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Dockets: A-612-05
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Citation: 2007 FCA 53

CORAM: **LÉTOURNEAU J.A.**
EVANS J.A.
MALONE J.A.

BETWEEN:

A-612-05

XCO INVESTMENTS LTD.

Appellant

and

HER MAJESTY THE QUEEN

Respondent

A-613-05

WEST TOPAZ PROPERTY LTD.

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Heard at Vancouver, British Columbia, on January 17, 2007.

Judgment delivered from the Bench at Vancouver, British Columbia, on January 17, 2007.

REASONS FOR JUDGMENT OF THE COURT BY: LÉTOURNEAU J.A.

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REASONS FOR JUDGMENT OF THE COURT
(Delivered from the Bench at Vancouver, British Columbia, on January 17, 2007)

LÉTOURNEAU J.A.

[1] These are appeals from a decision of Chief Justice Bowman (Chief Justice) of the Tax Court of Canada (Tax Court) rendered on November 14, 2005. The Chief Justice allowed the appellants' appeal in part. He reduced the income attributed by the Minister of National Revenue to the appellants by $557,556.

Issues on appeal

[2] These appeals raise three issues:

a) whether the Chief Justice erred in applying the specific tax avoidance provision found in subsection 103(1) of the *Income Tax Act* (Act) to reallocate income initially attributed by the appellants to Woodwards Store Limited (Woodwards), the newly admitted third member of their Partnership;

b) whether the Chief Justice erred in determining that the reasonable amount to allocate to Woodwards pursuant to subsection 103(1) of the Act was $557,556; and

c) if the Chief Justice was mistaken in applying subsection 103(1) to the Partnership's allocations of income, whether the general anti-avoidance rule (GAAR) in section 245 of the Act can apply so as to reallocate income among the partners.

[3] These three issues, as we shall see, encompass the five points in issue stated by the appellants in their memorandum of facts and law.

The facts underlying the Tax Court decision

[4] The appeals in the Tax Court were heard together and were from assessments for the appellants' 1993 and 1994 taxations years.

[5] This case centres on a partnership called The West Topaz Real Estate Partnership (the Partnership) created on 6 December 1986. The original partners were Bosa Brothers Construction Ltd. (BBCL) and XCO Investments Ltd. (XCO), who held a 99% interest and 1% interest respectively in the partnership. This division of interest reflected the initial capital contributions to the partnership of $99 and $1 respectively. Both partners were wholly owned subsidiaries of Astron Realty Group Inc., a corporation controlled by Natale Bossa (*XCO Investments Ltd. v. The Queen*, 2005 TCC 655, par. 5-6 [XCO TCC]). When the Partnership was established in 1986, the partnership agreement established that for both income tax and accounting purposes, the income allocated to the partners would be in accordance with their proportionate interests (Partnership Agreement, Article VII, cited in XCO TCC, *ibid*, par. 7).

[6] In December 1986, the same month that the Partnership was established, two properties were transferred to the Partnership: the Topaz Apartments and the Westhill Apartments. The latter property was transferred by BBCL. BBCL also transferred its partnership interest to the appellant, West Topaz Property Ltd. (West Topaz), a newly incorporated and wholly owned subsidiary of Astron Realty Group, Inc. (XCO TCC, supra, note 2, par. 8, 6). As the Chief Justice put it,

> The result was that from 1986 to 1992 the Partnership consisted of West Topaz as to 99% and XCO as to 1%. The Partnership owned the two apartment properties, Topaz Apartments and Westhill Apartments. West Topaz acted as trustee for the Partnership (*ibid*, par. 9).

[7] In 1992, a series of transactions occurred that gave rise to the present appeals. They are outlined in detail at paragraph 11 of the Chief Justice's reasons. In short, three things occurred in anticipation of the sale of the Westhill Apartments by the Partnership:

a) Woodwards, a public retail company with substantial accumulated non-capital losses, entered into the Partnership with respect only to the Westhill Apartments. It was given a right to participate in 80% of the operating income and net cash flow of the Westhill Apartments. In exchange, it contributed cash equal to the 80% of the estimated net equity of the Westhill Apartments, less outstanding mortgages, and less a 6.5% discount to reflect the fact that the tax base of the property was less than its current value. The estimated fair market value of the Westhill Apartments was $10,800,000. The total mortgages on the property were $8,500,000 (discussed below). Subtracting the 6.5% discount and mortgages, Woodwards actually contributed $1,260,000.

