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LIFETIME CAPITAL GAINS EXEMPTION ALLOWED DESPITE ERRORS

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The Tax Court of Canada recently released its decision in *Twomey v. The Queen*[1] which addressed whether the taxpayer could claim the lifetime capital gains exemption on his sale of small business shares and, more specifically, whether he held those shares for at least 24 months as required under the definition of "qualified small business corporation share" in subsection 110.6(1) of the *Income Tax Act* (Canada).[2]

At its core, however, *Twomey* dealt more fundamentally with whether corporate records could be corrected *ad hoc* to be binding on third parties, such as the Canada Revenue Agency ("CRA"), without the need for a rectification order. Without the correction, the taxpayer could not claim the entire lifetime capital gains exemption on his shares.

Background

Starting in 1994, the taxpayer and three other individuals operated a heating, ventilating, and air conditioning parts business through a corporation called Fortress Group Inc. ("Fortress"). All of the shares of Fortress were held by a separate corporation ("HoldCo") which was owned equally by the four individuals. In 1995, the taxpayer and another shareholder, D.K., bought out the other two shareholders' interest in HoldCo. For tax purposes, the transaction was accomplished by incorporating a new company ("NewCo") that purchased the HoldCo shares held by the other two individuals.

At the time of the buyout, the lawyer for the taxpayer and D.K. was instructed to incorporate and organize NewCo and to have the taxpayer and D.K., as equal owners, subscribe for 100 shares each for a total price of $200. During the course of the transaction, the acting lawyer decided that he was under a conflict of interest by acting for all four shareholders and engaged another lawyer, T.H., to organize the NewCo. In organizing the new corporation, T.H. was unaware of the accountant's instructions and issued only one share apiece to the taxpayer and D.K., not 100. The taxpayer and his advisors were always under the impression that the taxpayer held 100 shares in NewCo.

Sale of Shares

Several years later, the taxpayer and D.K. had a falling out and the taxpayer triggered a buy-sell clause pursuant to their shareholders agreement, which resulted in D.K. being forced to buying out the taxpayer's shares in NewCo. The taxpayer was advised to use his lifetime capital gains exemption on gains from 77 shares he owned in NewCo, which would save him $182,638 in his 2005 taxation year. It

was at this point that his advisors noticed that the taxpayer had been issued only one share in NewCo and not 100 shares. This was an obvious problem when claiming the lifetime capital gains exemption on the 77 shares sold to D.K.

Rather than seek a rectification order to correct the error with retroactive effect, which is the normal procedure, their lawyer, T.H, passed a simple resolution on February 5, 2005 to amend the corporate record to provide that each shareholder of NewCo held 100 shares instead of one share apiece.

Minister Disallowed Exemption Claim

The Minister disallowed the taxpayer's claim for the lifetime capital gains exemption on the basis that he only owned one qualified small business corporation shares; or more specifically, that the taxpayer did not hold 76 of the 77 shares for at least 24 months prior to disposition. In other words, the Minister found that the resolution had the effect of issuing 99 new shares instead of correcting the previous error and, accordingly, determined that the taxpayer only owned one share for at least 24 months. The Minister's view was that allowing the simple resolution would amount to retroactive tax planning.

Appeal Allowed: No Rectification Required

Pizzitelli, J. allowed the taxpayer's appeal and held that the taxpayer was entitled to claim the lifetime capital gains exemption on gains from the sale of his shares. He also held that the taxpayer was not guilty of any retroactive tax planning and not required to seek a rectification order to correct the error in the corporate record.

Pizzitelli, J. began his analysis with subsection 110.6(1) and the definition of a "qualified small business corporation share", in particular, the 24-month rule in clause (b). He was searching for guidance on when shares are *issued* and looked to paragraph 110.6(14)(f), which requires that the shares be issued to the particular person for purposes of the lifetime capital gains exemption. The Act does not define "issue" or "issuance" and so the Court looked to the *Ontario Business Corporations Act* ("OBCA"), where again there is no definition. What was relevant to the analysis was eventually found in subsection 139(3) of the OBCA which addressed the admissibility of corporate records into evidence, and it read:

> (3) The bound or looseleaf book or, where the record is not kept in a bound or looseleaf book, the information in the form in which it is made available under clause (2)(*b*) is admissible in evidence as proof, **in the absence of evidence to the contrary** (emphasis added)**,** of all facts stated therein, before and after dissolution of the corporation.

The taxpayer argued that while the corporate records stated that he owned only one share, there was an abundance of evidence to the contrary to rebut the record. In other words, while the share certificate seemed to indicate that the taxpayer only owned one share, there was plenty of evidence that he did, in fact, own 100 shares. The Minister argued that there was no "evidence to the contrary" without further corporate acts to substantiate the taxpayer's intention. Pizzitelli, J. agreed with the taxpayer that the

existence of a share certificate was not conclusive proof as to the veracity of the certificate in the presence of evidence to the contrary.

There was an abundance of evidence that the corporation and taxpayer had always intended to issue and have the taxpayer receive 100 shares in NewCo. The taxpayer's accountants had recorded consideration of $100 received for 100 shares in the corporation's general ledger and recorded the issuance of 200 common shares in the financial statements from the very beginning. Furthermore, the corporation had consistently reported on the corporation's tax returns that each shareholder held 100 shares.
Pizzitelli, J. went on to deride the Minister for proceeding with the appeal despite such overwhelming evidence. In his view, the corporate record was correctable by a simple resolution and that the February 5, 2005 resolution was a corporate act that reflected the intention of the corporation and its shareholders. He did not consider this to be retroactive tax planning.

Concluding Comments

Twomey poses a challenge to the Minister as it stands for the proposition that corporate records can be corrected, with retroactive effect, without the need of a rectification order. It has been the Minister's position that where corporate records require correction, the taxpayer must seek a rectification order; otherwise, a taxpayer could discretely amend their corporate records to accomplish retroactive tax planning.

The Minister is currently within the 30 day limit to consider an appeal. It will be interesting to see whether the Minister decides to limit the implications of this case to its facts or proceed to the Federal Court of Appeal to argue that such amendments be done only by rectification order. Until more direction is provided, it would be prudent to obtain a rectification order to correct corporate errors that have possible retroactive tax implications.

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[1] 2012 TCC 310 (hereinafter "*Twomey*").
[2] RSC 1985, c.1 (5th Supp.) as amended (the "Act"). Unless otherwise stated, all statutory references in this article are to the Act.