Tax Notes

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1455257 ONTARIO INC. V. THE QUEEN: MUST A DISSOLVED CORPORATION BE REVIVED BEFORE IT CAN PURSUE A TAX APPEAL?

— *Adam Friedlan, Friedlan Law, Richmond Hill, Ontario*

In *1455257 Ontario Inc. v. the Queen*, 2015 DTC 1160 (TCC), the issue in dispute was whether 1455257 Ontario Inc. ("257"), a dissolved corporation originally incorporated pursuant to the *Business Corporations Act* (Ontario) (the "OBCA"), had the capacity to carry on an appeal in respect of an assessment issued by the Minister of National Revenue (the "Minister") after the date of its dissolution. 257 was incorporated on December 15, 2000, and became a dissolved corporation on or around January 29, 2007, pursuant to section 241 of the OBCA. Prior to the dissolution Enrico Lisi was the president, secretary, and sole director of 257.

Section 241 of the OBCA provides that if a corporation fails to comply with the provisions of certain legislation it may be dissolved by the Director under the OBCA. A corporation so dissolved may be revived within twenty years of its dissolution under subsection 241(5).

A Notice of Assessment dated October 18, 2010, was issued against 257 pursuant to section 160 of the *Income Tax Act* (the "Act") in relation to the tax indebtedness of 1473661 Ontario Limited (although unstated in the decision, presumably a related company). 257 objected to the aforementioned Notice of Assessment which was subsequently confirmed by the Minister. Consequently, 257 filed a Notice of Appeal with the Tax Court of Canada on October 26, 2012. The Crown brought a motion for an Order to adjourn the appeal for 60 days to allow 257 to revive its corporate status pursuant to subsection 241(5) of the OBCA, alternatively to quash the appeal, and in the further alternative to require 257 to post security for costs and to require an undertaking from the former director or other interested persons in his or her personal capacity to comply with all Orders and Judgments issued by the Tax Court in the appeal.

The Court first ruled that no provision exists pursuant to the *Tax Court of Canada Rules (General Procedure)* (the "Rules") which addresses security for costs in 257's particular circumstances. Furthermore, the Court also ruled that no provision exists under the Rules which requires a personal undertaking to comply with all Orders and Judgments issued by the Tax Court as a pre-condition to pursue a statutory right of appeal.

Subsection 242(1) of the OBCA states as follows:

> 242(1) Despite the dissolution of a corporation under this Act,
>
> (a) a civil, criminal or administrative action or proceeding commenced by or against the corporation before its dissolution may be continued as if the corporation had not been dissolved;

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(b) a civil, criminal or administrative action or proceeding may be brought against the corporation as if the corporation had not been dissolved;

(c) any property that would have been available to satisfy any judgment or order if the corporation had not been dissolved remains available for such purpose; and

(d) title to land belonging to the corporation immediately before the dissolution remains available to be sold in power of sale proceedings.

The Court noted the principal focus of the case was the interpretation of paragraph 242(1)(*b*) of the OBCA and conflicting lines of authority in relation to that provision. The Court first made reference to the case of *GMC Distribution Ltd. v. Her Majesty the Queen*, 2012 GTC 37 (TCC), in which Webb J. held that until GMC, a dissolved OBCA corporation, was revived, it could not continue with its action. The ruling in *GMC* relied on the case of *Reliable Life Insurance v. Ingle*, [2009] OJ. No. 2312, which involved a motion for leave to grant an individual the right to represent two dissolved and un-revived corporations so that the corporations could defend themselves in civil actions. In *Reliable*, the Court concluded that while a dissolved corporation may be sued as if it had not been dissolved, it does not have the ability to defend itself unless and until it has been revived.

The Court then proceeded to review a line of cases raised by 257, which 257 asserted supported the proposition that its current appeal constituted a defence in accordance with paragraph 242(1)(*b*) of the OBCA for which revival was not necessary. In support of this assertion 257 relied on the case of *460354 Ontario Inc. v. Her Majesty the Queen*, 92 DTC 6534 (FCTD) (confirmed by the Federal Court of Appeal in *The Queen v. Sarraf*, 94 DTC 6229), in which the Court found that an assessment against a taxpayer under the Act is an administrative proceeding within the meaning of paragraph 241(1)(*b*) (now 242(1)(*b*)) of the OBCA, and pursuant to that provision a dissolved corporation has all the rights of appeal in relation to such an assessment.