b) Before Woodwards entered the Partnership, there were two mortgages on the property, totalling $3,500,000. On 13 March 1992, Natale Bossa set up a series of payments to place a $5,000,000 mortgage on the property, facilitating Woodwards' entry into the Partnership. The series of payments involved a circular transfer of money from Bosa Development Corporation, through:

i) Natale Bossa as a bonus;

ii) to Bancorp, a corporation controlled by Natale Bossa, as a shareholder loan;

iii) to the Partnership as a mortgage advance; and

iv) back to Bosa Development Corporation as a mortgage receivable.

c) On 19 March 1992, the original partnership agreement was substantially amended to reflect Woodwards participation in 80% of the Westhill Apartments, with West Topaz holding a 19.8% interest and XCO holding a 0.2% interest in that property. The partners agreed to share in the distribution of the proceeds of the sale in proportion to their interests. Woodwards was entitled to withdraw from the Partnership within 180 days, but, once Westhill Apartments was sold, it could not withdraw until the after the subsequent fiscal year-end of the Partnership. The definition of majority partner was revised to mean West Topaz rather than the holder of a majority interest (*ibid*, par. 11).

[8] On 20 March 1992, 420688 BC Ltd., an arm's length company, purchased the Westhill Apartments for $10,850,000.

[9] On 25 March 1992, Woodwards entered into an escrow agreement with the Partnership and Owen Bird, Barristers and Solicitors, whereby it was agreed that Woodwards' $1,260,000 capital contribution to the Partnership would be held in trust by Owen Bird. As is made clear by a reference in the escrow agreement, some time prior to 25 March 1992, Woodwards prepared and delivered its notice of withdrawal from the Partnership: see appeal book, vol. 1, page 311, paragraph 4. The Chief Justice cited the following facts from the appellants' submissions:

> The sale of the Westhill Apartments closed on July 8, 1992, with the receipt of sale proceeds of $10,090,467, not including an initial deposit of $750,000 that was paid earlier. The proceeds were disbursed as follows:
>
> $1,715,736 to CMHC;
> $1,860,952 to the National Trust Company;
> $5,000,000 to Bancorp in payment of the unregistered mortgage;
> $2,917 for legal fees; and
> $1,510,862 was disbursed to the Appellant;
>
> On July 13, 1992, the Appellant received the initial deposit of $750,000;
>
> On July 13, 1992, Owen Bird was instructed to release to the Partnership the $1,260,000 that was being held in escrow, plus accrued interest of $25,200. A cheque was made payable to the Appellant and deposited to its Royal Bank account; and
>
> On May 15, 1993, Woodwards transferred its interest in the Partnership to the Appellant for $1.00 and other good and valuable consideration;
>
> For the April 30, 1992 fiscal year-end of the Partnership Woodwards was allocated operating income for accounting purposes of $11,563 out of a total of $292,066. For tax purposes the allocation of operating income to Woodwards was $118,405 out of $292,066;

> On May 4, 1992, Woodwards received a letter advising them that their distributable share of operating income for March 1992 was $8,827. A cheque for that amount was included with the letter;
>
> A summary of the distribution of net sale proceeds dated July 13, 1992, shows net proceeds of $2,260,862 ($1,510,862 + $750,000). Woodwards 80% share of the proceeds was calculated to be $1,808,689.86. The Appellant accordingly sent Woodwards a cheque for that amount on July 13, 1992. The proceeds would have been $7,260,862 if not for the $5,000,000 Bancorp mortgage;
>
> For the April 30, 1993 year-end of the Partnership, Woodwards was allocated partnership income of $5,748,931 consisting of $5,725,794 related to the gain on the sale of the Westhill Aparments and $23,137 related to operating income. This income was sheltered using Woodwards' non-capital losses; and
>
> For the April 30, 1994 year-end of the Partnership, the residual amount of $6,652,877 in Woodwards' capital account was reallocated to the remaining partners. The Appellant was allocated 99% and XCO was allocated 1%; (*ibid*).

[10] In response to this allocation of income, the respondent expressed its view that Woodwards was not a true partner in the Partnership, and reallocated all of the income attributed to Woodwards back to the two appellants in proportion to their 99% and 1% respective interests (*ibid*, par. 12). The appellants appealed this reallocation to the Tax Court.

