TAX FOR THE Owner-Manager

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Tax Collection Powers Limited—for Now?

The CCRA has various statutory powers to collect tax debts (taxes, interest, penalties) owing under the Income Tax Act (ITA). For example, the CCRA can certify an unpaid tax debt and register the certificate in the Federal Court; the certificate is then deemed to be a judgment of that court. Similar powers are granted under provincial tax legislation. In certain cases, provincial tax debts are collected by the CCRA as agent for the provincial Crown.

In *Markevich* (SCC 2003), the taxpayer, a resident of British Columbia, received a notice of assessment in 1986 regarding unpaid federal and BC taxes for the 1980 to 1985 tax years. He did not challenge the assessment, nor did he pay the amounts owing. A portion of the debt was satisfied by the proceeds from the CCRA's sale of his house; the balance of the debt was internally written off by the CCRA. However, this action did not have the effect of legally extinguishing the debt. For about 12 years, the CCRA made no attempt to collect the debt, and accounting statements issued to the taxpayer did not reflect the balance in respect of the 1986 assessment. In January 1998, the CCRA issued a statement of account to the taxpayer that included the tax debt plus accrued interest.

The FCTD dismissed the taxpayer's application for a declaration prohibiting the CCRA from taking any collection action with respect to his tax debts for 1990 and prior years. The FCA allowed the taxpayer's appeal and held that the Crown was statute-barred from collecting his tax debt in respect of the 1986 assessment. The Crown appealed to the SCC.

The issue was whether federal and provincial statutory collection procedures were subject, respectively, to the limitation periods in section 32 of the Crown Liability and Proceedings Act (Canada) (CLPA) and the applicable provision of provincial limitation-period law (such as section 3(5) of the British Columbia Limitation Act (BCLA)). Section 32 of the CLPA would apply if the ITA did not otherwise provide for limitation periods with respect to the collection of tax debts and if the statutory collection procedures qualified as proceedings in respect of a cause of action. The SCC held that the ITA did not provide for such limitation periods, the collection provisions in the ITA did not exclude the operation of section 32 by implication, and the application of the limitation periods to the collection of tax debts did not offend the principles of horizontal and vertical equity. The court also found that the statutory collection procedures in the ITA were proceedings by the Crown in respect of a cause of action, and that section 32 of the CLPA therefore applied to such procedures. The SCC noted that the Crown could take steps to extend the limitation period—for example, by registering a certificate in the Federal Court (*Ross*, FCA 2002, leave to appeal dismissed).

For similar reasons, the SCC held that the limitation period of six years in section 3(5) of the BCLA applied to the BC statutory collection powers under the Income Tax Act (BC). On expiration of the limitation period, by virtue of sections 9(1) and (3) of the BCLA, the province's right and title to the tax debt (including interest) was extinguished.

Section 32 of the CLPA provides that provincial limitation statutes apply if the cause of action arises in a province; otherwise, the limitation period is six years. The SCC in *Markevich* held that tax debts under the ITA arose otherwise than in a province primarily for policy reasons.

In *MacKinnon* (FCA 2003), the court, relying on *Markevich*, held that the limitation period for the collection of a tax debt under the ITA begins to run not when the income is earned but rather as of the time when the tax debt comes into existence and the delay period in section 225.1 of the ITA expires.

As a result of *Markevich*, certain tax debts will now be statute-barred. Taxpayers and their advisers are advised to take steps—including contacting the tax authorities—to ensure that collection proceedings are never taken in respect of statute-barred tax debts.

In This Issue

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The benefits of *Markevich* may be short-lived, however. The federal and provincial governments may amend legislation so that limitation periods in their jurisdictions do not apply to the statutory collection procedures relating to tax debts. For example, the new Ontario Limitations Act, which is supposed to come into force in 2004, provides that, with limited exceptions, there is no limitation period in respect of a proceeding to recover fines, taxes, penalties, and interest on a tax or penalty.

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FCA Takes a Favourable Position on ABILs

Unlike a capital loss, which is deductible only from capital gains, a capital loss that qualifies as an allowable business investment loss (ABIL) is deductible from income from all sources. A debt that becomes bad may qualify as an ABIL, provided that it is disposed of in the year.

When a debt becomes a bad debt, a taxpayer can elect to have disposed of it for nil proceeds pursuant to subsection 50(1) of the Income Tax Act (ITA). However, the debt must have been acquired for the purpose of gaining or producing income from property, or else the resulting loss will be deemed to be nil by virtue of subparagraph 40(2)(g)(ii) of the ITA.

