reduced to writing recently suggests that perhaps the decision is being appealed.

In this instance the appellant had named its Chief Finance Officer (CFO) as its discovery nominee. This was despite that the transaction of interest occurred in 2000 and the nominated CFO had only joined the appellant company in 2002, thus having no personal knowledge of the matter. On the other hand, the appellant's Chief Executive Officer (CEO) did have personal knowledge of the matter from 2000 and was still in place as CEO. The key tax issue was characterization of a $7.7 million payment to the appellant in 2000, styled a "break fee", in the course of the appellant's take-over bid for shares of another company. The appellant claimed the payment as a windfall or alternatively capital receipt; but the Crown had assessed it as an income item. The applicable factual circumstances would determine this question. Thus, the importance of the discovery examination — being an opportunity for each party to clarify relevant facts — was clear.

The Crown's motion was brought under Tax Court Rules 93(2) and 95(2). Rule 93(2) provides that a corporate party is to select a knowledgeable current or former officer, director, member or employee to be examined on its behalf but if the examining party is not satisfied with that person, that party can apply for another person to be named. Rule 95(2) provides that a person named to be examined "shall make all reasonable enquiries regarding the matters in issue" of all the party's officers, servants, agents and employees, past or present, within or without Canada, and that "if necessary, the person being examined…may be required to become better informed and for that purpose the examination may be adjourned."

The appellant's CFO answered all but 20 of the Crown's 305 questions, giving undertakings for the 20. The Court accepted the Crown's assertion that the CFO's answers to specific questions about the break fee were "vague, non-committal and totally uninformative". The CFO was noted by the Court also as agreeing that he "can't speak to" either the 2000 negotiations of the break fee or the various terms of the pre-acquisition. Absent context from the discovery transcript it is unclear if here the CFO was simply acknowledging the evident fact that he could not speak to these matters personally, as he had not been there in 2000, but still could relay what he had learned in informing himself; or that he completely knew nothing, either first or second hand, about these matters.

Indeed, two paragraphs later (at paragraph 10 of the decision), the Court itself voiced this distinction, observing that from review of the complete discovery transcript, "not only does [the CFO]

1 (2010), 2010 CarswellNat 5602 (T.C.C. [General Procedure]).

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have no personal knowledge…but…it is doubtful he could inform himself". The latter conclusion (doubtful that he could inform himself) was not elaborated upon, although the Court cited a 1966 Exchequer Court general statement that the duty to inform oneself in preparation for discovery was "intended as a supplement to and not substitute for discovery". As well, the Court took note that at the discovery, upon respondent Crown's counsel questioning the CFO's lack of knowledge, appellant's counsel had "flippantly" responded. The Court denounced this as, "wholly unsatisfactory and frustrates the very purpose for a discovery" (which purposes are to allow the party to know the case against it and to obtain helpful admissions).

The Court summarized the CFO's disputed 20 responses as being of four types — that the CEO could give the best answer, that if anybody could answer the particular question the CEO could, that he (the CFO) had no personal knowledge, and that he (the CFO) had no knowledge. The Court concluded that in these circumstances it would not order the CFO to be better informed but rather would order that the appellant produce the CEO himself for examination. He "is the person who has knowledge of the facts that gave rise to the issue under appeal". The Court went on to say that the appellant "attempted to frustrate the discovery because it nominated an officer who had no knowledge of the events that led to the 'break fee' while it had, within its employ, two officers who were knowledgeable of the matters which gave rise to this appeal." Costs of $3,000 were ordered to be paid within 10 days to the Crown.

The decision is of interest. In the writer's practice, it is unusual to nominate for discovery a person who does not have at least some personal knowledge, when there is anyone available who has such knowledge. However, the Tax Court Rules do not stipulate this. From a practical viewpoint flexibility is required. There may be reasons such as language barriers or health concerns that render persons having personal knowledge not appropriate choices to testify in discovery. Plus, in most situations having 20 undertakings out of 305 questions is not troublesome. That is only one out of every 15 questions. Still, the Court (and Crown) considered that these 20 were the pertinent questions. Generally when a person is nominated as a discovery deponent, his/her name, title and brief description are provided opposing counsel in advance, to give counsel an opportunity to informally discuss in advance, if desired, the appropriateness of the nominee.

