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Contents

Acquisition of control of a corporation…

Unexpected tax consequences

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A change of control of a corporation calls for an in-depth analysis of the potential tax consequences for the parties involved in relation to, among other considerations, restrictions on use of the corporation's losses, the deemed year-end of the corporation, the loss of certain tax benefits, etc. An acquisition of control of a corporation may also result in certain unsuspected tax consequences.

In the case of *La Survivance* v. *R.*[1], the Federal Court of Appeal ruled on the issue of the moment at which an acquisition of control of a corporation occurs for the purposes of the *Income Tax Act* ("**ITA**"). In this case, the taxpayer ("**La Survivance**"), a publicly traded corporation, had sold all of the shares (the "**Shares**") of the capital stock of a corporation that it controlled ("**Les Clairvoyants**") to a privately held corporation ("**La Nationale**"). The sale of the Shares resulted in a change of control of, and in the status of, Les Clairvoyants, for the purposes of the ITA. Indeed, following the sale of the Shares, Les Clairvoyants qualified as a Canadian-controlled private corporation ("**CCPC**") because it was then controlled by a privately held corporation. Prior to the sale, Les Clairvoyants could not benefit from this status because it was controlled by a publicly traded corporation.

At the time of the sale of the Shares, La Survivance incurred a loss, which it claimed qualified as an allowable business investment loss ("**ABIL**"). As such, La Survivance could apply the ABIL incurred against any property or business income and not only against capital gains. More specifically, La Survivance claimed that the conditions required to qualify the loss incurred as a ABIL had been met because Les Clairvoyants qualified as a CCPC at the time when it had sold the Shares due to the application of subsection 256(9) of the ITA. The effect of this subsection is to provide that the moment at which the change of control of a corporation occurs is the commencement of the day on which the change of control takes place, rather than the precise moment during that day at which the change of control takes place, unless the corporation makes an election to the contrary. Thus, the application of subsection 256(9) of the ITA resulted in La Nationale being deemed to have controlled Les Clairvoyants at the moment when La Survivance sold the Shares. The Federal Court of Appeal agreed with La Survivance and allowed the ABIL.

In this case, the legal fiction that resulted from the application of subsection 256(9) of the ITA benefited the taxpayer. However, there are certain situations in which the application of this paragraph may be invoked against the taxpayer and result in disastrous tax consequences for the taxpayer such as, for example, the potential loss of the capital gains deduction resulting from the sale of eligible shares of the capital stock of a corporation.

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The corporate veil again!

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The distinct legal personality to which we often refer by the expression "corporate veil" certainly constitutes a fundamental principle of corporate law. However, when article 317 of the *Civil Code of Québec* came into force following the enactment of the new civil code in 1994, many thought that the corporate veil would become considerably thinner and thus certain shareholders would be more exposed to claims by creditors of the corporations they controlled.

Indeed, quite a few decisions rendered by our courts since 1994 have allowed the uncertainty to persist regarding the effectiveness of the corporate veil in the context of commercial transactions and have raised fears that interpretations which are very favourable to creditors at the expense of maintaining an impenetrable corporate veil would spread.

Fortunately, a few recent decisions serve as a reminder that lifting the corporate veil should not be the rule but rather the exception, which should only be applied in the particular circumstances referred to in article 317 of the *Civil Code of Québec*.

These recent decisions seem to establish a clear trend in the case law to the effect that raising the corporate veil is an exception to the principle of the limited liability of shareholders and it can be raised only when a controlling shareholder hides behind a corporation for the purposes of a fraud, abuse of right, or contravention of a rule of public order.

Nevertheless it remains advisable to always consider how the grounds giving rise to the lifting of the corporate veil might apply in relation to the transactions in which your clients are involved.

Resigning as a director:

It's not merely a formality!