In *Rich* (TCC 2001), the taxpayer's son operated a food supply business through a small business corporation, DSM Foods Inc. (DSM). The taxpayer owned 25 percent of the common shares of DSM and loaned $125,000 to DSM. In 1995, the taxpayer determined that the loan had become bad, elected under subsection 50(1) to dispose of the debt for tax purposes, and claimed an ABIL of approximately $93,000. The minister disallowed the deduction on two grounds: (1) that the loan was not a bad debt in 1995, and (2) that the loan was not made for the purpose of earning income. The taxpayer appealed to the Tax Court.

The court held that the taxpayer did not deal at arm's length with DSM and was required to take steps to collect the debt before determining that it had become a bad debt. Because the taxpayer had not done so, the court decided that he had not made an honest and reasonable determination that the loan was a bad debt in the year. The court also concluded that his predominant purpose in making the loan was to assist his son, not to earn income. The taxpayer appealed the decision (FCA 2003).

The FCA noted that the ITA does not identify the factors to be considered in making such a determination. It referred to the factors outlined in the Tax Appeal Board judgments in *Hogan* (TAB 1956) and *No. 81* (TAB 1953), and said that these criteria are to be applied whether the taxpayer and debtor deal on an arm's-length or non-arm's-length basis. Although a non-arm's-length relationship may be a relevant factor in determining whether a debt is a bad debt, it alone is not sufficient to invalidate a taxpayer's determination that a debt is a bad debt. The predominant consideration will be the creditor's assessment of the ability of the debtor to repay the debt in whole or in part.

Further, the FCA held that where a taxpayer's review of the relevant factors leads to a conclusion that collection of the debt is not reasonably possible, the taxpayer does not have to take proactive steps to collect the debt. This finding expressly contradicts the CCRA's administrative position that a debt is not a bad debt unless the taxpayer exhausts all legal means of collecting the debt or the debtor is insolvent with no means of repaying the debt (*Interpretation Bulletin* IT-159R3, paragraph 10).

The FCA quickly disposed of the income-earning issue, relying on the Supreme Court decision in *Ludco* (SCC 2001). Although the taxpayer's predominant purpose may have been to assist his son, his subordinate purpose was to earn income. This was sufficient to meet the test.

The FCA's decision in *Rich* is a reasonable approach to the provisions at issue and is a welcome clarification of this branch of the law. Clearly, the ABIL rules are designed to encourage investments in the debt and equity of small business corporations. This policy would be undermined if the rules were given an unduly restrictive interpretation and if a more onerous standard for deduction was imposed where the debt is owed by a party not at arm's length with the creditor. Family members are an important source of capital for small business owners. The *Rich* decision ensures that they will not be disadvantaged by being subjected to a more restrictive ABIL test than that applied to an arm's-length investor.

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De Facto Control: Subsection 256(5.1)

Before subsection 256(5.1) of the Income Tax Act (ITA) was introduced in the federal budget of February 1998 (effective in 1989 or 1990, depending upon the circumstances), control for purposes of the ITA meant de jure (legal) control—that is, having sufficient votes to elect the board of directors: *Buckerfield's* (Ex. Ct. 1964). A number of court cases, however, held that legal control existed in circumstances that looked suspiciously like de facto control (control in fact). See, for example, *Oakfield Developments* (SCC 1971) and *Imperial General Properties* (SCC 1985).

Even if legal control is not present, subsection 256(5.1) can nevertheless deem control to exist. It applies for all purposes of the ITA wherever the expression "controlled, directly or indirectly in any manner whatever" is used. The two most common circumstances in which the provision has been reviewed by the courts are in connection with Canadian-controlled private corporation (CCPC) status and the associated-corporation rules. Only time will tell whether, now that subsection 256(5.1) exists, the courts will attempt to interpret de facto control as de jure control in connection with provisions to which subsection 256(5.1) is not intended to apply.

Subsection 256(5.1) deems a corporation to be controlled by another corporation or by a person or group where "the controller has any direct or indirect influence that, *if exercised*, would result in control in fact." Statutory exceptions are provided in cases where the controller and the controllee are dealing with each other at arm's length "and the influence is derived from a franchise, licence, lease, distribution, supply or management agreement," the main purpose of which governs how the controllee is to carry on business.