Finally but importantly, here appellant's counsel's "flippant" remark (noted absent full context), clearly won the appellant no judicial points, as evidenced by the costs award. It is trite that respect is to be accorded opposing counsel whenever on (and also off) the record. It also is trite, as amongst experienced counsel, that what may have been a brilliant riposte when insouciantly uttered can read quite less humorously months and years (and forever) afterward in a tediously tone-deaf discovery transcript.

Keira Wong, LLB, BMedia – *Carswell*

INTEREST DEDUCTIBILITY: DECREASED FAIR MARKET VALUE

In a recent Canada Revenue Agency (CRA) technical interpretation, CRA was asked whether an individual could claim an interest expense deduction on the remaining portion of an outstanding loan used to acquire an investment property that had decreased in value. CRA's position was that after repaying part of the loan with a portion of the property that was acquired with the loan, the interest expense on the remaining portion of the loan was deductible. The thinking here was that as the portion of the loan outstanding in excess of the value of the property originally acquired is deemed to continue to be used for the purpose of earning income from the property pursuant to subsection 20.1(1) of the *Income Tax Act* (Canada) (Act) it therefore would be deductible under subparagraph 20(1)(c)(i). As well, CRA provided three scenarios to illustrate calculations for determining the total amount of borrowing considered to be used for income producing purposes when a portion of a loan is repaid. Each scenario is summarized below.

Scenario 1:

A taxpayer invests $3,000 loan proceeds equally amongst three companies. Subsequently, the fair market value (FMV) of each of two of the companies becomes $1,000 and $500 respectively. The third company ceases to operate and so the FMV of its shares becomes nil; thus, part of the property previously acquired with the borrowed money ceases to be used for an income earning purpose.

CRA stated that the $2000 used to invest in the first and second companies would continue to be considered to be used for income earning purposes. In order for interest on any portion of the remaining $1,000 of the loan to be deductible, CRA considered the application of subsection 20.1(1) of the Act. Citing subparagraph 20.1(1)(b)(iv), CRA would deduct an amount equal to the FMV of the third company that the taxpayer would have received had it disposed of the third company shares (FMV of nil) from the amount of $1,000 borrowed to invest in the company. CRA concluded that although part of the property had ceased to be used for income earning purposes, interest on the total $3,000 loan was deductible by virtue of section 20.1.

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Scenario 2:

A taxpayer invests a $3,000 loan in company shares. Subsequently, the taxpayer disposes of all shares for proceeds of $1,500, which are not reinvested in an income producing property. The borrowed money outstanding immediately before the property was disposed of was $3,000. In this scenario, CRA stated that $1,500, which is the amount of borrowed money traceable to the proceeds of the shares disposed, is deemed to be used for income earning purposes as a result of subsection 20.1(1) of the Act.

Scenario 3:

A taxpayer obtains two different loans of $2,000 and $1,000, investing the entire amount in a portfolio of shares (CRA noted that the two loans would be treated as one loan based on comments in the 1994 Technical Notes). Subsequently, the value of the acquired shares decreases to $1,500 and the taxpayer disposes of part of the share portfolio which has a FMV of $1,000 and cost of $2,000; the proceeds are used to settle the $1,000 loan. The $2,000 loan remains outstanding, and the taxpayer holds remaining assets with a FMV of $500 with a $1,000 cost .

Since the taxpayer still holds shares it had acquired with $1,000 of borrowed money, $1,000 of the outstanding loan of $2,000 would continue to be considered used for income earning purposes, inview of the direct use test. Furthermore, CRA's position was that the amount of borrowed money traceable to the $1,000 proceeds on the disposition of shares was deemed *per* subsection 20.1(1) to be used for income-earning purposes. As such, CRA indicated that the total of the loan considered to be used for income-earning purposes was $2,000. That is the sum of the amount borrowed for income-earning purposes as a result of direct use test ($1,000) and the amount of borrowed money deemed to be used for income-earning purposes by virtue of subsection 20.1(1) ($1,000). CRA also noted that when a taxpayer disposes of the property to the creditor in return for a reduction in the amount owed, subparagraph 20.1(1)(b)(i) would not apply with respect to the reduction, since the reduction would not constitute consideration to which the borrowed money is traceable. However, CRA stated that subparagraph 20.1(1)(b)(iii) would be applicable in such a case.

