TAX FOR THE Owner-Manager

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Valuation of a Service Business's WIP Revisited

In an earlier issue of this newsletter, I analyzed the Tax Court of Canada's decision in *CDSL Canada Limited* (2008 TCC 106), a case that dealt with the valuation of the work in progress (WIP) of a consultant for income tax purposes. (See "Valuation of a Service Business's Work in Progress," *Tax for the Owner-Manager*, October 2008.) The TCC held that the taxpayer's WIP was required to be valued for income tax purposes at its fair market value (FMV), which was the amount recorded on its financial statements under the percentage-of-completion method. The taxpayer appealed to the Federal Court of Appeal, which reversed the TCC and held that notwithstanding the taxpayer's financial statement presentation, its WIP can be valued at cost in accordance with subsection 10(1). The essence of the FCA decision (2009 DTC 5030) is as follows.

The WIP of a service business constitutes inventory. Subsection 10(1) of the Income Tax Act requires inventory to be valued, at the end of the year, at the lower of its cost and FMV. This rule applies even if financial statements prepared in accordance with generally accepted accounting principles (GAAP) reflect WIP at FMV, because the law overrides GAAP.

Given the FCA's decision, it is worthwhile taking a look at the meaning of "cost" in the context of a service business that is not a professional business mentioned in section 34 (that of an accountant, dentist, lawyer, medical doctor, veterinarian, or chiropractor).

It is generally accepted that a proprietorship cannot pay a salary to its proprietor and that a partnership cannot pay salaries to its partners. (It should be noted that in *Archbold* ([1995] 1 CTC 2872 (TCC)), the court held that a partnership could pay a deductible salary to its partners. *Archbold* appears to be the only tax decision of its kind to date. The case was heard under the informal procedure, and the CRA does not accept the decision.) Therefore, if the service business is carried on as a proprietorship or partnership, the cost of its WIP will not include a factor for time spent by the proprietor or partners in generating the WIP.

If the service business is carried on in corporate form, WIP will include all or a portion of the salaries paid to shareholder-managers, resulting in a higher inventory value than in the case of a proprietorship or partnership. If, for whatever reason, the corporation does not pay salaries to its shareholder-managers, the corporation or trust will be on the same footing as the proprietorship or partnership. The best outcome might be achieved by operating the business through a partnership of corporations if all remuneration is paid by the corporate partners rather than by the partnership.

Of course, taxpayers in the professions referred to above do not have to be concerned with the meaning of "cost," because section 34 allows for an election to exclude any amount in respect of year-end WIP.

Although the FCA's decision in *CDSL* is welcome, there are still some circumstances in which the tax rules concerning inventory valuation are not as clear as they should be. This is unfortunate, given that inventory valuation is fundamental to determining income. A discussion of some of the uncertainties follows. (Note that I have not included a number of specific statutory exceptions to the rules discussed—for example, those applicable to valuing the inventory of an adventure in the nature of trade.)

In *Friesen* (95 DTC 5551), the Supreme Court held that well-accepted business and accounting principles require that inventory be valued at the lower of cost and market, as required by subsection 10(1). Notwithstanding the provisions of that subsection, regulation 1801 appears to allow a taxpayer to choose, for income tax purposes, to value all of the inventories of its business at their FMV. However, appearances can be deceiving. In *Cyprus Anvil* (90 DTC 6063), the FCA

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held that once the subsection 10(1) method or the regulation 1801 method has been chosen, it must be followed consistently from year to year. Keeping in mind the requirement in subsection 10(2) that the current year's opening inventory is to be valued on the same basis as the prior year's closing inventory, the *Cyprus Anvil* decision was effectively legislated by the subsequent enactment of subsection 10(2.1), which provides that the method chosen for valuing inventory at the end of a particular taxation year must generally be used by most taxpayers to value inventory at the end of the following year.

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New Form T661 for SR & ED Claims

The CRA has released form T661-08 ("Scientific Research and Experimental Development (SR & ED) Expenditure Claim"). The new form replaces T661-06. Either version of the form can be used for taxation year-ends up to December 31, 2008. The new form T661-08 is mandatory for taxation year-ends from January 1, 2009. The introduction of the new form accompanies a general tightening of the CRA's approach to SR & ED claims that makes it more difficult for many taxpayers to obtain program benefits.

For the CRA, the new form improves efficiency: (1) it eliminates stand-alone technical submission documents, thereby reducing the paper burden and the associated labour; (2) it converts SR & ED project technical descriptions to a standardized format with tightly defined, albeit limited, text content; and (3) it features a significantly increased number of "tick boxes" that will aid in automated screening—that is, the profiling of claims for potentially contentious audit issues such as contract payments, work outside Canada, and projects done in an environment of commercial production.

For taxpayers who claim SR & ED, the benefits are less certain. There is mounting anecdotal evidence that the CRA has been making significant administrative changes in its interpretation of the scientific eligibility criteria. Those changes seem to be aimed at curtailing, if not eliminating, claims for activity under paragraph (c) of the definition of "experimental development" in subsection 248(1) in favour of claims for "basic research" (paragraph (a)) or "applied research" (paragraph (b)). If such a change in the interpretation of SR & ED eligibility is being implemented, certain industries, such as software, custom machinery, and manufacturing, can expect that the CRA will use the enhanced profiling capability supported by form T661-08 to apply greater scrutiny to claims from those sectors.

