

## REPORT ON RECENT DEVELOPMENTS

### *Recent Case Law*

#### **PUSHING THE LIMITS OF DEDUCTIBILITY**

##### *Pantorama Industries Inc. v. The Queen*<sup>1</sup>

The taxpayer recently won an important victory before the Federal Court of Appeal in a case involving one of the most basic determinations in income tax law: whether an amount qualifies for a current deduction or whether deduction is denied on the basis that the amount is on account of capital.

##### *The Facts*

Since 1971, the taxpayer Pantorama has been in the business of operating a chain of retail clothing outlets. In 1979, the taxpayer outsourced the task of finding new locations and negotiating leases and lease renewals to a consultant specialized in this area. The consultant, which had about 80 clients, acted as the taxpayer's "retail store advisor".

Over the four taxation years under reassessment, the taxpayer operated over 200 stores, all of which were in leased premises. Over the same period, the taxpayer opened new stores, closed some old ones, and renewed between 25-30 leases annually.

The consultant was remunerated for its services to the taxpayer based on a two-tier fee: a fixed monthly fee and a variable fee based on the surface area of new leases and on the duration of lease extensions. The variable fees were significant.

The taxpayer deducted both the fixed and variable fees in computing its income. The CRA reassessed, denying the deduction of the variable fees. Denis Lapierre and Konstantinos Voggas of Sweibel Novek represented the taxpayer. They argued that the fees were not paid to acquire an asset, but rather as a necessary part of carrying on the taxpayer's business year after year. They also pointed out that, had the same functions been performed by an employee internally, instead of being outsourced, there would have been no issue as to deductibility of the expenses.

##### *The Tax Court of Canada*

In ruling against the taxpayer, the TCC found that the variable fees (paid to procure new leases or extend leases) pertained to the taxpayer's business structure and provided the taxpayer with an enduring benefit. The fact that the variable fees were an annual expense, did not, in the Tax Court's view, change the overriding purpose of business expansion.

##### *The Federal Court of Appeal*

The Federal Court of Appeal, recognizing that the fees paid to the leasing consultant were part of the taxpayer's business operations, allowed the taxpayer's appeal.

Writing for the Federal Court of Appeal, Noel J. seized upon the recurrent aspect of the variable fees, noting that:

While it is possible that expenses which recur every year over the life of a long established business are on capital account, this would tend to be rather exceptional. When the matter is

<sup>1</sup> 2005 FCA 135 (April 15, 2005).

considered from the perspective of the appellant's business, as it must be, it seems clear that the variable fees were not paid "in order to secure an actual asset to the [appellant] but to enable [it] to continue to carry on, as it had done in the past...."

Noel J. went on to say that "... once a structure is in place, moneys paid each year to ensure that it can continue to be exploited favourably are on revenue account." This general statement may prove helpful to taxpayers in other situations where the deductibility of a recurring expense is at issue.

Noel J. also opined that the Tax Court of Canada's determination was based on a "juristic" classification of what legal rights were created (leases) rather than the taxpayer's purpose in making the payments to the consultant (which was to maintain a network in place but which did not add anything to the business). Finally, Noel J. commented that had the functions related to the variable fee been performed by employees, the CRA would not have objected to the deduction of salary and related expenses. As such, there was no reason to deny the deduction simply because the taxpayer outsourced that part of its business.

### *What this Means for Taxpayers*

Aside from the immediate impact for the taxpayer, the Federal Court of Appeal's judgment is perhaps indication of a shift in attitude on how to distinguish between income and capital payments: Consider the matter from the perspective of the taxpayer's business and not only on the basis of what is in fact acquired or what legal rights are created.

## **A REASONABLE STANDARD FOR JUDICIAL REVIEW**

*Denis Lanno v. Canada Customs and Revenue Agency*<sup>2</sup>

The *Lanno* decision is another Federal Court of Appeal ruling that bodes well for taxpayers. It appears to establish a new standard for Federal Court review of cases where the Minister has denied relief under various "fairness" provisions in the *Income Tax Act* (Canada) and has already been followed.<sup>3</sup>

### *Facts*

Mr. Lanno was one of many investors in a real estate project which generated significant losses. When CCRA (as it then was) announced it was conducting a review of said losses, the taxpayer and certain of the other investors in the project retained the services of BDO Dunwoody.

In April 1997, the taxpayer received notices of reassessment of his 1993-1995 taxation years, denying the claimed losses on the basis that there was no reasonable expectation of profit. Assuming that BDO Dunwoody was handling all objections, the taxpayer did nothing further on receipt of the reassessments.

In February 2002, the taxpayer realized that objections had never been filed on his behalf, and, in December 2002, submitted a fairness relief request under subsection 152(4.2) which allows the Minister to reassess tax after the normal reassessment period, "...if application therefor has been made by the taxpayer."

The last salient fact: In May 2002, the Supreme Court released the *Stewart*<sup>4</sup> decision, which rejected the CCRA's reasonable expectation of profit test, the very test invoked by CCRA as a basis for denying the taxpayer's losses.