Bruce Russell, QC – *Partner, McInnes Cooper*

TIEDE – WHEN A BUSINESS, TO ENABLE DEDUCTIONS

The recent Tax Court decision of *Tiede v. R.*,[1] although modest as to quantum at issue, is a useful update as to when a business commences. This remains an issue arising from time to time with the Minister of National Revenue (Minister). Of course absent a business, deductions *per* sections 9 and 18 of the *Income Tax Act* (Canada) cannot be permitted.

In *Tiede*, the appellant was a Manitoba-resident employee of Atomic Energy of Canada Limited (AECL). In February 2003 he was notified he would be laid of from his AECL employment; and he was, effective June of that year. He immediately developed plans to commence self-employment in photography. He bought equipment and renovated the basement of his house accordingly. Photography had been his hobby for many years, although what he now wanted to get into as a business was a specific type of photography being digital imaging, for which he needed specific training and equipment. All was moving along as planned, although with no income, until September 2003 when AECL proposed to cancel the layoff. The appellant went back to AECL and has remained there ever since. He claimed that his photography business had not ended, however; it had merely had its timeline for commencing to generate revenue extended. He claimed losses of approximately $11,000, $4,000 and $9,000 for 2003, 2004 and 2005 years respectively. The Minister denied same, resulting in the Tax Court appeal.

The first question was whether a business had ever commenced. No revenue had been earned (except for less than $50 for passport photos at the suggestion of his accountant). The Court, *per* Woods, J., determined that a business had been commenced, as of February 2003. The learned Court cited a decision of Bowman, J. (as he then was) — *Gartry v. R.*[2] — for the proposition that when a business commences is unique to each situation; and typically sits somewhere between the two extremes of when the intention to start the business is first formed and when money starts being earned. The writer respectfully suggest that within this continuum, generally all reasonable expenses incurred in initial organization of a business, even if ultimately the business never "gets off the ground", are recognizable.

The Court in *Tiede* ascribed to the appellant the aim of commencing to earn income from photography products and services "in a relatively short period of time". As such it was "common sense" that he should be able to deduct reasonable business expenses while the business "was being actively pursued". The Court however felt it was again "common sense"

1 (2011), 2011 CarswellNat 255 (T.C.C. [Informal Procedure]).

2 (1994), [1994] 2 C.T.C. 2021 (T.C.C.).

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TIEDE – WHEN A BUSINESS, TO ENABLE DEDUCTIONS

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that the activity did not continue as a business past the date of the appellant's work resumption with AECL. At the risk of quibbling, this question should probably reflect a more subjective determination of discerning the appellant's actual intent, subject to reasonability. Indeed, the Court did note that at time of hearing more than eight years had passed without the appellant's plans having moved beyond the formative stages. That this justifies the end point for deductions tidily occurring upon recommencement of AECL work, does not necessarily follow. The appellant may in good faith have intended to still do this self-employment photography work on a part time basis with a correspondingly and necessarily extended time line for generating income, with this intention falling off in due course. The Court may have considered this option; although unmentioned.

One final point, addressed in the recent article "Allowing Business Expenses Post Cessation of Active Business" (*Tax Hyperion*, Vol. 8, No. 1), concerns when a business ends. Jurisprudence has recently re-confirmed that while the activity phase of the business may end, the business will be viewed as continuing from the perspective of allowing deductions for costs incurred in seeking to dispose of assets of the business; even during several further years. Historically, when a business actually ends, for purposes of being able to continue to make deductions, has been another friction point with the Minister. In *Tiede* this rightly was not raised, in the absence of any evidence that the appellant taxpayer was seeking to sell his photography business assets. Further, the Court characterized the end of the business phase (when the appellant returned to work with AECL) as being the point when the appellant's photography activities reverted to hobby mode. Any selling of assets after that point were, by this characterization of "hobby", rendered non-deductible.

Paula Ideias – *Carswell*

PERSONAL TAX SEASON: WHAT'S NEW FOR 2010?

With personal tax season fast approaching, listed below are some of the 2010 tax changes that practitioners should be aware of that may impact clients' personal tax returns.