New form T661-08 makes a clear distinction between basic and applied research (paragraphs (a) and (b) of the definition) and experimental development (paragraph (c)). The form provides for only 1,050 words of technical description in the categories of basic and applied research, whereas 1,400 words are available for describing experimental development. The additional word count for experimental development is allocated to a mandatory description of "technological obstacles."

The new term "technological obstacles" seems to be related to the familiar SR & ED criterion of "technical uncertainty," but the CRA guide that accompanies the new form places the bar somewhat higher for "obstacle" than for "uncertainty." Guide T4088 defines technological obstacles as "the shortcomings and/or limitations of the current state of technology that prevented you from developing the new or improved capability." Technological uncertainty is defined in *Information Circular* 86-4R3 as "[w]hether or not a given result or objective can be achieved, and/or how to achieve it, is not known or determined on the basis of generally available scientific or technological knowledge or experience."

Senior CRA officials have stated that there is "no new policy," and there has been no change in the legislation. Is there any real evidence that the release of form T661-08 heralds a shift in policy with regard to SR & ED? Two respected national associations representing different sectors of the Canadian business community (Canadian Advanced Technology Alliance and Canadian Manufacturers and Exporters) have recently issued communiqués to the federal government citing widespread complaints from their members. The complaints indicate that the CRA's SR & ED administrative policies are indeed changing despite the government's statements to the contrary. Both CATA and CME have observed that not only are CRA auditors assessing SR & ED claims more harshly, but new and significantly different criteria are being applied to judge scientific eligibility.

Beyond the broad policy implications of what constitutes eligible SR & ED and what does not, new form T661-08 will have a significant impact on SR & ED claimants in all industry sectors.

While the creation of the new form was likely rooted in an initiative aimed primarily at small business, the most severe impact will likely be felt by big business. The filing process dictated by the new form requires that detailed descriptions be written for all projects claimed. Previously, descriptions were required only for the 20 largest projects. Clearly, big companies with large and complex claims will have much more work to do for the 2009 year-end SR & ED filings.

Moreover, the number of projects in a claim for a given total dollar amount will increase. For example, a company making an SR & ED claim for $1 million in expenditures may find that six or even nine projects are needed to describe the scope of R & D activity that had historically been covered in three or four projects. There are two reasons for this. First, form T661-08 requires that each project be classified using one five-digit code selected from a list of about 150 different science and technology fields. Since only one code is allowed per project, multidisciplinary projects will now have to be split into multiple individual projects, one for each discipline. Second, with a maximum of 1,400 words per project, only the most skilled wordsmiths will be able to adequately explain complex R & D activity without resorting to the creation of multiple projects.

From a compliance standpoint, there are two areas of concern. First, since the project technical descriptions and other information (such as availability of supporting documents) are now part of the tax return, the company officer who signs the tax return is now accountable for the accuracy of the scientific and technical information. Previously, such information was typically contained in separate documents that were one step removed from the main body of the tax return and did not always contain the same level of certification that was present on form T661. Second, form T661-08 makes no provision for the inclusion of diagrams, charts, tables, photographs, or anything except text characters. Much of the documentation that would have been sent to the CRA must now be retained at the taxpayer's site in case of audit. This, together with the superior suitability of the new form for profiling, automated or otherwise, implies that the CRA expects to rely on rigorous field audits of what it views as "risky claims." Anyone who doubts that the frequency of such audits will increase need only know that by mid-2009 the CRA will have hired at least 100 additional SR & ED science auditors.

The names of the three key employees whose wages are claimed in the project, presumably the leaders, must be given, along with their qualifications (university degree, diploma, etc.). While this requirement does not necessarily mean that persons without such qualifications will be excluded from SR & ED claims, it signals that the CRA may be considering using academic qualifications as one of its project pre-screening criteria.

The matter of contract payments gets its own set of screening flags. Line 266 is a statement of payment received for the claimed SR & ED work. Lines 267 through 269 identify any subcontractors that were paid to perform SR & ED work. There is also a requirement in the guide and on form T661-08 that the taxpayer have contract documents, including a statement of work at hand, available in the event of a "detailed review"—that is, an audit.

Recommendations

1) If your year-end falls in the first half of the year (January through June 2009), mark the implementation date for form T661-08 so that your SR & ED claim is filed correctly and in plenty of time. Allow extra time to gather information and prepare the project's technical descriptions. It is likely that most accounting firms, and even some SR & ED consultants, will be surprised by the magnitude of these changes. The CRA itself might run into some glitches as it rolls out this process, leading to delays in claim processing and prolonged audits.
2) Plan your tax affairs so that more of the expected SR & ED benefit is absorbed to reduce taxes payable at year-end. This reduces dependence on the refund cheque, which could be delayed 12 months because filings must now be current before one can begin to apply for an SR & ED benefit.
3) Because of the new screening flags for incoming and outgoing contract payments in addition to the requirement for a "statement of work," it is now more important than ever to have formal written contracts for all transactions, whether buying or selling, since you cannot tell which ones will have to be included in your SR & ED claim.
4) Implement a time-tracking system. Do not wait until the end of the year to identify the projects and write the story. Define a list of projects and then map out the associated activities in real time throughout the year. Log the time entries using a project management coding system that can be referenced back to the coding system being implemented by the CRA.
5) Assemble a database of qualifications (degree, institution, year of graduation, etc.) for all employees likely to be engaged in SR & ED activity. It is worth noting that qualifications need not be limited to university degrees; technicians and skilled tradespeople also carry designations worth

recording. It is desirable to tie the qualifications into the time-tracking system, if possible.

