THE LAWYER'S DAILY

**The Lawyer's Daily** | 111 Gordon Baker Road, Suite 900 | Toronto, ON M2H 3R1 | www.thelawyersdaily.ca
Phone: (800) 668-6481 | Fax: (905) 479-3758 | John.Carson@lexisnexis.ca

**Tax**

# Federal Court of Appeal reverses Tax Court decision on litigation expenses

By **Amanda Jerome**

(March 27, 2018, 9:40 AM EDT) -- The Federal Court of Appeal has allowed the appeal of a Tax Court of Canada decision in a move lawyers say demonstrates that corporate entities who incur litigation expenses after a business has been wound should not be denied Input Tax Credits (ITCs).

In *Onenergy Inc. v. Canada* 2018 FCA 54, the court heard that the appellant, ONEnergy Inc., had been conducting business under the name Look Communications, a telecommunications business that operated in Ontario and Quebec.

According to court documents, the business was unsuccessful and in December 2008 the company announced Look would be "wound up" and its assets sold. By the following spring, Look had reached an agreement to sell its 100 MHz licence spectrum and its CRTC broadcast licence for $80 million.

When Look was in operation it had a share option plan and a "share appreciation rights plan" (SAR), which provided that certain share rights could be awarded to directors, employees and consultants by Look's board.

According to court documents, when a share right was exercised Look would make a payment to the rights holder in "an amount equal to the difference between the fair market value of the shares of Look when the rights were exercised and when the rights were awarded."

By 2009, various directors, executives, shareholders and employees held significant amounts of share rights. According to court documents, during the time between the sale of assets being announced and the closing transaction Look's board cancelled all options and share rights and used a valuation of $0.40 per share. The board also set aside $11 million for a severance retention and bonus pool.

The proceeds from the business' sale was $64 million and payments for the cancellation of options and shares, as well as bonuses, were made to former executives. According to the court, Look's shareholders opposed what they considered an excess of payment to the former executives in the amount of $14,700,000. They commenced action at the Ontario Superior Court of Justice against the former executives to recover the funds.

"The issue in this appeal relates to the GST or HST paid by Look in relation to the legal services provided with respect to the lawsuit that Look commenced against the Former Executives," wrote Justice Wyman Webb on the appeal.

He noted that the question before the court was, under rule 58 of the *Tax Court of Canada Rules* (*General Procedure*), "whether, on the facts agreed to by the Parties and any other facts found by the Court, the Appellant is deemed to have incurred litigation costs in the course of a commercial activity pursuant to subparagraph 141.1(3)(a) of the *Excise Tax Act* (the "Act")."

Justice Webb noted that the Tax Court judge, Justice Campbell Miller, while applying subsection 141.1(3) of the *Excise Tax Act* found that there was a difference between "winding down a business" and "winding down a corporation."

"While he found that the Spectrum sale was part of the commercial activities of Look, the litigation against the Former Executives was not," Justice Webb wrote, adding that Justice Miller also determined that any connection between the litigation and the winding down of the corporation was not sufficient to allow Look to claim input tax credits for the GST or HST paid in relation to the legal services used against the former executives.

The Federal Court of Appeal noted that Justice Miller found that section of the *Excise Tax Act* to be broadly worded while describing the legal expenses incurred by Look to be "as close to what I would consider a 'personal expense' in a corporate context as I can imagine."

Adrienne Woodyard, DLA Piper

Justice Webb agreed that s. 141.1(3) is broadly worded, but wrote that Justice Miller made a "palpable and overriding error in finding that the amounts paid for legal services were 'personal' and that there was no connection between the litigation and the source of the funds used to pay the Former Executives."

"The disputed amounts were paid to the Former Executives for their cancelled options and SARs and as a bonus. The options and SARs would have been part of the compensation or remuneration payable to the Former Executives and the bonus would also be remuneration paid to these persons," wrote Justice Webb.

"Although the legal basis for the claim against the Former Executives may be a breach of fiduciary duty, the result of that breach (if established) would be an overpayment of remuneration. Therefore, in my view, the litigation should be characterized as a claim for overpaid remuneration," he added.

Justice Webb described the remuneration as "not personal" because it would have been paid for services rendered as part of Look's commercial activities or the termination of those activities.

"The amounts paid to the Former Executives were therefore inextricably linked to the sale of the Spectrum and License and there was a direct connection between the source of the funds (the proceeds from the sale of the Spectrum and License sale) and the litigation. The legal expenses incurred to attempt to recover any overpaid remuneration were not personal," he explained in his decision.

Justice Webb wrote that the connection between the termination of Look's commercial activity and the legal services acquired for the litigation against the former executives is sufficient enough to permit Look to claim the input tax credits for the GST or HST paid in relation to those legal services.

Justice Webb, with Justices David Near and Mary Gleason in agreement, determined in a decision released March 19 to allow the appeal, reversing the decision of the Tax Court.

Adrienne Woodyard, a partner at DLA Piper who specializes in tax law, said this decision provides "surer footing" to argue that a corporate registrant who incurs expenses after the windup of its business but before, or during, the winding down of the corporation itself should not be denied ITCs.

"It also supports the argument that expenses should not be classified as 'personal' simply because the business is no longer operating at the time they are incurred, unless they relate to the collection of accounts receivable," she said.

"A collections dispute is not the only type of litigation a business may become embroiled in after the windup of a business, and the Federal Court of Appeal's affirmation that the phrase 'in connection with' in ss. 141.1(3) must be interpreted broadly may be helpful to clients who hope to recover the GST/HST on the legal fees they incur in litigating these matters," she explained.

Jennifer Leve, Morris Kepes Winters LLP

Jennifer Leve, an associate at Morris Kepes Winters LLP who specializes in personal and corporate tax planning, said that the phrase "in connection with" is one that tax lawyers come across a lot in their work.

"At the appeal level, the court said that what they [the employees] were litigating for was still related to the business even though the business was over. They were litigating for the remuneration of the employees and the directors, so that's salary, and that's related to the business in order to make sales or taxable supplies. So even though the business may not be operating any longer, what they're doing is still 'in connection with' what the business actually was before. The court took a very broad view of the term 'in connection with' and the legislation," she said.

Leve, in agreement with Woodyard, said this decision is good for tax lawyers and their clients because it shows that ITCs on litigation are still possible even if a business has wound down.

"What the Federal Court of Appeal is saying is collecting unpaid accounts is part of the business. Doing things like getting back money from overpaid employees because they've lined their pockets somehow is still remuneration and remuneration is related to making a taxable supply, or operating a commercial activity," she explained.

The Canada Revenue Agency, on behalf of the respondent, declined to comment on the decision, but provided the following statement: "The courts provide Canadians with a further independent review of disputed issues and court decisions serve to clarify the law or resolve differences of opinion between the Canada Revenue Agency and taxpayers."

Counsel for the appellant did not respond to request for comment.

---