It is important to note that subsection 256(5.1) can apply even if the influence that would give control, though present, is not exercised.

Interpretation Bulletin IT-64R4 sets out the CCRA's views on when subsection 256(5.1) is applicable. The jurisprudence to date indicates that subsection 256(5.1) control exists in the following circumstances:

- A shareholders' agreement provides a director with a casting vote: *Multiview* (TCC 1997).
- A person or group has a clear right and ability to effect a significant change in the board of directors or its powers, or to influence in a very direct way the shareholders who would otherwise have the ability to elect the board: *Silicon Graphics* (FCA 2002).
- There is economic dependence (see below): *Transport M.L. Couture* (TCC 2003); *LDG 2000* (TCC 2003); and *Mimetix Pharmaceuticals* (FCA 2003).
- There is operational control (see below): *Transport M.L. Couture* and *Société Foncière* (TCC 1996).
- Operations are integrated (for example, there are cross-guarantees of debt): *LDG 2000*.
- There are close familial connections among the shareholders that would allow a person to influence directly shareholders who could choose the board of directors: *Transport M.L. Couture*.
- The operations of a corporation are directed by a person or group: *LDG 2000*.

Economic dependence has been held to exist in the following circumstances:

- The controllee was the only client of the controller.
- A corporation legally controlled by the controller was virtually the only customer of the controllee.
- A corporation legally controlled by the controller procured financing for the controllee.
- The controller was the only investor in the controllee's business.
- The controller granted the controllee a sublicence for no consideration.
- The controller loaned the controllee a large sum without interest.

Operational control was held to exist where the controllee had no employees or place of business of its own and these were supplied by the controller.

The concepts of economic dependence, operational control, and integration of operations overlap somewhat. Because the finding of de facto control depends on the facts in each case, the specific label attached to a particular concept is perhaps of academic rather than practical interest. The difficult question for advisers is when the degree of influence exerted by a third party in any particular case is sufficient to bring the relationship within the de facto control rules.

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Capital Dividends: Practice Update

Under subsection 83(2) of the Income Tax Act, a private corporation may elect to have a dividend that becomes payable treated as a capital dividend. Generally, two conditions must be met for the election to be valid:

1) The election must be filed on time. The due date for filing is the *earlier* of the particular time at which the dividend becomes payable and the day on which any part of the dividend is paid.

2) The election must be filed in prescribed form. This means filing a copy of form T2054, a certified copy (not the original; see below) of the resolution declaring the dividend and authorizing the election, and a schedule showing the computation of the corporation's capital dividend account.

Because the time between the decision to distribute a capital dividend and the completion of the prescribed form is often limited, the filing requirements are sometimes completed by an adviser who is not a lawyer. Many such advisers do not know the difference between an original resolution and a certified copy;

thus, the original executed copy of the resolution has sometimes been submitted with form T2054. In the past, the CCRA has been flexible and accepted an original resolution as part of a valid election. This is no longer the case, however. It is our understanding that when an original resolution is submitted, the CCRA will now send a letter indicating that the election is invalid and giving the taxpayer 30 days to rectify the situation by submitting a certified copy of the resolution.

What is the difference between an original resolution and a certified copy? A certified copy of a written resolution of the directors or shareholders of a company is a duplicate copy of the resolution passed by the directors (or by the shareholders where they are authorized to do so) that has been certified by an officer of the company (preferably the company's secretary) to be a true copy of the original written resolution as signed by the directors or shareholders. Because a written resolution is proof that all necessary corporate action has been taken by the company to approve the subject matter of the resolution, it is often requested during the course of completing a transaction to ensure that the company has been properly authorized to do as it intends. However, the original resolution cannot be tendered to show that all such necessary action has been taken, since the corporate law requires that the company retain the original in its permanent records. The corporate law provides that a copy of the resolution, certified to be a true copy of the original, is sufficient evidence of the doing of the matters described in the resolution; this is why the filing requirement refers to a certified copy rather than the original copy of the resolution.

Failure to follow the proper procedure can result in more than merely the embarrassment of a 30-day letter. Advisers who execute certified copies before the original is passed in order to submit form T2054 could find themselves faced with a practical as well as an ethical dilemma. What if the directors or shareholders subsequently refuse to execute an original because of a falling out among the parties? Similarly, what if circumstances make it more difficult to get a certified copy well after the original has been executed?