6) Implement a document management system. Use your corporate server as a repository to store and organize documents that evidence SR & ED work. Use the same project management coding as that used in the time tracking suggested in recommendation 4.

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2009 Budget Amends Subsection 256(9)

In *La Survivance* (2007 DTC 5096 (FCA)), the Federal Court of Appeal held that by virtue of subsection 256(9), a taxpayer could lose the ability to claim his or her capital gains exemption on the sale of what would otherwise be qualified small business corporation (QSBC) shares to either a public company or a non-resident of Canada. (See "The Unintended Consequences of Subsection 256(9)," *Tax for the Owner-Manager*, July 2008.)

At that time, subsection 256(9) of the Act provided that where control of a particular corporation was acquired at any time during a particular day, control would be deemed to have been acquired at the beginning of that day, unless the corporation elected out of the provision. Consequently, where control of a corporation was acquired by a public company or a non-resident of Canada, the particular corporation, as of the beginning of the day on which control was acquired, would no longer be a small business corporation and shares in its capital stock would not be QSBC shares when they were actually acquired (later that day) by the public company or the non-resident. As a result, the holder of the shares would be ineligible to claim his or her capital gains exemption in respect of any resulting capital gains.

The Budget Implementation Act, 2009 (Bill C-10), which received royal assent on March 12, 2009, amends subsection 256(9) by providing that for the purposes of determining whether a particular corporation is a small business corporation and a CCPC, control of a corporation is not deemed to have been acquired at the beginning of the particular day on which control was in fact acquired. Thus, when a public company or a non-resident of Canada acquires control of a particular corporation that was a small business corporation and a CCPC, for the purposes of determining whether certain shares are QSBC shares, the taxpayer will not have to elect out of subsection 256(9) in order to be eligible to claim his or her capital gains exemption, assuming that he or she otherwise qualifies.

The amendment is effective for an acquisition of control after 2005. However, taxpayers may elect not to have the amendments apply to an acquisition of control that occurs after 2005 and before January 28, 2009.

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Lipson: Certainty and Predictability or Certainly Unpredictable?

Just over three years ago, the Supreme Court of Canada issued its first decisions on the interpretation and application of section 245 of the Act, the general anti-avoidance rule (GAAR). In *Canada Trustco* ([2005] 2 SCR 601), McLachlin CJ, writing for a unanimous court, set out a detailed analytical framework for determining when GAAR should apply, and she repeatedly cautioned that the provisions of the Act must be interpreted in a manner that provides certainty and predictability to taxpayers. However, subsequent decisions of the Tax Court of Canada and the Federal Court of Appeal demonstrate that, contrary to this principle, determining when GAAR will apply has to a large extent become unpredictable. Accordingly, when, a relatively short time later, the Supreme Court announced that it had granted leave to appeal the Federal Court of Appeal's decision in *Lipson* (2007 FCA 113), the tax community held out hope that the Supreme Court understood the uncertainty that its prior decisions had created and was embracing the opportunity to provide further clarification and certainty. Those hopes were shattered with the release of the Supreme Court's reasons in *Lipson* (2009 SCC 1).

The facts in *Lipson* can be summarized as follows. The Lipsons agreed to buy a house for $750,000. Shortly thereafter, Mrs. Lipson borrowed $562,500 from a bank to buy shares of a private corporation (Holdco) from Mr. Lipson. Mr. Lipson used the $562,500 he received to pay for a portion of the house. Another $562,500 was borrowed and secured by a mortgage on the newly acquired house (the mortgage loan). The proceeds of the mortgage loan were then used to repay Mrs. Lipson's initial loan. Subsequently, Mrs. Lipson received dividends on the Holdco shares and paid the interest on the mortgage loan.

The tax consequences under the Act (apart from GAAR) were relatively straightforward and not in dispute. Pursuant to paragraph 20(1)(c), Mrs. Lipson was entitled to deduct the interest expense incurred on the first loan and, pursuant to subsection 20(3), was subsequently entitled to deduct interest on the mortgage loan that replaced the first loan. Because Mr. Lipson did not elect out of the application of subsection 73(1), he realized no gain on the disposition of the Holdco shares, and the attribution rule in subsection 74.1(1) applied to attribute any income or loss arising from the Holdco shares back to Mr. Lipson, which generally resulted in a net deduction for Mr. Lipson (both the dividend income and the interest expense were attributed to Mr. Lipson).

The minister denied Mr. Lipson the interest deduction on the basis that this deduction resulted from abusive tax avoidance that was prohibited by GAAR, and both the Tax Court of Canada and the Federal Court of Appeal upheld the minister's position.