257 also cited the decision of *Malamas v. Crerar Properties Corp.*, [2009] OJ No. 4726, in which Malamas brought a motion to strike Crerar's statement of defence because Crerar was argued to lack capacity to defend itself because the action had been commenced after Crerar had been dissolved. The Court in that case dismissed the motion on the basis that paragraph 242(1)(*b*) must contain an implicit right for a dissolved corporation to defend itself against an action because it would be "unthinkable" and run contrary to the presumption against absurdity for the law to recognize the right of one party to bring an action while denying the other party the right to defend itself.

After reviewing the two relevant lines of authority, the Tax Court ruled that the findings in each of the decisions *GMC* and *Reliable* were correct and that revival is necessary in order for a corporation to defend itself against a proceeding brought against it after its dissolution. The Court noted that while *GMC* had focused on paragraph 242(1)(*a*) of the OBCA because GMC was assessed and had filed its appeal prior to its dissolution, the reasoning had applied to both paragraph (*a*) and (*b*) of subsection 242(1) of the OBCA. In other words, *GMC* had interpreted both paragraphs (*a*) and (*b*) of subsection 242(1) of the OBCA as requiring the revival of a dissolved corporation before it could defend itself.

The Court noted that in *Malamas* the Court had interpreted paragraph (*a*) (the provision dealing with actions commenced before dissolution) as containing a right to a defence while on its face interpreting paragraph 242(1)(*b*) as not containing such a right. The Court in *Malamas* had then relied on the presumption against absurdity to construe paragraph 242(1)(*b*) as containing a right to a defence. The Court contrasted the approach in *Malamas* with that in *Reliable* and concluded the approach in *Reliable* had properly construed the relevant provisions of subsection 242(1) in light of their context and the statutory regime in section 242 of the OBCA, namely, that a corporation should not escape its liabilities by virtue of its dissolution but that interested parties could see to the revival of a dissolved corporation to protect their interests. The Court also noted that the reasoning in *Malamas* raised several problematic questions including who would be entitled to instruct counsel during any proceedings while a corporation was still dissolved, and who would pay the costs of the defence.

On the basis of the foregoing, the Court ruled that upon dissolution in 2007, 257 ceased to exist. To cure that impediment, 257 needed to be revived and unless and until that was done pursuant to subsection 241(5) of the OBCA, 257 lacked the capacity to pursue or defend its appeal. Therefore the Court ordered the appeal to be adjourned for 60 days from the date of the Order to allow 257 to take steps to revive its corporate status pursuant to subsection 241(5) of the OBCA.

It is interesting to note that the Court in this case chose not to apply the holding from *460354* (affirmed by the Federal Court of Appeal in *Sarraf*) on the basis of a change effected subsequent to the rendering of those decisions in the wording in subsection 241(5) (the provision of the OBCA addressing revival). A subsequent amendment to an entirely different subsection of the OBCA appears to have significantly influenced the Court's interpretation of subsection 242(1) in this case. The varied approaches taken by courts with respect to the meaning of paragraph 242(1)(*b*) of the OBCA may suggest that the meaning of the provision is ambiguous. Consequently, in the opinion of the writer it may be advisable for the Ontario legislature to consider amending subsection 242(1) of the OBCA to provide clarity on this matter.

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CURRENT ITEMS OF INTEREST

Federal and Quebec EI Premium Rates and Maximum Limits for 2016

On September 24, 2015, the CRA released the following information for the 2016 federal and Quebec Employment Insurance (EI) premium rates and limits:

	Federal	**Quebec**
Maximum annual insurable earnings	$50,800	$50,800
Rate	1.88%	1.52%
Maximum annual employee premium	$955.04	$772.16
Maximum annual employer premium	$1,337.06	$1,081.02

FOCUS ON CURRENT CASES

This is a regular feature examining recent cases of special interest, coordinated by *John C. Yuan* and *Christopher L.T. Falk* of McCarthy Tétrault LLP. The contributors to this feature are from McCarthy Tétrault LLP, Montreal, Toronto, Calgary, and Vancouver.

Section 110.6 and the Legal Fiction Around the Legal Personality of a Child Conceived but not yet Born

***Pellerin v. The Queen*, 2015 DTC 1179 (Tax Court of Canada)**

In *Pellerin*, the Tax Court was asked to determine whether shares sold by the taxpayer, Mika Pellerin, before his second birthday qualified for the capital gains exemption for qualified small business corporation shares under section 110.6 of the *Income Tax Act* (the "Act").