Whether the Chief Justice erred in applying the anti-avoidance provision contained in subsection 103(1) of the Act

[11] Subsection 103(1) of the Act reads:

103. (1) Where the members of a partnership have agreed to share, in a specified proportion, any income or loss of the partnership from any source	**103.** (1) Lorsque les associés d'une société de personnes sont convenus de partager en proportions déterminées tout revenu ou perte de la société de

or from sources in a particular place, as the case may be, or any other amount in respect of any activity of the partnership that is relevant to the computation of the income or taxable income of any of the members thereof, and the principal reason for the agreement may reasonably be considered to be the reduction or postponement of the tax that might otherwise have been or become payable under this Act, the share of each member of the partnership in the income or loss, as the case may be, or in that other amount, is the amount that is reasonable having regard to all the circumstances including the proportions in which the members have agreed to share profits and losses of the partnership from other sources or from sources in other places.	personnes provenant d'une source donnée ou de sources situées dans un endroit déterminé ou tout autre montant qui se rapporte à une activité quelconque de la société de personnes et qui doit entrer en ligne de compte dans le calcul du revenu ou du revenu imposable de tout associé de cette société de personnes et lorsqu'il est raisonnable de considérer que cette convention a pour objet principal de réduire les impôts ou de différer le paiement des impôts qui auraient pu être ou devenir payables par ailleurs en vertu de la présente loi, la part du revenu ou de la perte, selon le cas, ou de l'autre montant, revenant à chaque associé de la société de personnes est le montant qui est raisonnable, compte tenu des circonstances, y compris les proportions dans lesquelles les associés sont convenus de partager les profits et les pertes de la société de personnes provenant d'autres sources ou de sources situées à d'autres endroits.

(Emphasis added)

[12] There is now no dispute that a valid Partnership existed between Woodwards and the appellants. The Chief Justice was satisfied that the legal relations created by the partnership agreement were not shams and were genuine and legally effective: see paragraphs 14 and 15 of his decision.

[13] That said, he properly found, in our view, that the bringing of Woodwards into the Partnership was principally tax motivated at least from the appellants' perspective. Counsel for the appellants at the hearing before us conceded as much. For an outlay of something over one half

million dollars, the appellants were expecting to save taxes of over $2,000,000: see paragraph 31 of his decision. He was “unable to identify any other commercial or non-tax purpose”: *ibidem*.

[14] The appellants submit that subsection 103(1) does not apply in the present instance as there was profit trading, not loss trading. They rely upon the decision of the Tax Court of Canada in *Loyens v. Her Majesty the Queen*, 2003 TCC 214 where, at paragraph 110, the judge wrote:

> From my reading, I do not see how the Respondent can glean any remarks that support the proposition that profit sharing is prohibited… Clearly *OSFC Holdings Ltd.* prohibits loss trading. However, I would not extend the principles enunciated in *OSFC Holdings Ltd.* with respect to loss trading to conclude that profit trading is interchangeable with loss trading.

[15] The *Loyens* case raised a section 245 (GARR) analysis as to whether there had been an abuse of the provisions of the Act as a whole. Subsection 103(1) addresses a different problem and provides a different test. The subsection applies when there is a sharing of income (or loss) of the Partnership, which is the case in the present instance.

[16] Having found that subsection 103(1) applies because there is a sharing of income and the principal reason for the agreement with Woodwards was the reduction of tax otherwise payable, this brings us to the second question to be answered, i.e. whether the allocation of income to the partners was unreasonable.

[17] The Chief Justice found that an allocation to Woodwards of 80% of the income from the Westhill Apartments was unreasonable in view of the fact that Woodwards’ contribution was both

ephemeral and for all practical purposes risk-free: see paragraphs 33 and 34 of his decision. These are findings on questions of fact or mixed fact and law and therefore can only be disturbed on appeal if the appellants satisfy us that the judge made a palpable and overriding error.

[18] In our view, there was sufficient evidence to support his conclusions. Mr. Lazzari, an accountant responsible primarily for tax matters for Bosa Development Corporation, testified that having Woodwards as a partner was never contemplated to be a long term arrangement: see transcript of proceedings, vol. 1, pages 90, 93 and 214. Indeed, there was no community of business interest between Woodwards, which was a public retail company, and the Partnership operating a rental business. The sale of Westhill Apartments was imminent and it was not contemplated that Woodwards would remain a partner beyond the fiscal year in which the sale occurred.