The Supreme Court, by a narrow majority of 4-3, also upheld the minister's position, with two strong but disparate dissents. A comparison of LeBel J's decision for the majority with Binnie J's critical dissent on behalf of two of the dissenting justices reveals the difficulty that the Supreme Court had in applying the framework it laid out in *Canada Trustco*. Rothstein J, in a separate dissent, took a much different approach and concluded that he did not need to rely on GAAR because the specific anti-avoidance rule in subsection 74.5(11) adequately dealt with the issue (notwithstanding that, according to Binnie J, neither party relied on that provision). LeBel J and Binnie J both concluded that

1) there were tax benefits and an avoidance transaction, a position that the Lipsons had conceded;
2) the only issue was whether the tax benefit resulted from an avoidance transaction that constituted a misuse or abuse of provisions of the Act;
3) the analysis for answering this question required
   a) identifying which provisions were associated with each tax benefit,
   b) identifying the object, spirit, and purpose of those provisions, and
   c) determining whether the transaction fell within or frustrated that purpose;
4) there were two tax benefits—the deduction of interest by Mrs. Lipson and the attribution of that deduction to Mr. Lipson; and
5) the relevant provisions were paragraph 20(1)(c) and subsections 20(3), 73(1), and 74.1(1).

All three decisions concluded that the steps taken to allow Mrs. Lipson to rely on paragraph 20(1)(c) to deduct the interest incurred on the mortgage loan did not, on their own, constitute a misuse or abuse of the Act and that GAAR should not apply to *Singleton*-type transactions. Ultimately, the fundamental point of disagreement between LeBel J and Binnie J was on the object, spirit, and purpose of subsection 74.1(1).

LeBel J, with virtually no written analysis, determined that subsection 74.1(1) is "designed to prevent spouses from benefiting from their non-arm's length relationship by attributing, for tax purposes, any income or loss from property transferred to a spouse back to the transferring spouse." LeBel J then concluded that Mr. Lipson's reliance on subsection 74.1(1) to attribute Mrs. Lipson's dividend income and interest expense (a net loss) back to him reduced Mr. Lipson's income from what it would have been without the transfer; therefore, he benefited from the non-arm's-length transfer, and the resulting attribution of interest expense constituted abusive tax avoidance (that is, the dividend income attribution was not reversed).

Binnie J found the purpose of subsection 74.1(1) to be the opposite of the purpose divined by LeBel J:

> In my respectful view, what LeBel J believes s. 74.1(1) is designed to *prevent* is actually a reasonable statement of what subsection 74.1(1) seeks to *permit*. . . . [T]he tax consequence my colleague condemns is precisely the consequence called for by s. 74.1(1) unless the taxpayer opts out.

Accordingly, Binnie J concluded that the steps implemented by the Lipsons did not abuse the spousal attribution rules and that GAAR should not apply.

By differing so fundamentally over the object, spirit, and purpose of one particular provision in the Act, the justices of the Supreme Court highlighted the very problem with the *Canada Trustco* framework that lower courts and practitioners were hoping would be clarified: how to discern the object, spirit, and purpose of a provision of the Act. Unfortunately, not only did the Supreme Court fail to provide any guidance on this difficult point, LeBel J's extremely brief analysis in support of his conclusion on the purpose of subsection 74.1(1) may invite lower court judges to take a similarly non-structured approach to this issue. Given the significant division between the three judgments and the lack of contribution to the *Canada Trustco* analytical framework, it seems most reasonable to conclude that *Lipson* will simply fade into the background and *Canada Trustco* will remain the seminal GAAR case.

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Timing Is Everything: Tax Implications of a Divorce

In a transfer of property pursuant to a divorce settlement, the income tax rules may trigger serious adverse consequences if the transferring spouse is a non-resident and the receiving spouse is not. The examples that follow illustrate some possible outcomes.

Example 1

Mr. and Mrs. X jointly own a principal residence in Canada. Mr. X leaves Canada and ceases to be a resident. Soon thereafter, Mr. X divorces Mrs. X. As part of the divorce settlement, Mr. X transfers his interest in the Canadian principal residence to Mrs. X. The divorce has been acrimonious.

Example 2

Assume that the facts are the same as those in example 1, except that the divorce and the transfer of half of the principal residence take place while Mr. X is resident in Canada.

Tax Implications of Example 1

Mr. X is not subject to departure tax on his interest in the principal residence because the residence is real property situated in Canada. Generally, however, on the transfer of his interest to Mrs. X, there will be a section 116 certificate requirement. This is the case because a disposition of taxable Canadian property by a non-resident has occurred. Further, the transfer to Mrs. X will be at fair market value: the interspousal rollover under subsection 73(1) is not available because the transferor is not a Canadian resident. Therefore, 25 percent of the tax on the transferor's net capital gain must be remitted to the CRA. If Mr. X does not pay that amount, then Mrs. X, the purchaser, is liable to pay it.

Part of the gain on the property on the transfer by Mr. X can be sheltered by the principal-residence exemption. It is interesting to note that even though Mr. X may not have been a resident of Canada at any time when the house was his principal residence, at least one year of his period of ownership is sheltered by the principal-residence exemption because of the "1+" rule in the formula. The CRA has accepted this interpretation on audit.