The matter before the Court arose in respect of a trust that was settled in January 2005 (the "Trust") for the benefit of the taxpayer's father (Mathio Pellerin); his children and grandchildren from their birth or their adoption; and any legal person controlled by Mathio Pellerin. It was agreed between the parties that the taxpayer was born on March 8, 2007, and was conceived around June 2006.

On October 1st and November 28th, 2008, the taxpayer received as capital distributions from the Trust shares of two corporations. In both cases, the Trust had held the shares for at least 24 months. On October 2nd, the taxpayer disposed of the shares that he had received the day before. Similarly, on November 28th, the taxpayer disposed of the shares that he had received earlier that day.

These two transactions generated capital gains of more than $160,000, which were included in the taxpayer's income tax return for 2008. In respect of the gains, the capital gains exemption was claimed, the deduction being the amount of the taxable capital gains realized by the taxpayer on the sale of the shares on October 2nd and November 28th.

In 2011, the Minister reassessed the taxpayer, disallowing the capital gains exemption, which ultimately resulted in this appeal.

The sole issue before the Court related to the requirement that for the capital gains exemption to be available, the shares disposed of by the taxpayer must have been held by the taxpayer or by persons related to the taxpayer for a 24-month period prior to the disposition. In this regard, at least after the taxpayer was born, the taxpayer and the Trust were deemed to be related for purposes of the capital gains exemption pursuant to the provisions of subparagraph 110.6(14)(*c*)(i), as the Trust was a personal trust and the taxpayer was a beneficiary of the Trust.

The Minister advanced several arguments in support of his position. First, the Minister maintained that the taxpayer did not meet the 24-month holding requirement in paragraph (*b*) of the definition of qualified small business corporation shares ("QSBCS") in 110.6(1), given that the taxpayer was not two years old when he sold the shares. Further, the Minister argued that, even though the Trust was related to the taxpayer after his birth, this status would not be retroactive to prior to the taxpayer's birth. Furthermore, the Minister maintained that the effect of the Trust deed, which made Mathio Pellerin's children and grandchildren beneficiaries "from their birth or adoption", was that the taxpayer could only become a beneficiary of the Trust from the time of his birth and not before. Therefore, according to the Minister, the 24-month period criteria under paragraph (*b*) of the QSBCS definition could not have been satisfied.

Boyle J. focused his analysis on the age of the taxpayer at the time of the share sales and on the taxpayer's relationship with the Trust. Boyle J. considered *Montreal Tramways Co. v. Léveillé* (1933 SCR 456), in which the Supreme Court of Canada set out the fundamental civil law principles regarding the legal personality of a child conceived but not yet born. Boyle J. also considered the *Civil Code of Québec*, which provides rights to an unborn child provided that the child is born alive and viable. Based upon his review of the civil law, Boyle J. concluded that there is no doubt, as a matter of civil law, that once the taxpayer was born alive and viable, he was considered to be a beneficiary of the Trust retroactively to his conception (around June 2006).

According to Boyle J., based upon this legal fiction, the 24-month requirement was satisfied, given that the taxpayer and the Trust were the only owners of the shares during the 24-month period prior to the sale and that the Trust and the taxpayer were related throughout that period since the taxpayer was an actual beneficiary from birth and was deemed a beneficiary since his conception.

As for the argument based on the provisions of the Trust deed, which the Minister maintained would prevent the taxpayer from becoming a beneficiary of the Trust prior to his birth, Boyle J. concluded that as of the birth of the taxpayer, alive and viable, the legal fiction takes full effect and the taxpayer is retroactively considered a beneficiary from the time of his conception. According to Boyle J., nothing in the Trust deed was inconsistent with this reading, which was the interpretation that should be preferred given the applicable law. Additionally, Boyle J. noted that the *Civil Code of Québec* provides that generally applicable laws of public order should never be departed from by private agreements between parties, such that even if the Trust deed had been intended to have the effect proposed by the Minister, the Trust deed would not have that effect.