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Various statutes provide that the directors of a corporation may be held personally liable for certain of the corporation's debts incurred while the director held that position (among others, unpaid salaries and wages, deductions at source and sales taxes). These provisions highlight the importance of being able to determine the precise moment when a director ceased holding the position, because the liability relates directly to the holding of the position.

It should also be noted that corporations have disclosure obligations regarding the composition of their boards of directors. The information provided to the governmental authorities is available to the public and third parties who consult the public records can assume that the information that appears in them is correct[1].

The courts have had many opportunities to rule on the liability of individuals sued in their capacity as a corporate director when these individuals have claimed that they had resigned before the occurrence of the events that may have resulted in their liability[2]. In this context, courts have allowed a defendant to make proof of the exact date of his resignation as a director and thus rebut the presumptions in the applicable statutes, mainly for the reason that a director's only obligation is to deliver a notice of his resignation to the corporation and it is the corporation's responsibility to file a notice of the resignation in the appropriate public records.

This being said, and even though courts allow former directors to raise this kind of defence, a wise resigning director can minimize the risk of being sued and probably avoid a lot of trouble and expense by signing a resignation that specifically states its effective date, keeping a copy of the proof that it was delivered to the corporation and, lastly, ensuring that notice of it is filed in the public records as required by law. Thus, a resigning director should obtain assurance that the corporation has filed the required notice with the appropriate governmental authorities and require that he be provided with a stamped copy of such notice or, even better, file the required notice himself.

1. See sections 62 and 82 of the *Act respecting the Legal publicity of sole proprietorships, partnerships and legal persons*, paragraph 123.31(2) of the *Companies Act* (Quebec) and paragraph 253(2) of the *Canada Business Corporations Act*.
2. See, in particular, *Commission de la construction du Québec* v. *Marceau-Marin*, AZ-50354024 (C.Q. 2005) and *Commission de la construction du Québec* v. *Raymond*, J.E. 2001-951 (C.Q.).

Don't forget the deemed year-end!

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The *Income Tax Act* (the "**Act**") provides for various times at which a corporation will have a deemed year-end for tax purposes. The taxation year of a corporation ends at the times, among others, when it becomes or ceases to be a Canadian-controlled private corporation, or when control of it is acquired.

During the federal roundtable discussion at the recent 2008 convention of the Association de planification fiscale et financière, the Canada Revenue Agency ("**CRA**") gave its opinion on the tax consequences of deemed year-ends not identified by corporations. The CRA was asked to express its opinion on the hypothetical case of a Canadian-controlled private corporation ("**CCPC Inc.**") that had its normal year-end on December 31 and had been the object of an acquisition of control on July 1, 2001. CCPC Inc., being unaware, in good faith, of the acquisition of control that occurred on July 1, did not file an income tax return for the taxation year deemed to have ended on June 30, 2001. CCPC Inc. therefore filed its income tax return for the period from January 1 to December 31, 2001 and received a notice of assessment from the CRA for the taxation year in question.

Questioned about prescription of the taxation year ended on December 31, 2001 and about the choice of a new financial year-end, the CRA determined that the taxation year from January 1 to December 31, 2001 could not be prescribed because that period did not exist for the purposes of the Act and concluded that CCPC Inc. had two taxation years in 2001, that is, one from January 1, 2001 to June 30, 2001 and the other from July 1, 2001 to December 31, 2001. The CRA added that those two taxation years could not become prescribed because no income tax returns for them had been filed and no notices of assessment had been issued with respect to those taxation years. However, the CRA did not express a precise opinion regarding the question about prescription of the years following the acquisition of control.

On the question of choice of year-end, the CRA determined that it would be December 31 for the taxation years ending after the acquisition of control. Other consequences could also flow from the situation described above, in particular the possibility of the CRA imposing penalties for failing to file income tax returns and the addition of interest on the income tax payable for the taxation year ended on June 30.

In summary, one should be alert to properly identifying events and transactions that result in a corporation having a deemed year-end for tax purposes.

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