Tax Implications of Example 2

The transfer will qualify as a "qualifying transfer" under subsection 73(1.01) because it is part of a marriage settlement between Mr. X and Mrs. X. Because Mr. X is a Canadian resident, the transfer occurs at the adjusted cost base of his interest. There is no section 116 filing requirement, because Mr. X is a resident of Canada at the time of the transfer.

In example 1, it is the responsibility of Mr. X to file a Canadian tax return and show that he has no Canadian tax liability. Assuming that is the case in example 2, he will receive a full refund of the Canadian withholding tax even though it may have been withheld and remitted by Mrs. X. Owing to the acrimonious relationship between the two parties, it is very likely that Mr. X will pocket the money in his new foreign jurisdiction of residence, thereby creating severe economic hardship for Mrs. X. Even though the CRA may be sympathetic to the economic hardship caused by the facts in example 1, it will be compelled to enforce the tax law. Therefore, Mrs. X must seek tax counsel before the transaction, not after.

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Cash Advances to Subsidiary Are Deductible

In *Valiant Cleaning Technology Inc.* (2008 TCC 637), the issue was whether the appellant could treat certain cash advances to a subsidiary as current expenses, thereby resulting in non-capital losses. The case is of interest for the court's careful analysis of the case law in this area.

The appellant, a tier 1 supplier in the car industry, was involved in the business of designing and supplying industrial pressure washers. The appellant made cash advances to its UK subsidiary from 1996 to 2001. Initially, it treated the advances as capital outlays in its accounting records and tax returns, which resulted in capital losses. During a CRA audit, the taxpayer recharacterized the capital losses as non-capital losses. The recharacterization was rejected by the CRA, which led to a request for a determination of losses and ultimately to notices confirming the losses as capital losses. The taxpayer conceded that the initial investment and the first two advances were on account of capital, but took the position that the remaining losses were on income account.

Campbell J found that during the relevant period, the major players in the automotive industry decided to reduce the number of their tier 1 suppliers and to force those companies retaining tier 1 status to expand globally to allow for close geographical proximity with the major players' factories and plants. For the taxpayer, the maintenance of tier 1 status was essential to the survival of its Canadian operations. It made a business decision to retain tier 1 status and expand globally and thus acquired a UK corporation. The advances made in 1999 and subsequent years were made to purchase material, pay labour, and cover other operating expenses for existing contracts of the subsidiary. The advances were made even when it was clear that the subsidiary was headed for bankruptcy or closure of its operations. The only reason the taxpayer made the payments was to protect its tier 1 status and its own economic viability within the industry. Campbell J also found that although the initial advances were clearly on account of capital, the subsequent advances were made solely for the purpose of protecting the revenue stream of the Canadian operations.

The court considered a number of previous cases in which the issue was the deductibility of advances made to a subsidiary. This decision is of interest for the extensive review of those cases.

In *Shell Canada Limited* (99 DTC 5669 (SCC)), McLachlin CJ noted that the use of the funds is of the utmost importance in the determination of deductibility. The adverse decisions in *Stewart & Morrison Ltd.* ([1974] SCR 477), *Morflot Freightliners Limited* (89 DTC 5182 (FCTD)), and *Cathelle Inc.* (2005 DTC 858 (TCC)) were distinguishable on their facts from *Valiant Cleaning Technology*.

The decisions in *Berman & Co. Ltd.* (61 DTC 1150 (Ex. Ct.)), in which advances made directly to the subsidiary's suppliers to preserve its reputation and ongoing commercial relationship with them were held to be deductible, and in *F.H. Jones Tobacco Sales Co. Ltd.* (73 DTC 5577 (FCTD)), in which payments in respect of guarantees of the subsidiary's customer loans made to a direct source of income were held to be deductible, supported the taxpayer's position. Campbell J also relied on her decision in *Excell Duct Cleaning Inc.* (2006 DTC 2040 (TCC)), in which she held that bad debts in respect of advances made to franchisees in an effort to preserve an ongoing source of income were deductible.

In *Easton et al. v. The Queen et al.* (97 DTC 5464 (FCA)), the court noted two exceptions to the general rule that an advance or outlay on behalf of a corporation would be treated as a loan for the purpose of providing working capital. One of the exceptions is an advance or outlay that was made for income-producing purposes related to the taxpayer's own business, not that of the corporation in which he or she holds shares. Campbell J concluded that the facts in *Valiant Cleaning Technology* fell within this exception.

Relying on the decision in *MNR v. Algoma Central Railway* (68 DTC 5096 (SCC)), Campbell J held that the source of income did not have to be direct in order for advances to be deductible. She also held that the fact that the advances had the secondary effect of the subsidiary taking on new contracts was not fatal to the deductibility of the advances. She examined several cases that set out the general principles applicable in determining the deductibility of losses. In particular, she relied on the decision of Lord Pierce in *B.P. Australia Ltd. v. Comr. of Taxation of the Commonwealth of Australia* ([1966] AC 224 (PC)) for the proposition that to determine the deductibility of an expense one must discover its true purpose.

