Focus

BUSINESS LAW

The connectivity requirement

A pair of Tax Court cases rule against taxpayers deducting legal fees

Peter Aprile

Late last year, the Tax Court of Canada released its reasons for judgment in *Ironside v. Canada* [2013] T.C.J. No. 298, and *Gouveia v. Canada* [2013] T.C.J. No. 353. In *Ironside* and *Gouveia*, the Tax Court considered the deductibility of legal fees the taxpayers incurred to defend against charges the Alberta Securities Commission and Ontario Securities Commission, respectively, brought against them. The facts and primary arguments in *Ironside* and *Gouveia* were similar and, therefore, we will highlight the salient facts for brevity.

In *Ironside*, the taxpayer, an accountant, earned business income as officer and director of a corporation in the oil and gas industry (BRRC). However, at the time he was BRRC's officer and director he was not practising as an accountant. He earned income through his BRRC roles.

BRRC was victim to a hostile takeover and Ironside was forced to resign. After the takeover, Ironside earned business income from his new chartered accounting practice. The ASC subsequently opened an investigation to determine whether he acted contrary to the securities legislation in his role as BRRC's officer and director. Ironside incurred legal fees to defend against the charges and deducted these legal fees from the income he earned from his chartered accounting practice on the basis that the ASC charge would lead the Institute of Chartered Accountants to take disciplinary action, cancel his registration as a chartered accountant, and prohibit him from gaining or producing income in this capacity.

In *Gouveia*, Gouveia was employed as a freezer company's director and officer (Atlas). In 2002 and 2003, Gouveia reported the employment income he earned from Atlas along with business income earned from a sole proprietorship management consultancy business. In 2003, Gouveia resigned from Atlas. The OSC brought charges against Gouveia related to his conduct while working for Atlas, and a class action lawsuit was initiated against Atlas as well. He incurred legal fees to defend against the charges and deducted these legal fees from the income he earned from his consultancy practice on the basis that the OSC charges, and the lawsuit, would impact the income he could earn from his consultancy practice.

Stated simply, the taxpayers' primary submissions in *Ironside* and *Gouveia* were that the subject legal fees were incurred to protect their new businesses and preserve their ability to earn income from these businesses.

The Tax Court considered whether the legal fees were incurred for the purpose of earning business income. The Tax Court reviewed the factors that the Supreme Court of Canada considered in *Symes v. The Queen* [1993] S.C.J. No. 131, to determine whether the legal fees were incurred for the purpose of earning business income:

- First, whether the expense was the type that similar businesses would normally incur, and

Hypothetical, Page 12

Focus BUSINESS LAW

Hypothetical: Expenses must be business related, not personal

Continued from page 10

whether the deduction is ordinarily allowed as a business expense by accountants.

- Second, whether the particular expense would have been incurred if the taxpayer was not engaged in the pursuit of business income.
- Third, whether the need to which the expense related would have existed "but for" the business.

The Tax Court held that the central component the *Symes* factors attempt to reveal in these types of cases is the connectivity between the need which the expense meets and the business itself. Moreover, the connection between the expense and the earning of the income must be direct and immediate in time. If the connection is too hypothetical, speculative, remote or distant in time, the expense is not deductible. "Not only must taxpayers adduce evidence of a direct relationship between the 'need that the expense meets' and the business, but they must also establish a connection between the expense and the ability of the taxpayer to earn future income from that business," ruled Justice Diane Campbell in *Ironside*. "This adds another dimension to the thread of the connectivity requirement that runs through the caselaw."

> Not only must taxpayers adduce evidence of a direct relationship between the 'need that the expense meets' and the business, but they must also establish a connection between the expense and the ability of the taxpayer to earn future income from that business.
>
> **Justice Diane Campbell**
> Tax Court of Canada

In *Ironside* and *Gouveia*, the Tax Court concluded that the need to defend was not directly related to the subject businesses. In addition, the legal fees were severable from the income-earning operations and not a consequence of the risk of earning income from the subject businesses. Ironside did not incur the legal fees in the course of his accounting business. Instead, he incurred the legal fees while working at BRRC. The Tax Court held that the connection between these legal fees and Ironside's accounting business was too remote. Similarly, Gouveia did not incur his legal fees in the course of his consultancy business; they were a direct result of his Atlas directorship and office. In these circumstances, the legal expenses were personal and not incurred to protect actual, or potential, consulting business income. The Tax Court dismissed bot of the appeals.

The Tax Court's decisions in *Ironside* and *Gouveia* indicate that the connectivity analysis will play an important role for the courts in determining the deductibility of legal fees to defend against regulatory offences, civil actions and criminal charges.