Child Benefits

- Shared Custody – Parents who have shared custody of their children can equally split the monthly payments of the Child Tax Benefit, Universal Child Care Benefit (UCCB) and the quarterly GST/HST credit.
- UCCB for Single Parents – Single parent families have the option of either declaring the UCCB on the parent's return, or taxing the sum on the return for the individual for whom the eligible dependant amount was claimed.

Dividend Tax Rates

In 2010, eligible dividends are taxable at 144% with a federal dividend tax credit of 17.97%. Dividends other than eligible dividends are taxable at 125% with a federal dividend tax credit of 13.33%.

Employment Insurance Opt-In for Self-Employed Individuals

Beginning in January 2010, self-employed individuals can opt in to the Employment Insurance program and receive special benefits similar to those currently available to salaried employees, including maternity benefits, parental and adoption benefits, sickness benefits, and compassionate care benefits (for more information, see the Service Canada website at www.servicecanada.gc.ca).

Home Buyers' Plan (HBP)

The maximum Home Buyers' Plan amount that can be withdrawn from a registered retirement savings plan (RRSP) under the HBP has increased to $25,000.

Investment Tax Credit

Eligibility for the mineral exploration tax credit has been extended to flow-through share agreements entered into before April 1, 2011.

Medical Expenses

Medical expenses incurred after March 4, 2010 for procedures done solely for cosmetic purposes no longer qualify for the medical expense tax credit. This includes surgical and non-surgical procedures aimed purely at enhancing one's appearance. A cosmetic procedure will continue to qualify as a medical expense if the treatment is required for medical or reconstructive purposes (for more information, see CRA Guide RC4064, *Medical and Disability-Related Information*).

Registered Disability Savings Plans (RDSP)

For deaths after March 3, 2010, the RRSP rollover rules are extended so that a deceased individual's RRSP proceeds can be transferred on a tax-deferred basis to a registered disability savings plan of a financially dependent infirm child or grandchild (for more information, see www.cra.gc.ca/rdsp).

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PERSONAL TAX SEASON: WHAT'S NEW FOR 2010?

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Scholarship Exemption and Education Amount

Post-secondary programs consisting mainly of research are eligible for the scholarship exemption and the education amount only if they lead to a college or CEGEP diploma, or a bachelor, masters or doctoral (or equivalent) degree. Post-doctoral fellowships are taxable. For a scholarship, fellowship, or bursary received in connection with a part-time program for which the part-time education amount can be claimed in respect of that program, the scholarship exemption is equal to the amount of tuition paid for the program plus the costs of program-related materials (for more information, see CRA Pamphlet P105, *Students and Income Tax*, or www.cra.gc.ca/students).

Security Options

- Election to Defer Security Option Benefits – Clients who exercised options and bought eligible securities after 4pm EST on March 4, 2010 can no longer make an election to defer the security option benefits for those securities.
- Relief for Tax Deferral Elections on Security Option Benefits – Clients may elect for special relief in respect of gains from a disposition of eligible securities on which the client elected in a previous year to defer the security option benefits (see Form RC310, *Election for Special Relief for Tax Deferral Election on Employee Security Options*).
- Cash-Out Stock Options – Effective March 4, 2010, in order to allow employees stock option deductions on their personal income tax returns, employers with "cash-out" stock option plans may have to provide written proof that the company has not taken any deduction in consideration of such plans.

U.S. Social Security Benefits

For 2010 and subsequent years, Canadian residents in receipt of U.S. social security benefits since January 1, 1996 (and their spouses and common-law partners who are eligible to receive survivor benefits) can deduct an extra 35% of the benefits in addition to the existing 15% deduction allowed under the Canada-U.S. Tax Treaty. This allows for a total combined deduction of 50%.

Karen D. Stilwell – *Tax Associate*, *McInnes Cooper*

LAND & SEA ENTERPRISES – ITCs DENIED

Land & Sea Enterprises Ltd. v. R.[1] is an appeal from GST/HST reassessments for the period from May 1, 2004 through April 30, 2005. At issue was the denial of input tax credits (ITCs) to the Appellant corporation during a time when it was overhauling its operations and changing its business from pipeline welding and painting of parking lots and intersections to horse farming. The decision in this case, denying all but a few of the ITCs sought, emphasizes the importance of the legal distinction between a corporation and its owner-manager and relates this distinction to the importance of adhering to the requirements of subsection 169(4) of the *Excise Tax Act* (the "*Act*") and the *Input Tax Credit Information (GST/HST) Regulations*, SOR/91-45 (the "*Regulations*"). Ultimately, because the legal distinction between the Appellant and its owner-manager, Mr. Johnston, was not observed in the behaviour of Mr. Johnston and the corporation nor in the relevant invoices, most of the ITCs sought were denied.