In the end, Campbell J allowed the taxpayer's appeal because the advances were made to protect the taxpayer's income stream and future as a tier 1 supplier. This case illustrates the circumstances in which advances to a subsidiary can be deductible expenses, and it provides a very useful overview of the cases relevant to this issue.

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Utilization of Tax Attributes from Statute-Barred Years

In *Leola Purdy, Sons Ltd.* (2009 TCC 21), the Tax Court of Canada reminded taxpayers that if there is an error in computing a tax attribute in a statute-barred year, it may be possible, in certain circumstances, to adjust the amount when it is utilized in a subsequent taxation year.

The case dealt with the issue of whether, in appealing an assessment that gains on index futures contracts realized in the taxpayer's 2002 taxation year were on income account, the taxpayer could claim that losses on dispositions in similar transactions in a statute-barred year were also on income account and could be carried forward to offset the gains in 2002. The Tax Court of Canada held that these losses could be treated on income account, notwithstanding that the taxpayer had claimed the losses as capital losses in filing its 1998 tax return.

The taxpayer traded in various index futures contracts. In filing its returns for the 1997 to 2002 taxation years, it reported the resulting gains and losses on capital account. It realized losses in 1997 and 1998 and gains in 1999 through 2002 on these transactions. The taxpayer adjusted the balances in its capital dividend account (CDA) accordingly, and elected capital dividend treatment in respect of dividends paid in

1998 and 2002. In reassessing the taxpayer's 2002 taxation year, the minister treated the gains on the futures contracts as being on income account.

The taxpayer appealed on two grounds: (1) that the 2002 gains were on capital account, and (2) that if the 2002 gains were taxable on income account, then its losses on similar transactions in 1998 were likewise on income account and, pursuant to paragraph 111(1)(a) of the Act, it was entitled to apply its loss on dispositions of contracts in its 1998 taxation year to reduce its income in 2002.

At trial, the taxpayer conceded the first issue and limited its argument to the second one. The minister argued that to allow the taxpayer's appeal would require a reassessment of the 1998 taxation year, which was statute-barred.

The Tax Court of Canada allowed the appeal and concluded that there was no need to reassess the 1998 taxation year in order to correct an error in the assessment of that year. Rip CJ relied on other cases that have permitted the recharacterization or recomputation of a carryforward amount (for example, a net capital loss that is redetermined to be a non-capital loss) applied in a year (the year under appeal) in order to correct errors in the statute-barred year in which the carryforward amount was generated (for example, *New St. James Ltd.*, 66 DTC 5241 (Ex. Ct.)).

In reaching his decision, Rip CJ referred to the following comments of Bowman J in *Coastal Construction and Excavating Limited* (97 DTC 26 (TCC)):

> The Minister is obliged to assess in accordance with the law. If he assesses a prior year incorrectly and that year becomes statute-barred this will prevent his reassessing tax for that year, but it does not prevent his correcting the error in a year that is not statute-barred, even though it involves adjusting carry-forward balances from previous years, whether they be loss carry-forwards or balances of investment tax credits. *New St. James Limited v. M.N.R.*, 66 DTC 5241; *Allcann Wood Suppliers Inc. v. The Queen*, 94 DTC 1475. No question of estoppel arises: *Goldstein v. The Queen*, 74 DTC 1029.

In *Leola Purdy*, the taxpayer's losses on the index futures contracts incurred in the 1998 year were treated as being on income account, and those losses were permitted to be carried forward to reduce income in the 2002 year—less, of course, the portion of the losses that had already been utilized to reduce taxable capital gains in 1998, 1997, and 1996 and the portion that would have been used to reduce the taxpayer's taxable income to nil in 1998. Although 1998 was statute-barred and the taxpayer's tax liability for that year could not be affected, in order to correctly compute the amount of non-capital loss available to be carried forward to 2002, the taxable income in 1998 had to be taken into account.

While the findings in this case are consistent with the decision in *Papiers Cascades Cabano Inc.* (2006 FCA 419), the result may not always be in favour of the taxpayer. In *Papiers Cascades Cabano*, the minister reviewed the eligibility of certain expenditures and property in respect of which investment tax credits (ITCs) were claimed. The minister recomputed the ITC balances at the end of each of the taxation years from 1993 to 1996. According to the minister's new computation, the ITC balance at the end of the 1995 taxation year was negative. At this point, however, the 1993 to 1995 years were statute-barred. The CRA tried to get around the problem by reducing the 1996 opening balance of unclaimed ITCs, to which the taxpayer objected. In allowing the Crown's appeal, the Federal Court also cited the case of *Coastal Construction* and stated that a determination of the balance of a carryforward of ITCs for a statute-barred year is not tantamount to an assessment.

In *Leola Purdy*, the court did not address whether the capital dividends that were paid in 1998 and 2002 were excessive. The finding that the gains and losses were on income account should have resulted in an adjustment to the taxpayer's CDA. Presumably the Crown did not raise this issue. If the taxation year in which the second capital dividend was paid (2002) was not statute-barred, an assessment of tax under part III of the Act could have been made if the CDA adjustment resulted in an excessive capital dividend in 2002. This result would be consistent with the CRA's views set out in a technical interpretation (2006-0185291E5, June 11, 2007). In that interpretation, the CRA commented that since the computation of the capital dividend account is at a point in time, it is not subject to the "normal reassessment period." As a result, the CRA can adjust the amount of a capital gain or loss until a capital dividend has been paid. Once a capital dividend has been paid, the taxation year in which the capital dividend is paid becomes subject to the "normal reassessment period."