Finally, Boyle J. had to determine whether the "throughout the 24 months" requirement in section 110.6 requires that related person status exists during the whole period or only at the time of sale. Boyle J. determined that, based upon the grammatical meaning of both the French and English versions of the provision and upon a purposive interpretation, the persons needed to be related only at the time of sale. According to Boyle J., the purpose of the ownership criteria was to prevent a taxpayer from claiming a capital gains exemption in respect of gains that accrued while the shares were owned by an unrelated party. Boyle J. therefore concluded that the ownership criteria would be fulfilled if at the time of the sale, the taxpayer was related to a person who held the shares throughout the 24-month period. The appeal was therefore allowed.

Pellerin is a good illustration of the critical importance of determining applicable legal principles in seeking to determine the tax implications of a transaction.

— *Jessica Van Acker*

RECENT CASES

Travel to warm climates does not qualify as a medical service

The Crown was appealing a Tax Court decision (2014 DTC 1148) that held that travel expenses to Thailand and Indonesia for the taxpayer and her husband were incurred to obtain medical services. The taxpayer suffered from temporomandibular joint dysfunction which was a debilitating condition that led to the replacement of joints with prosthetic devices. The prosthetic devices were adversely affected by the cold winter climate of Thunder Bay where the taxpayer lived. The taxpayer and her husband travelled around the world from 1988-2009 to warmer climates for the winter. The taxpayer successfully appealed a reassessment that had disallowed the travel expenses. The taxpayer had argued that similar expenses had been allowed for 2008 in an informal decision of the Tax Court. The trial Judge relied on the 2008 decision in reaching her decision.

The appeal was allowed. The issue is whether the Judge erred in concluding that the disallowed travel expenses were medical expenses. The issue of whether the disallowed expenses constitute medical expenses is a question of mixed fact and law which is to be overturned only if there is an overriding and palpable error. If there is a readily extricable question of law, it is reviewable on the standard of correctness. The taxpayer argued that the trial Judge made findings of fact that the travel expenses were to obtain medical services and there was no overriding or palpable error in reaching that conclusion. However, in following the 2008 decision, the trial judge determined that the issue was the interpretation of "medical expenses" which is a question of law. As such, it must be determined if the Judge correctly determined that the beneficial effects of a warm climate qualifies as a medical service. For travel expenses to qualify as medical expenses the services obtained at the destination must not be available locally, the route must be direct and it must be reasonable to travel for the services. Legislation is to be interpreted in a consistent manner looking at the text, context and purpose. From a textual reading, medical expenses are amounts paid to a medical practitioner or licensed hospital for medical services that are provided to the taxpayer. That determination applies to travel expenses as well. The purpose of the travel component of the medical expense tax credit is to help Canadians who are forced to travel long distances to obtain medical services that are not available locally. The beneficial effects of a warm climate are not services provided to the taxpayer by a person or a hospital and as such they do not qualify as medical services. The trial judge erred in her interpretation as to what constitutes medical services. The disallowed expenses did not qualify as medical expenses.

The Queen v. Tallon, 2015 DTC 5082

Application for extension of time to file appeal granted — applicant acted as soon as circumstances permitted

The applicant was seeking an order to extend the time within which to appeal his assessments for the 2007 and 2008 taxation years. The applicant filed paperwork to appeal six months after notices of reassessment were issued, in the belief that he had eighteen months to appeal. In fact, appeals must be filed within ninety days.

The application for an order to extend the time to appeal was granted. An order extending the time within which to appeal may be granted subject to the conditions set out in the legislation. The applicant must show an intent to appeal within ninety days of receiving the assessment, the application must be made as soon as circumstances permitted, it is just and equitable to grant the application and there must be reasonable grounds for appeal. The respondent argued that the applicant failed to demonstrate an intent to appeal and did not make the application as soon as circumstances permitted. Those grounds concern appeal procedure and while the legislation must be followed, unless non-compliance is clear, the application should not be dismissed on procedural grounds. The applicant's bookkeeper testified that the intent to appeal was formed as soon as reassessments were received following notices of objections being filed. While her testimony was not fully credible, there was enough evidence to support the applicant's belief that he acted as promptly as possible. On viewing all the evidence, it is reasonable to infer that the applicant formed the intent to appeal when he saw the large amounts owing in the notices of reassessment. Filing six months later was reasonable given the time it takes to prepare an appeal and that the applicant was travelling and moving offices. It is not easy for a taxpayer to navigate the appeals procedure. The applicant reasonably relied on the Court's

website when filing his appeal. Neither the Court's website nor the forms for extension applications mention the conditions necessary for a successful extension application. The respondent conceded that the grounds in the notice of appeal were not frivolous. It was just and equitable to grant the application.