Although serious time pressures are often inherent in many transactions that involve the making of the election to distribute a capital dividend, the adverse tax consequences of an invalid election can be even more serious. Advisers should ensure that the proper procedure is carried out by having an original resolution executed, followed by the completion of a certified copy for filing.

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Minimizing Interest and Penalties

When a taxpayer is faced with deciding whether to contest the CCRA's assessment of tax, he or she may also find it useful to consider strategies for minimizing any interest and penalties that may become payable.

Settlement discussions can arise at various times during the assessment and post-assessment process. Potential savings are greatest if the settlement is reached early in the process. Before submitting a settlement proposal, however, the taxpayer should take account of a number of matters.

First, and most obviously, all the relevant facts must be established at the earliest possible date. The CCRA will make its assessment on the basis of its understanding of the facts available to it. It is sometimes possible to persuade an auditor not to make an assessment at all by bringing forward facts that the taxpayer did not disclose because he or she believed them to be irrelevant.

Second, if an assessment has already been made, it is in the taxpayer's interest to establish which facts the auditor took into account and whether there are additional facts that cast a different light on the taxpayer's liability. The facts known to the auditor are often disclosed in the course of meeting with an appeals officer after a notice of objection to the assessment has been filed. The auditor's T-20 report is a useful document in this regard. It is usually produced upon the taxpayer's request; but if the appeals officer refuses to deliver a copy, the taxpayer should seek to obtain it under access-to-information procedures. When the taxpayer's adviser has uncovered all the relevant facts and has determined which of those were known to and considered by the auditor, a reasoned decision regarding a settlement offer can be made.

Third, if it is apparent that some or all of the assessed tax will have to be paid, the taxpayer should consider whether any interest or penalties accruing on the tax can be reduced or forgiven. *Information Circular* 92-2 sets out the circumstances in which the CCRA will consider granting relief. The usual grounds for doing so are circumstances that were outside the taxpayer's control (for example, flood or fire, serious illness, or death in the immediate family) or improper actions on the part of the CCRA (including a failure to process the taxpayer's case in a timely manner). The taxpayer's inability to pay the interest and penalties may also be a relevant factor.

Fourth, taxpayers and their advisers should remember that—in theory, at least—the CCRA is not authorized to make any settlement that is not supported by the provisions of the Income Tax Act. Contrast this with a civil litigation, in which the parties are free to settle on any mutually acceptable basis regardless of the applicable law: they may settle because they want to avoid publicity, because they are concerned about the costs of proceeding to trial, or because they have decided that the risk of failure outweighs the chance of success. None of these factors is relevant in a decision to settle a tax dispute. The adviser who frames the settlement offer in terms that can be supported under the Income Tax Act—not in terms of purely pragmatic or practical considerations—increases the likelihood that the CCRA will accept the offer.

In general, the CCRA will not exercise its discretion to waive interest and penalties unless the taxpayer has taken reasonable steps to comply with the Income Tax Act—or at least has taken reasonable steps to minimize non-compliance. In this regard, the CCRA will consider the following factors:

- Was the real reason for the non-compliance an attempt by the taxpayer to take retroactive advantage of changes in the law?
- Is there sufficient documentation to verify the facts on which the waiver claim is based?
- Has the taxpayer shown respect for the tax laws in his or her conduct?

There is no prescribed form for requesting a waiver of interest and penalties; a simple letter will usually suffice.

Taxpayers and advisers should be aware that their success in settlement matters often will depend on intangible factors, such as their credibility and their ability to win the respect and confidence of the CCRA. Settlements are seldom achieved if hostility and recrimination are allowed to get in the way of informed and cooperative negotiation.

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CCPC Planning: Intercorporate Management Fees

The CCRA's position on the deduction of intercorporate management fees has not changed recently. However, some practitioners and taxpayers assume that these management fees will be treated in the same way as salaries or bonuses paid from a Canadian-controlled private corporation (CCPC) to an owner-manager. Often, this is not the case.

Generally speaking, the CCRA does not challenge the reasonableness of salaries or bonuses paid to a principal shareholder who is active in a corporation's business, provided that there is a history of distributing profits to the employee-shareholder, or that the employee-shareholder is being rewarded for his or her special expertise. However, the CCRA does not extend this administrative position to management fees because of its concern about the inappropriate multiplication of the small business deduction and the intercorporate transfer of losses.