To eliminate the risk of an adjustment by the CRA long after a year is statute-barred, taxpayers always have the option of requesting a notice of loss determination under subsection 152(1.1). When a notice of determination is requested, the determination is binding on both the minister and the taxpayer pursuant to subsection 152(1.3) of the Act for the purpose of calculating the income, taxable income, and amount payable or refundable to the taxpayer in any other taxation year. The notice of determination is subject to the normal rights of objection and appeal in respect of the determination and is available for losses, but not for ITCs.

During the current economic times, tax attributes such as non-capital losses, net capital losses, and ITCs may not be utilized for several years. However, this case illustrates that an adjustment—favourable or unfavourable—can still be made when the amount is applied in a subsequent taxation year that falls within the "normal reassessment period."

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Directors' Due Diligence Defence in Insolvencies

In a recession, directors of financially troubled companies may be faced with a choice between making statutorily required tax remittances and using the taxes collected to pay other creditors crucial to the continued operation of the business. In such situations, directors should be mindful that they are jointly and severally liable with their companies for unremitted taxes and trust monies (subsection 323(1) of the Excise Tax Act (ETA); subsection 227.1(1) of the Income Tax Act (ITA); and section 43(1) of the Ontario Retail Sales Tax Act (RSTA)). A director who acts reasonably to prevent the company's failure to remit may be relieved of liability for unremitted taxes under a due diligence defence (ETA subsection 323(3), ITA subsection 227.1(3), and RSTA section 43(3)). However, the courts have generally required a high level of diligence on the part of a director asserting such a defence.

The courts have generally been consistent in holding that directors who have lost legal control to a trustee in bankruptcy are not liable for unremitted taxes after the change in control. The liability of directors during "proposal in bankruptcy" situations is less clear. A typical situation is one in which a director has not yet legally lost his power to act as a director, but has lost de facto control over the company's finances to a third party—usually the company's bank.

This was the issue in *Savard* (2008 TCC 309), where the Tax Court had to determine whether to hold a director liable for taxes not remitted during the period in which the corporation was operated under a proposal filed under the Bankruptcy and Insolvency Act (BIA). The taxpayer was the sole director of a company that provided repair and towing services for heavy and high-end vehicles. In the course of an audit, the CRA determined that the company had failed to remit the GST it had collected. The company's financial problems were triggered by a falloff in business, which prompted the bank to call in the company's loans. The company filed a notice of intention to file a proposal under the BIA, which was accepted by its creditors and approved by the Quebec Superior Court. A trustee was appointed for the proposal. When the proposal was approved by the Superior Court, the company retained an accounting firm at the request of the bank to prepare cash flow forecasts and provide close supervision of the company's finances.

After several months, the trustee applied to the Superior Court to have the proposal set aside on the ground that there were large sums unpaid because the bank was continually reducing the credit it was prepared to make available to the company. The trustee added that the bank had directed the company to pay the security it had given to the bank, causing injustice to other creditors. The court set aside the proposal, and the company was declared bankrupt.

The taxpayer argued that he was entitled to the due diligence defence pursuant to ETA subsection 323(3). He said that before the notice of intention was filed, the company's GST returns were filed on time and the company owed no net tax. After the notice of intention was filed, the staff member originally responsible for that task was replaced by the representative of the accounting firm. The accounting firm handled everything—it determined what expenses would be allowed and who would get paid. The taxpayer claimed that he was no longer in full control of the management of the company. He argued that the accounting firm's mandate was to make sure the bank was repaid; therefore, even if he had written a company cheque to pay the taxes, it would have been declined by the bank.

The court reviewed the applicable standard for the defence of reasonable diligence, considering both *Soper* ([1998] 1 FC 124), in which the Federal Court of Appeal held that the test had both subjective and objective elements, and *Peoples Department Stores Inc. (Trustee of) v. Wise* ([2004] 3 SCR 461), in which the Supreme Court of Canada adopted an objective standard for applying an identically worded due diligence defence in section 122(1) of the Canada Business Corporations Act).

The court then considered whether the de facto control exercised by the accounting firm and the bank over the company's finances was sufficient to exclude the taxpayer from the scope of ETA subsection 323(1). The court followed *McKinnon* ([2001] 2 FC 203), where the Federal Court of Appeal found it "inappropriate to import into [ITA] subsection 227.1(1) a requirement that it is only engaged if the directors have *de facto* control over the financial operation of the company, particularly the payment of its bills."

The Tax Court further noted that under the BIA, a trustee in a proposal has only the powers granted by the proposal. (This is to be contrasted with a formal bankruptcy, in which the trustee assumes legal control of the company's affairs.) Absent evidence to show that the trustee had taken control of the company under the proposal, the Tax Court concluded that the taxpayer had not legally lost control of the company, and therefore would be liable for unremitted taxes unless he had acted reasonably to prevent the company's failure to remit.

