Agenda

• Introduction
• Objective
• The importance of transaction costs
• Common problems in determining the tax treatment of transaction costs
• Expenditure analysis – The legislative scheme
• Transaction cost analysis overview
• Is transaction cost analysis being properly applied?
• A few words on the Rio Tinto Alcan decision of the Tax Court
The Presentation Objective

To provide an overview of the methodology necessary to thoroughly and properly analyze the income tax treatment of transactions costs and to then take a close look at whether this methodology is being applied consistently by both the CRA and the practitioner community.
The importance of Transaction costs

Transaction costs include a wide variety of expenditures including…

- Accounting and legal;
- Investment banker fees;
- Fairness opinions;
- Communication & Printing costs;
- Director Circular costs;
- Misc Fees including Hello and Break fees
The importance of Transaction costs

Transaction costs often represent material amounts…

- International Colin Energy: $1.2M
- Potash Corporation of Saskatchewan: $1.7M
- BJ Services: $48.7M
- Rio Tinto Alcan: $97.0M
The importance of Transaction costs

High on CRA’s radar for two main reasons…

• Reassessment potential

• Indicator of tax planning
Determining the income tax treatment of Transaction costs

The right way

The proper approach to transaction cost analysis requires a systemic analysis that considers the actual facts (including a detailed understanding of the business to which the transaction costs relate and the specifics of each transaction), the legislative scheme of the Income Tax Act and the various judicial doctrine that have been formulated by the courts.
Determining the income tax treatment of Transaction costs

The wrong way

Having identified a particular troublesome transaction cost it is not uncommon for many to solely rely upon quick searches for the answer rather than perform the requisite analysis. Such searches include existing case law, tax articles, tax textbooks and other publications, tax services, CRA publications including Ruling documents etc. These types of searches typically play a subordinate complimentary role in the total analysis only.
Transaction cost analysis overview

1. An in-depth understanding of the business;
2. Delineate the business into its capital and income components;
3. Understand the purpose, intention, and expectations of the expenditures;
4. Analyze each expenditure separately;
5. Compare the outcome of the analysis to judicial doctrine and relevant transaction case law;
6. Determine whether the analysis is consistent with the case law & judicial doctrine and if not the reasons for the difference.
Transaction cost analysis overview – The ITA

An understanding of the interaction amongst the various provisions of the Income Tax Act is crucial to the ability to be able to undertake a proper analysis of all expenditures. The principle provisions are...

- 9(1)
- 18(1)(a) & (b)
- 20(1)

Note: The paper prepared for this presentation includes a detailed flowchart setting out the basic analysis.
Transaction cost analysis overview – Judicial Doctrine

- Transaction-based approach;
- Symmetry?
- Accurate Picture/Running expenses;
- Law not Accounting;
- Source of Income;
- Capital vs Income;
- Expense Characterization;
- The Entity concept;
- Nothings.
Transaction cost analysis overview – Capital vs Income

One of the more important judicial doctrine is capital vs income where decades of case law dealing with unique facts and specific transactions has led to the development of a number of concepts such as…

• Enduring benefit;
• Once and for all;
• Recurring or non-recurring expenditures…
Transaction cost analysis overview – Capital vs Income

The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a common sense appreciation of all the guiding features which must provide the ultimate answer. Although the categories of capital and income expenditure are distinct and easily ascertainable in obvious cases that lie far from the boundary, the line of distinction is often hard to draw in borderline cases; and conflicting considerations may produce a situation where the answer turns on questions of emphasis and degree. **BP Australia Ltd [1966] A.C. 224**
Capital structure vs Income structure

One cannot fully appreciate the intention behind a transaction without first understanding the nature of the business and being able to conceptually divide the business into two pieces – a capital structure vs its income structure.

In brief the core of a business capital structure includes its work force, its long-term financing, its share structure, its fixed assets whereas the revenue generating or income structure is the income earning process seen as separate.

The courts have distinguished these two structures with expressions such as “selling versus production”, fixed versus circulating capital” and “structure versus the money earning process” to name a few of the more common expressions.
Transaction cost analysis overview – Capital vs Income

Depends on what the expenditure is calculated to effect from a practical and business point of view rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process. Hallstroms Pty. Ltd. (1946) 72 C.L.R. 634
Transaction cost analysis overview – Capital vs Income

...no one test or principle or rule of thumb is paramount. The question is ultimately a question of law for the court, but it is a question which must be answered in the light of all the circumstances which it is reasonable to take into account and the weight which must be given to a particular circumstance in a particular case must depend rather on common sense than on strict application of any single legal principle. Johns Manville (SCC) 85 DTC 5373
The current abbreviated version of Capital vs Income

“Here no capital asset was acquired, nothing of an enduring benefit came into existence nor was any capital asset preserved.”
International Colin Energy (TCC) 2002 DTC 2185, para. 48

...expenses can be classified by reference to their form (recurring or single outlay), effect (enduring benefit) or purpose. Because expenses can be incurred for a myriad of reasons, the courts have cautioned that the aforementioned tests must be applied on a case-by-case basis. In other words, there is no set formula as to their application. Rio Tinto Alcan (TCC) 2016 DTC 1144, para. 79
Is transaction cost analysis being properly applied?

Practitioners

1. Over-reliance upon the court decisions in Colin Energy, BJ Services, Boulangerie Ste-Augustine & Truckbase Corporation;

2. Applying accounting concepts to transaction cost issues;

3. Failure to properly consider the shareholder connection.
Is transaction cost analysis being properly applied?

The CRA

1. Some interpretations & positions inconsistent with current commercial reality (hostile takeover bids & communication costs);

2. Inconsistent application of the transaction based approach;

3. Failure to provide useful timely internal and external guidance, communication & training/education on transaction costs.
A few words in the Rio Tinto Alcan decision

- Oversight & execution expenses – a new concept?
- The capital structure issue – unresolved!!!
- The interpretative expansion of ITA 20(1)
Transaction Costs – Closing remarks

In this presentation I have attempted to…

• provide a general overview of the methodology required in conducting a thorough and professional transaction cost based analysis;

• have alluded to concerns about short-cut approaches that miss the mark;

• have taken a close look at some of the areas of concern applying transaction cost analysis in the practitioner community;
Transaction Costs – Closing remarks

• have been critical of the CRA with respect to certain interpretations that are sometimes inconsistent with today’s commercial reality;

• been critical of the CRA for failing to provide timely useful information with respect to transaction cost issues that would assist all concerned in determining with confidence the accurate reporting of transaction costs.