[19] As for the fact that Woodwards' contribution to the Partnership was practically risk-free, the evidence before the Chief Justice revealed that the Partnership agreement, when it was amended, specifically limited Woodwards' liability to debts or obligations relating solely to Westhill Apartments.

[20] In addition, under an escrow agreement, Woodwards' capital contribution was safeguarded until it agreed to release the funds or until it received its initial distribution from the sale of the Westhill Apartments. In fact, this is what occurred: Woodwards' capital contribution to the Partnership was not released from the escrow agreement until after Woodwards received its payout from the sale of the Westhill Apartments: see appeal book, page 342, the letter of the appellants to

Owen, Bird acknowledging payment of the initial distribution to Woodwards and requesting the release of Woodwards' capital contribution pursuant to the escrow agreement. On the basis of that evidence, the Chief Justice was entitled to draw a conclusion that, in fact, Woodwards' contribution was "for all purposes risk-free".

[21] The appellants contend that the Chief Justice failed to take into account the fact that the provision regarding the allocation of income and loss for tax and accounting purposes among members of the Partnership was made more than five years before Woodwards joined the Partnership. It was, they submit, a rational, reasonable and normal formula for the allocation of income under the Act. They argue that "a court should not substitute its view as to what is reasonable in the circumstances by second guessing the business judgment of a taxpayer": see paragraphs 16 to 18 of their Memorandum of Fact and Law. They cite, in support of their position, this excerpt from Martin J. in *Signum Communications Inc. v. The Queen*, 88 DTC 6427, at page 6430, a decision later affirmed by this Court, 91 DTC 5360:

> … where there is a rational, reasonable and normal formula employed in the allocation of the losses, as there was in this case where they were allocated in proportion to the capital contributed, there are no grounds on which the Minister can invoke the provisions of section 103.

[22] A reading of the reasons provided by the Chief Justice shows that he did not fail to take into account the Partnership's provision regarding the allocation of income among the members of the Partnership. It is clear under subsection 103(1) of the Act that the proportions in which the members have agreed to share profits and losses is only one of the circumstances to be looked at. The

subsection required him *to look at all the circumstances* in determining whether the amount allocated is reasonable. This is what the Chief Justice did.

[23] In our view, the Chief Justice was right to conclude that, having regard to all the circumstances, the allocation of 80% of the income to Woodwards was unreasonable.

[24] Though the Partnership was valid, there was no real basis upon which to distribute profits to Woodwards. The participation of Woodwards as a partner was always intended to be short-term. Its capital contribution was hardly necessary or useful to the Partnership. It offered nothing in the way of expertise to the Partnership. In effect, it contributed nothing other than its losses. Though the effect of the transaction in this case was to transfer profit to a loss company (rather than to transfer loss to a profitable company), the appellants were able, through the participation of Woodwards, to take advantage of Woodwards' accumulated losses for less than it would have cost them in taxes had the Partnership's income been allocated to them directly.

[25] In our view, this case was an appropriate case in which to apply subsection 103(1). We are of the view that the Chief Justice did not err in this respect.

Whether the Chief Justice erred in determining that the reasonable amount to allocate to Woodwards pursuant to subsection 103(1) of the Act was $557,556

[26] The Chief Justice was of the view that the true economic reality of the arrangement between Woodwards and the appellants was an important ingredient in determining what would be a

reasonable allocation of income in the present case: see paragraph 35 of his decision. Keeping that in mind, he concluded that a reasonable treatment of the arrangement under section 103 of the Act would be to treat Woodwards' share of the income as the amount it actually received, i.e. $557,556.

[27] We cannot say that his decision in this respect is unreasonable. The $557,556 that Woodwards took out of the Partnership was money that the appellants never benefited from and they should not be taxed on this income. The other income allocated to Woodwards for tax purposes was not reasonably allocated and is properly viewed as taxable in the hands of the appellants.

Whether the general anti-avoidance rule (GAAR) in section 245 of the Act can apply so as to reallocate income among partners

[28] We do not need to answer this question in view of the conclusions that we have reached with respect to section 103 of the Act.

Conclusion

[29] For these reasons, the appeals will be dismissed with one set of costs, plus disbursements in each file.

"Gilles Létoureau"

J.A.

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

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DELIVERED FROM THE BENCH BY:	LÉTOURNEAU J.A.

APPEARANCES:

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