The court noted the special role played by the accounting firm in the day-to-day management of the company and accepted the taxpayer's submissions that he was not in a position of de facto control. Further, he had acted to the best of his ability to avoid the failure—for example, by injecting additional funds of his own. In the Tax Court's view, it was reasonable for the taxpayer to believe that the company could be turned around. In the result, the court allowed the appeal and vacated the assessment.

The decision affirms that a director seeking to establish a due diligence defence to a failure to deduct and remit faces a high standard if he or she is to succeed. This may seem especially unfair in a case such as this one, in which the director has lost day-to-day control of the affairs of the corporation. This decision indicates that a director relying on the due diligence defence when he or she has lost de facto (but not legal) control must have taken positive steps to prevent a company's failure to remit. Surprisingly, it appears that losing de facto control of a company's finances to a third party may not be sufficient in and of itself to persuade a court that the director is entitled to the due diligence defence. Further positive steps aimed at attempting to ensure tax compliance appear to be called for. It is a question of fact in each case what steps are required, and competent legal advice is an important component of any strategy adopted to preserve the due diligence defence.

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Advances: Loans or Salary?

The *Merchant* case (2009 TCC 31) provides useful guidance on when amounts paid to an employee will be considered payments of salary rather than loans from an employer. The characterization of the payment is relevant in determining the timing of the income inclusion. An amount received as salary or remuneration by an arm's-length employee is included in income when it is received. There is generally no income inclusion with respect to an amount received as an employee loan unless the loan is subsequently forgiven. In *Merchant*, the Tax Court held in favour of the taxpayer and found that the true character of the amount received by the taxpayer was a payment of salary and therefore taxable in the year of receipt, not in the later years in which the "loans" were written off. The minister had assessed the later years on the basis that the payments were loans written off in those years.

The facts in *Merchant* are relatively straightforward. The taxpayer received numerous cheques from his employer in 1997, 1998, and 1999. The minister argued that several of the cheques were employee loans or advances that should have been included in the taxpayer's income in 2001 when the loans were forgiven (pursuant to paragraph 6(1)(a) and subsection 6(15) of the Act). The taxpayer was also assessed for having received a deemed employee interest benefit in 2000 (under subsections 6(9) and 80.4(1)).

The minister argued, first, that some (but not all) of the cheques issued to the taxpayer over the years indicated that amounts had been withheld for income tax, CPP premiums, and EI premiums. In the minister's view, the other cheques that were issued without source deductions were therefore employee loans, not payments of compensation. Second, the employer's accounting records itemized or documented each of the amounts at issue as a "loan" or "advance" that was repayable by the taxpayer. The amounts were also credited to a shareholder's loan account in the taxpayer's name even though he was not a shareholder of his employer's company. Finally, the minister argued that the taxpayer's intent to become a future shareholder suggested that the amounts that he received were not payments of compensation, but amounts that eventually would be credited toward his future share purchases.

Webb J noted that if the amounts at issue were received by the taxpayer as loans that were to be repaid from any source (as argued by the minister), he would not have received any compensation for services rendered during the entire 1998 taxation year, since none of the cheques issued that year indicated that any source deductions had been made. The proposition that the taxpayer "would have worked for the entire year for no pay . . . has no merit."

Webb J then pointed out that prior jurisprudence has held that accounting entries do not determine tax consequences. In particular, he quoted extensively from *Continental Bank of Canada* (94 DTC 1858), where Bowman J (as he was then) referred to Viscount Simon's pronouncement that "the name given to a transaction by the parties concerned does not necessarily decide

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the nature of the transaction. . . . The question always is what is the real character of the payment, not what the parties call it."

On the evidence before the court, Webb J concluded that the true nature of the amounts issued to the taxpayer was payment for services. Although the cheques were described as "loans" or "advances" on the employer's accounting records, this description did not accord with reality, since neither the taxpayer nor his employer intended to create a creditor-debtor relationship, and no true right of recovery existed for either party.

Furthermore, Webb J said that even if the amounts at issue were advances that were to be repaid from the taxpayer's future earnings, they would still be payments of compensation. In other words, even if the employer had a right of recovery limited to future salary or bonuses that would subsequently be paid to the taxpayer, the true character of those amounts would be remuneration for services rendered. In *Meredith* (94 DTC 1271), the Tax Court indicated that if a recipient is entitled to an advance on possible future earnings, and if the future income (if earned) is the sole source of and security for repayment with no liability to repay even if the source proves to be inadequate, then the recipient has received those advances as a form of wages or salary. Therefore, whether the amounts at issue in this case were received as compensation for services already rendered or as advances of future earnings, the amounts were payments of remuneration to be included in income in the year of receipt.

Finally, Webb J countered the minister's third argument by stating that the Act applies to an individual on the basis of what the individual does, not what the individual intends to do. Therefore, the taxpayer's desire to become a future shareholder of his employer's company did not influence or alter the tax treatment of the payments at issue.

In the result, the minister was ordered to reassess the taxpayer on the ground that no amount was payable to the employer in 2000 or 2001, and therefore the amounts previously assessed by the minister should not have been included in the taxpayer's income during those years.

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