Apic v. The Queen, 2015 DTC 1174

Expenses incurred by corporate taxpayer on chocolate spread development project did not qualify for SRED treatment

The corporate taxpayer, a CCPC, was engaged in developing a superior chocolate spread using cocoa butter and milk proteins without synthetic ingredients and conservation agents (the "Project"). In assessing the taxpayer for 2009 and 2010 the Minister disallowed the deduction of the SRED expenses and investment tax credits claimed relating to the Project, on the ground that its activities associated with the Project did not constitute SRED as defined in subsection 248(1) of the Act. The Minister did, however, allow a portion of the alleged SRED expenses to be deducted by the taxpayer as normal business expenses. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was dismissed. To qualify for SRED treatment, a project must involve, among other criteria, a technological uncertainty which cannot be removed using known techniques and usual procedures (see *RIS-Christie v. The Queen*, 99 DTC 5087 (FCA)). In this case the development of the Project involved the use of known procedures and ingredients in an attempt to develop a superior chocolate spread. As a result the work done by the taxpayer in the Project did not meet one of the essential SRED criteria mentioned in the *RIS-Christie* case. The Minister's assessments were affirmed accordingly.

R&D Pro-Innovation Inc. v. The Queen, 2015 DTC 1170

Taxpayer's move not work-related and thus not an "eligible relocation" qualifying for moving expense deductions

In 2003 the taxpayer's long-term employment was terminated. From May 14, 2004 to August 27, 2011 the taxpayer lived on a refurbished boat in which he sailed from Pickering, Ontario, to various locations, including West Palm Beach, Florida. Two months after his return to Pickering from West Palm Beach on August 27, 2011, he commenced living with his mother, and on March 1, 2012 took up self-employment, but later took on full-time employment. In assessing the taxpayer for 2012, the Minister disallowed his attempt to deduct, as work-related moving expenses, expenses incurred in 2011 in sailing for 52 days from West Palm Beach to Pickering and in subsequently storing his boat. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was dismissed. The taxpayer's allegation that his move from Pickering to enable him to start a business at his mother's residence was unsupported by the evidence. He had no specific work plan when he left Florida for Pickering. His move, therefore, was not an "eligible relocation" and hence did not justify his moving expense claim. The Minister's assessment was affirmed accordingly.

Kew v. The Queen, 2015 DTC 1172

Records obtained after CRA engaged in penal investigation excluded from evidence

The Canada Revenue Agency (the "CRA") conducted two audits of companies owned by the taxpayer and his family. The taxpayer was a shareholder of both companies and an employee of one of the companies. In the course of carrying out the audits, the CRA became aware that amounts had been paid to the taxpayer from one of the companies and the amount paid did not accord with the amount of income he reported for tax purposes for the years in question. The taxpayer brought an application seeking a declaration that the information and records obtained through the audit should be excluded from evidence, as the collection of that evidence had breached his rights under sections 7 and 8 of the *Canadian Charter of Rights and Freedoms*.

The application was allowed in part. The Court held that the jurisprudence provides for a distinction between audit and investigative functions under the *Income Tax Act*. When the predominant purpose of an audit is an investigation into a taxpayer's penal liability, there exists an adversarial relationship between the CRA and the taxpayer that precludes the CRA from using its compliance powers. At the point at which that predominant purpose crystallizes, the CRA must, in observance of the taxpayer's Charter rights, cease to rely on its regulatory powers and must resort to warranted searches in furtherance of its penal objectives. The Court reviewed in detail the course of the audit of the companies. It held that from the time the auditor was assigned to carry out the audit until he received the response to his first query, his predominant purpose was non-penal and appropriate. However, the response to that first query provided him with the knowledge that there was a discrepancy between the taxpayer's declared income for 2007 and 2008 and the amounts that had been paid to him by one of the companies during those years. The Court concluded that, at that point, the auditor had reasonable and probable grounds to believe that the taxpayer had committed tax fraud or tax evasion during those years. By the time the auditor sought a response to his second query, his predominant purpose had become a penal investigation into the taxpayer's income tax liability for non-payment of tax on earned but undeclared income. The Court concluded, therefore, that the taxpayer's application to exclude evidence should be dismissed with respect to information provided to the CRA in response to the first query. However, information provided in response to the second query was to be excluded from evidence.

The Queen v. Mori, 2015 DTC 5081

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