Under paragraph 18(1)(a) of the Income Tax Act, a management fee is deductible if it is incurred by the taxpayer for the purpose of gaining or producing income from a business or property. Section 67 adds the requirement that the management fee must be reasonable. It is usually easy to determine whether the income-earning requirement has been met; however, the reasonableness of a management fee can be determined only on a case-by-case assessment of the facts.

The CCRA has considered the deductibility of management fees in a number of technical interpretations (TIs), and will take into account the following factors:

- the nature of the service rendered,
- the time expended in performing those services, and
- the fees that would be paid to obtain the services from other sources.

For example, TI 2001-0114993 illustrates the CCRA's concern that management fees might be used to allocate profit rather than to pay for actual services rendered. In that TI, the CCRA was asked about the deductibility of management fees paid from Opco to Holdco and then to the shareholders of Holdco. The CCRA confirmed that it would not extend its administrative policy on salaries to management fees and suggested instead that the remuneration be paid directly to the individuals active in Opco's business.

Three court cases address the reasonability of management fees: *Bronson Homes* (TCC 1993), *Pazner Scrap Metals* (TCC 1991), and *Agriculture and Industrial Corporation* (TCC 1991). In each case the court held that the taxpayer will be expected to provide evidence that the management fee was incurred to earn income and that the amount of the fee was reasonable. Usually, this means showing an agreement in writing to pay the fee.

The court upheld the assessment in *Bronson Homes*, where there was no documentation for the management fee. Although there was evidence that management fees had been incurred, documentary evidence supporting the work performed by the holding company was lacking. In *Pazner*, the court said that although there was a written agreement, it lacked the features necessary to substantiate the integrity and reasonableness of the management fee. The parties were inconsistent in following the terms of their agreement, especially with respect to the calculation of the fee. The court held that certain components of the management fee were not reasonable and therefore were not deductible.

These decisions make it clear that when the issue of deductibility goes to court, it will be up to the taxpayer to prove that the fees were incurred to earn income (generally, by showing that services were provided under a written agreement) and that the amount of the fee was reasonable (by leading evidence regarding the nature, amount, and continuity of the services provided).

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GAAR and the Concept of Tax Benefit

The recent decision in *Canada Trustco* (TCC 2003) is significant for those involved in complex financing transactions. The taxpayer entered into a sale and lease-back transaction in circumstances in which it appeared to have little or no commercial risk because of ancillary financing arrangements. The minister used the GAAR to disallow the taxpayer's claim for capital cost allowance (CCA) on the purchased assets. The court refused to uphold the GAAR assessment and allowed the appeal.

Canada Trustco is one of the few cases to date in which the court has attempted to deal in any detail with the concept of "tax benefit."

Canada Trustco Mortgage Company (CTMC) bought $120 million worth of truck trailers from Transamerica Leasing Inc. (TLI), an arm's-length party. The trailers were then circuitously leased back to TLI. As a general rule, regulations 1100(15) to (19) of the Income Tax Act provide that CCA on leasing property cannot be deducted from non-leasing income. Section 16.1 and regulations 1100(1.1) to (1.3) further restrict the amount of CCA available in respect of "specified leasing property." Certain properties, including trailers, are exempt from these rules.

For its 1997 taxation year, CTMC claimed CCA on the trailers in excess of its leasing income from them and deducted the excess from other leasing income. The CCRA applied the GAAR to deny the tax benefit arising from this CCA on the basis that there was a misuse of the relevant provisions of the Act and regulations, or an abuse of the provisions of the Act read as a whole, because CTMC was not at risk for the purchase price of the trailers and therefore should have no "cost" of them for tax purposes. Alternatively, the Crown argued that the "specified leasing property" rules were intended to apply only in circumstances in which there was a "true" financing of assets. There was no such financing here, because no part of the purchase price of the trailers was available to the vendor for use in its business. (The proceeds of sale were applied as prepaid rent under the lease, and deposited with the bank that provided the purchase money financing as security for repayment of the purchase money loan.)

The court adopted the approach to section 245 set out in *OSFC Holdings Ltd.* (FCA 2001). Although it found that there was both a tax benefit and an avoidance transaction, the court held that the GAAR was not applicable because there was no misuse or abuse as required by subsection 245(4). In reaching his conclusion, Justice Miller first analyzed whether the deferral of tax constituted a tax benefit. The taxpayer argued that the concept of tax benefit is a comparative one. When this transaction was compared with one that involved a standard sale-leaseback (that is, one in which the purchaser/lessor of the assets was at risk), no tax benefit arose as a result of those transactions: the tax deductions claimed were exactly those that would have been claimed if CTMC had been at risk.