Chief among the ITCs claimed by the Appellant corporation were those related to expenses incurred for the construction of a new barn, the purchase of a tractor, and the purchase of farm supplies. As explained by Mr. Johnston in testimony, the expenses were incurred during the period when the activity of the corporation was evolving from providing construction and welding services to the provision of horse boarding, breeding, and grooming services. The Crown's position was that the Appellant was not entitled to the ITCs in respect of the barn because it had not acquired the barn in the course of its commercial activities. This position was based, in the main, on the fact that the Appellant had acquired the barn during the transition period for improvement of its capital property and that, therefore, the Appellant did not use the barn in the course of its commercial activities immediately after it was acquired. It was the alternative position of the Crown that the barn was not used in the course of the commercial activities of the Appellant. With respect to the remaining items, the position of the Crown was that the expenditures were personal expenditures of Mr. Johnston.

The decision of Justice Campbell first canvasses the law regarding when a business begins and the related availability of ITCs during the initial start-up phase and applies those principles to the circumstances of the Appellant. Concluding that indeed there were "business activities" being conducted during the start-up phase of the horse farming business, the crux of this decision then focuses on the question of whose business was it — was it that of Mr. Johnston or that of the Appellant*?* Getting down to first principles regarding the legal distinction between a corporation and its owner-manager, Justice Campbell writes:

> [16] Some of the problem with the Appellant successfully claiming all of the ITCs during this period is the inability of Mr. Johnston to separate his activities from that of the Appellant and to maintain proper supporting records. As 100 per cent owner of the Appellant, he treated his own commercial activities interchangeably with those of the Appellant corporation, failing to recognize the importance legally of the Appellant as a separate and distinct entity. <u>Piercing this corporate veil and treating the corporate entity and its shareholders as one unified entity will be done only in those rare cases where there exists the clearest of compelling circumstances</u>. [emphasis added.]

1 (2011), 2011 CarswellNat 320 (T.C.C. [Informal Procedure]).

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Notwithstanding the fact that corporation changed its name in anticipation of the new business activities and the fact that the Appellant was carrying on a horse farming business at the time of trial, Justice Campbell found that the preponderance of facts supported the conclusion that the farm business, during the relevant time period, was in fact that of Mr. Johnston himself. In reaching this conclusion, Justice Campbell relied primarily upon such facts as: during the relevant time period, the Appellant did not own any of the horses but they were owned by Mr. Johnston; there were no agreements in place between Mr. Johnston and the Appellant for lease of a separate shop or the barn; and, there was no evidence that Mr. Johnston was acting as agent of the Appellant. On this last point, Justice Campbell squarely placed the burden upon the owner-manager to keep proper books and records:

> [19] […] Mr. Johnston is the sole owner of the business and it was upon his shoulders to ensure that, if he was acting as the Appellant's agent, correct documentation from third parties reflected that the purchases were for the Appellant's operations. The *Companies Act*, R.S.P.E.I. 1988, c. C-14, section 29 permits corporations to create and pass by-laws appointing corporate agents. However, no such by-law was submitted into evidence.

Further supporting her conclusion that the business was that of Mr. Johnston personally was the fact that many of the invoices under dispute were addressed to Mr. Johnston personally — not to the Appellant. In the context of the analysis above, this factor also decides the appeal. Noting that non-compliance with the documentary requirements as set out in the Regulations will operate to deny eligibility for ITCs, Justice Campbell denies the appeal for all invoices except those which were addressed directly to the corporation.

The moral of this story is one that will apply to many taxpayers. It is not uncommon for business owners to incorporate a company through which to carry on a business, often for the benefits of limited liability and the availability of the small business rate and potential tax deferral benefits. However, many small owner-managed corporations are operated in a very informal way, with the potential for the legal distinction between the corporation and the owner-manager lost in the day-to-day operations of the business. In particular, as regards the availability ITCs, it is essential that these formal requirements be fully appreciated by business owners.

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