<sup>2</sup> 2005 FCA 153 (May 2, 2005).

<sup>3</sup> *Vitellaro v. CCRA*, 2005 FCA 166 (May 5, 2005).

<sup>4</sup> 2002 DTC 6969.

### *Minister's Denial of Fairness Request*

The Minister denied the fairness request on the grounds that the sole reason for the request was to take advantage of a successful appeal to the Courts by another taxpayer (the understanding being that this was a reference to the *Stewart* case).

The taxpayer made further submissions in support of his request for relief, emphasizing that the *Stewart* decision was not the sole basis for the fairness application and that he was simply an individual who honestly, if mistakenly, believed objections had been filed by his accountants. The taxpayer also pointed out that three other individuals in his position had had their requests for relief granted.

The Minister met these further entreaties with further denials of relief, adding to the initial grounds of denial by stating that the CCRA cannot assume responsibility for what amounted to an omission by the taxpayer's advisors and that fairness decisions cannot be used to extend time limits to file an objection.

Madame Justice Snider of the Federal Court concluded – seemingly with some regret – that there was no basis upon which the Court could intervene. The taxpayer appealed to the Federal Court of Appeal.

### *Analysis of the Court of Appeal*

The Court of Appeal summarized its role as that of determining whether the Trial Judge had applied the correct standard of review and, if in the negative, to assess the decision in light of the correct standard. The Court then drew a distinction between “grounds for review” and the “standard of review.”

As for grounds for review, the Court of Appeal confirmed that a court may interfere with a Minister's exercise of discretion only if “that decision was made in bad faith, if its author clearly ignores some relevant facts or took into

consideration irrelevant facts or if the decision is contrary to law.”<sup>5</sup>

On the issue of standard of review, however, the Court held that the standard of review must be one of whether the Minister's decision was “reasonable” and not whether it was “patently unreasonable.” Applying that standard to the relevant facts, the Court of Appeal disagreed with the Minister's reasons for denying the request, finding that:

- it was wrong to say that fairness relief cannot be invoked to extend the time for filing an objection, as this contradicts the CCRA's published position;<sup>6</sup>
- the CCRA's conclusion that the taxpayer's request was solely motivated by a court decision was contradicted by the court record, which clearly established that the relief application was based on misunderstandings that resulted in the failure to file timely objections; and,
- the CCRA never addressed the issue of whether the taxpayer should be treated differently than the three other individuals who succeeded in obtaining fairness relief.

In light of the foregoing, the Federal Court of Appeal found that the Minister's denial of relief to the taxpayer was unreasonable and ordered that the taxpayer's request be reconsidered. Whether the reconsideration will provide a favourable outcome remains to be seen.

### *Best Practices: A Word of Caution*

In the course of its judgment, the Court of Appeal found as a certainty that, had Mr. Lanno objected on a timely basis, he would have benefited from the *Stewart* decision and his objections would have succeeded, resulting in a refund. It also noted that, as no objections were

<sup>5</sup> *R. v. Barron*, 1997 DTC 5121 at 5122.

<sup>6</sup> IC 75-7R3: “Reassessment of a Return of Income.”

filed, the Minister's authority to reverse the reassessments depended on a successful fairness application.

It is worth mentioning that both levels of the Federal Court expressed concern over the fact that the taxpayer's advisors never made any follow-up with their client when they failed to receive copies of his reassessments and also over the fact that almost 11 months elapsed between the time the taxpayer realized that no objections

had been filed and the date on which the taxpayer finally requested fairness relief. That delay became problematic due to the intervening "pro-taxpayer" ruling in *Stewart*, which caused the CCRA to question the taxpayer's motive for seeking fairness relief. While there is perhaps no clear guideline that can be drawn, taxpayers and their advisors should be reminded that undue delays can work against them.

## *Sweibel Novek News*

### *Welcome*

We are pleased to welcome Marcie Akerman to our firm. Marcie was called to the Bar of the Province of Ontario in July 2004. She has now completed her civil law degree and expects to be called to the Quebec Bar this fall.

### *Change to LLP Status*

As of June 1, 2005, Sweibel Novek will become a limited liability partnership and will be known as Sweibel Novek s.e.n.c.r.l., or the English version Sweibel Novek L.L.P. This change is prompted by recently enacted legislative amendments which allow lawyers to practice their profession through a limited liability partnership or a corporation. The law also provides that a limited liability partner shall not be responsible for the obligations of the partnership nor for the professional error or negligence of another professional who the limited liability partner has not supervised or controlled.

Be assured that this change will not in any way affect the quality of our services or our relationship with our clients. We will continue to strive to provide the highest quality legal services in a professional and efficient manner.

Should you have any questions regarding this change in status, please contact us.

*The material contained herein is necessarily of a general nature and cannot be regarded as legal advice. The members of our firm would be pleased to provide additional information. You may reach us at (514) 849-1188 or by e-mail as follows:*

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