The Crown argued that as a matter of statutory construction it was not necessary to identify a comparable transaction to decide whether the impugned transactions gave rise to a tax benefit. In this particular case, the tax benefit was the deferral of tax arising by reason of the CCA deduction. In *McNichol* (TCC 1997) and *Canadian Pacific Ltd.* (TCC 2000), Justice Bonner suggested that finding a comparable was a required part of the tax-benefit analysis. Justice Miller distinguished those cases and said that although some cases may lend themselves to a comparative analysis, such an approach may not fit in other situations. He also noted that this case concerned a commercial venture whose very essence involved tax implications; therefore, there was no simple tax-untainted transaction to which these transactions could be compared.

Justice Miller observed in passing that he was not satisfied that a comparative test is even a necessary precondition to a finding of tax benefit as a matter of statutory interpretation. It remains for another court (perhaps the Court of Appeal in this case) to make such a definitive finding.

It seems clear that Justice Miller used a normative transaction approach in this case by comparing the actual tax result of the transactions with a "no-transaction" standard. He concluded that, after the transactions were taken into account, the taxpayer enjoyed a deferral of tax in comparison with what its position would have been without the transactions, and that this deferral was a tax benefit. To the extent that the decision does adopt a comparative approach, it is consistent with the two cases noted above as well as with several other cases in which a similar approach seems to have been adopted.

Justice Miller's comments might also be interpreted as setting out two separate tests for determining whether a tax benefit exists. Where there is a real commercial venture, the appropriate standard is a presumed normative transaction. Where there is not, the normative transaction is based on a "no-transaction" hypothesis. Justice Miller's approach can be reconciled with Justice Bonner's comments by saying that the determination of a tax benefit requires a comparison of the result of the actual transaction with the most likely transaction the taxpayer would have undertaken in the circumstances. If a transaction really is tax-driven, the "no-transaction" hypothesis may then be the appropriate normative transaction.

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Ceasing To Be a Director

Directors can face significant liabilities for a corporation's failure to remit taxes. The three main sections that impose liability are subsection 227.1(4) of the Income Tax Act (ITA), section 322 of the Excise Tax Act (ETA), and section 43(5) of the Ontario Retail Sales Tax Act (RSTA).

A director's liability is not open-ended: statutory limits apply, and in appropriate cases a due diligence defence is available. One important provision limits to two years the time within which an assessment may be brought against a director for taxes unremitted by the corporation: see subsection 227.1(4) of the ITA, subsection 323(5) of the ETA, and section 43(5) of the RSTA.

Netupsky (TCC 2003) is a recent case that is helpful for a director who is struggling to prove non-involvement in a corporation's affairs for more than two years. It focuses on the importance of knowing what constitutes a valid resignation as a director, and when that resignation becomes effective.

Netupsky was the president and sole director of his company. He resigned as a director in 1995 by delivering a written resignation to the registered office of the company. The resignation was deposited in the company's minute book on December 14, 1995—more than two years before he was assessed as a director. However, the appropriate notice was not filed with the BC corporate registry, nor was the resignation entered in the company's register of directors. When the CCRA assessed directors' liability, it conducted a search of the BC provincial corporate registry and, finding Netupsky to be a director, assessed him.

At the Tax Court, the CCRA took the position that Netupsky's purported resignation was not valid because both the provincial corporate registry and the company's own register of directors still listed him as a director at the time the assessment against him was made. The Tax Court ruled that the resignation was valid because it was carried out in the manner prescribed in section 154 (now section 130) of the BC Company Act, which, at the relevant time, provided as follows:

> (1) A director ceases to hold office . . . when he (a) dies or resigns. . .
> (2) *Every resignation of a director becomes effective at the time a written resignation is delivered to the registered office of the company* or at the time specified in the resignation, whichever is later. (Emphasis added.)

The court held that the resignation became effective on delivery of a written resignation to the registered office of the company. Its effectiveness did not depend on delivery of a notice of resignation to the registrar of companies. Under the BC corporate statute, the company, not the director, is required to file the notice.

The Tax Court held that Netupsky's resignation was valid, and because it was tendered more than two years before the assessment, Netupsky was not liable for the assessment.