Peter Aprile, principal of ATX Law, is a tax dispute and litigation lawyer. His practice is focused on representing individuals, small and medium sized businesses in tax disputes with the Canada Revenue Agency. He has obtained favourable results for clients across a wide range of tax issues at all stages including the Tax Court of Canada and Federal Court.

A not-for-profit spin on the oppression remedy

Nick Porco

Ontario's *Not-For-Profit Corporations Act, 2010* (NPCA), which is expected to be proclaimed into force this year, is a stand-alone piece of legislation governing the rights and obligations of not-for-profit corporations (NFP). While modelled after the *Business Corporations Act* (BCA), the NPCA does not contain a specific "oppression remedy" section. However, it does contain similar language in two distinct sections meaning that the oppression remedy, as found in these two acts, may coincide.

In a "for-profit" corporate environment, stakeholders' reasonable expectations usually involve financial interests. However, an NFP's mandate is service rather than profit, and as such, members' financial interests are less central. As a result, statutory remedies are generally tailored to ensure that the respective members of an NFP are treated fairly, rather than safeguarding their profit motive. This vantage point is seen at play in sections 136 and 174 of the NPCA.

Section 136 allows a court to wind up an NFP corporation. Its language is similar to section 248 of the BCA, with one notable exception — the familiar term "oppressive conduct" is not present. Rather, section 136 limits the winding-up remedy to actions that are unfairly prejudicial or unfairly disregard the interests of a member, creditor, director or officer. In *BCE Inc. v 1976 Debentureholders*, the Supreme Court in 2008 noted that "oppressive" conduct is more serious and more offensive than conduct described as "unfairly prejudicial" or "unfairly disregards," calling it "burdensome, harsh and wrongful." By choosing to eliminate oppressive conduct from the purview of section 136, the NPCA is implying that the higher standard of burdensome, harsh and wrongful is not required in order to seek a "winding up" of a NFP. This makes sense given that fairness is a guiding theme in an NFP's operations. The higher standard of oppressive conduct is simply not needed in order to wind up an NFP, as once it is established that the activities unfairly disregard or are unfairly prejudicial to its membership *et al*, the purpose of the NFP ceases.

Section 174 allows an NFP member or debt obligation holder to apply to the court for the appointment of an inspector in order to investigate the affairs of an NFP. Section 174 also contains language similar to section 248 of the BCA and, unlike section 136, includes the "oppressive" conduct triggering event. Specifically, subsection 174(2) enables a court to appoint an inspector if, inter alia, "the activities or affairs of the corporation or of any of its affiliates are or have been carried on or conducted, or the powers of the directors are or have been exercised, in a manner that is oppressive or unfairly prejudicial to or unfairly disregards the interests of a member or debt obligation holder." Upon making that order, a court is then empowered to "make any order that it thinks fit." This is a broad remedial power akin to the powers granted to a court under section 248 of the BCA. It is interesting to note that the higher standard of "oppressive" conduct is included in the investigation section when the remedies available are broader than those contained in the winding-up section of the NPCA.

JUANLJONES / ISTOCKPHOTO.COM

One further issue that arises is whether an applicant's "reasonable expectations" play a role in obtaining the respective remedies under sections 136 and 174 of the NPCA. The "oppression remedy," as the Supreme Court noted in *BCE Inc.*, "is an equitable remedy." It seeks to ensure fairness — what is "just and equitable." It gives a court broad, equitable jurisdiction to "enforce not just what is legal but what is fair." Sections 134, with its omission of "oppressive" conduct combined with its specific and limited relief, would not invoke the court's equitable jurisdiction. As such, it would not require an analysis of a claimant's "reasonable expectations." However, section 174 is more open in terms of the relief that an applicant may seek. Like section 248 of the BCA, section 174 gives a court wide latitude in terms of the remedies available to aggrieved parties. The court is entitled to invoke its equitable jurisdiction in order to rectify complaints. Presumably, reasonable expectations should, therefore, play some role when seeking ancillary relief to the appointment of an inspector.

On the whole, the NPCA is both welcomed and needed. It ensures that NFPs can operate under their own unique legislation, separate and apart from the legal burdens and obligations associated with "for-profit" legislation. While the NPCA is modelled after the BCA, its goals and objectives are different. The underlying goal for members is one of fairness. Thus, while law applicable to section 248 of the BCA, such as the oppression remedy, may assist an applicant in defining the acts of "oppression," "unfairly prejudicial" and "unfairly disregards" in sections 136 and 174 of the NPCA, the substantive and existing oppression remedy law may assist an applicant only in relief ancillary to the appointment of an inspector pursuant to section 174.

Nick Porco is a lawyer with BPR Litigation Lawyers, who practises business-related litigation as well as complex corporate commercial disputes.

We want to hear from you!
Send us your verdict:
comments@lawyersweekly.ca