Netupsky underscores the importance of ensuring that a director's resignation is formally tendered to the corporation as soon as possible after the director decides to resign. That will start the clock ticking on the limitation period in most cases, thereby minimizing the director's exposure for any unremitted tax.

Although Netupsky was successful in relying on the technical requirements of the corporate law, the decision illustrates the practical importance of ensuring that any other corporate, legal, and quasi-legal requirements are also met. Understanding and abiding by the resignation requirements in the corporate legislation is just the first step in that process. In this regard, provisions similar to section 154 of the BC Company Act are found in section 108 of the Canada Business Corporations Act and section 121 of the Ontario Business Corporations Act. Note, however, that section 19(2) of the OBCA prohibits the resignation of a director named in the articles unless a successor is appointed or elected.

Although the court's decision, correctly, in our view, states the legal requirements for a valid director's resignation, in our experience neither the CCRA nor Ontario observes these requirements at the administrative level. Rather, they proceed on the basis that the resignation is not effective until the notice is filed with the Companies Branch. A director concerned about possible

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personal liability should ensure that the notice is filed with the ministry and delivered to the corporation.

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REOP Revisited

In *Stewart* (SCC 2002), the Supreme Court of Canada said that a reasonable expectation of profit (REOP) was not the determining factor in deciding whether a particular activity constituted the carrying on of a business. The court criticized the use of the REOP test as a tool for second-guessing a taxpayer's bona fide commercial decisions, especially where there was no personal element in the commercial activity. The court did say that where the activity involves aspects of a hobby or a personal pursuit, the existence or non-existence of a REOP may be an important factor in determining whether the activity constitutes a source of income (or loss) for tax purposes.

As the post-*Stewart* jurisprudence develops, it is interesting to watch the courts grapple with the question of exactly when an activity has an element of hobby or personal choice attached to it. Hobby farmers have the longest history here, but writers, painters, sculptors, and inventors have also attracted the CCRA's attention by claiming losses from their ventures against income from other sources. The decision in *Leblanc* (TCC 2002) is another instructive example. The taxpayer, a musician, suffered losses in the 1992-1994 tax years. The minister denied the deduction of the losses on the basis that the taxpayer was not engaged in a commercial activity and thus had no REOP. Associate Chief Justice Bowman allowed the appeal "without hesitation" and went on to make comments that should be noted by any adviser involved in a REOP case.

The starting point in these cases is a factual analysis based on ordinary principles of commercial common sense. One looks at such things as the capitalization of the activity, the knowledge of the participant, and the time spent pursuing the activity in comparison with the other source(s) of income. It is important to consider whether the taxpayer has gone about the activity in a businesslike way. Justice Bowman noted that the 60-year-old Mr. Leblanc had devoted his life to music; he spent all of his time in music-related activities, including composing, publishing, and promoting his work. During the years under appeal, he had very little income from his music; hence the losses. Neither the amount of the expenses claimed nor their reasonableness was challenged; the issue was really the minister's view that there was no REOP.

For the CCRA, artistic endeavours are particularly difficult when the question is the existence or non-existence of a business. There is often an unconscious bias on the CCRA's part: artists like being artists, after all, and they would pursue an artistic career whether or not it made money. This presumption is reinforced when the artist reports losses rather than income. In fact, in *Interpretation Bulletin* IT-504R2 the CCRA acknowledges that a taxpayer may not realize a profit during his or her lifetime but may still have a REOP. In practice, however, not all assessors are this sensitive to the realities of an artistic calling.

Justice Bowman has led the criticism of an unduly narrow approach to the use of a REOP test as the determining factor in deciding for or against a business. He has consistently pointed out that the real test is the "commerciality" of the venture. The fact that the taxpayer pursues the vocation out of a love for the activity should not be a bar to finding that the activity constitutes a business if the venture otherwise meets this test. When losses are claimed, the initial question is whether the expenses incurred are personal or living expenses. If they are not, the REOP test must be applied only with extreme care. Leblanc obviously loved music and devoted all of his time to his musical activities. He was a recognized composer and had published songs, recordings, and CDs to his credit. In allowing his appeal, the court found that his activities were organized in a businesslike way, and that they went beyond a hobby and constituted a business.

Justice Bowman's analysis identifies the factors that ought to be considered in REOP cases, and cites a number of cases involving other types of activities in which the courts have held in favour of the taxpayer. Although cases of this kind tend to be fact-specific, *Leblanc* is a most useful precedent for anyone fighting a REOP-based assessment.

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