Federal Court of Appeal

Cour d'appel fédérale

Date: 20111214

Docket: A-442-10
A-443-10

Citation: 2011 FCA 352

CORAM: **EVANS J.A.**
LAYDEN-STEVENSON J.A.
MAINVILLE J.A

BETWEEN:

LYNCORP INTERNATIONAL LTD.

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Heard at Calgary, Alberta, on December 14, 2011.

Judgment delivered at Calgary, Alberta, on December 14, 2011.

REASONS FOR JUDGMENT BY: EVANS J.A.

CONCURRED IN BY: LAYDEN-STEVENSON J.A.
MAINVILLE J.A.

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REASONS FOR JUDGMENT

EVANS J.A.

Introduction

[1] This is an appeal by Lyncorp International Ltd (Appellant) from a decision of the Tax Court of Canada, reported at 2010 TCC 532. In that decision, Justice Campbell Miller (Judge) disallowed certain expenses that the Appellant had incurred in supplying services, which it claimed to be able to deduct from its income from property in the taxation years 2002 and 2003.

[2] The Appellant said that it had incurred the expenses for the purpose of earning income from a business or property within the meaning of paragraph 18(1)(*a*) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (ITA), which provides as follows.

18. (1) In computing the income of a taxpayer from a business or property no deduction shall be made in respect of	18. (1) Dans le calcul du revenu du contribuable tiré d'une entreprise ou d'un bien, les éléments suivants ne sont pas déductibles :
(a) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property;	*a)* les dépenses, sauf dans la mesure où elles ont été engagées ou effectuées par le contribuable en vue de tirer un revenu de l'entreprise ou du bien;
...	[…]

[3] The Appellant has narrowed the scope of the appeal to a single question: did the Judge err in holding that expenses incurred by the Appellant when its sole owner, David Mullen, travelled by private jet to provide gratuitous services to corporations in which the Appellant owned shares, were not for the purpose of enabling it to earn future income from property, namely the shares in the corporations? Lyncorp had substantial property income from other sources.

[4] The Judge also held that these expenses did not entitle the Appellant to input tax credits (ITC) under subsection 169(1) of the *Excise Tax Act*, R.S.C. 1985, c. E-15 (ETA) so as to enable it to recover the Goods and Services Tax (GST) that it had paid for the flight services. He found that these services were not used in the course of the Appellant's "commercial activity".

[5] The facts are common to both appeals and are set out at length in the Judge's reasons. For present purposes, it suffices to say that the Appellant owned shares in four corporations. Mr Mullen visited these corporations to provide business consulting and operational services, for which (with one exception) neither he nor the Appellant charged a fee. He travelled in an airplane in which the Appellant had a fractional ownership. The Appellant sought to deduct from its income the expenses of Mr Mullen's flights, and to claim ITCs to recover the GST that it had paid for the supply of the flight services.

[6] For the reasons that follow, I would dismiss both the ITA and the ETA appeals. These reasons apply to both appeals, and a copy will be inserted in both files.

ITA appeal

[7] The Judge (at para. 68) put the issue relevant to this appeal as follows:

> … does the Appellant's investment in shares of the business ventures, with the possibility of dividends being declared on those shares, support the deduction of the disputed flight expenses, claimed to have been incurred for the purpose of producing the dividend income?

[8] He held (at para. 73) that the flight expenses related directly to the business income of the four corporations because they were incurred to make them more profitable. However, the relationship of the expense to the Appellant's property source of income (the shares) was only indirect. He concluded pithily (at para. 75) by saying:

> This generosity was neither a loan nor an equity investment by the Appellant. It might best be described as an agreement to pay someone else's expenses. Equity investments yield dividend income. Debt investments yield interest income. Free

> services, with no obligation to repay, yield only hope. This is not a deductible expense.

[9] The Appellant says that the Judge lost sight of the fact that it is sufficient to claim a deduction under paragraph 18(1)(*a*) that the Appellant incurred the expenses to increase the profitability of the corporations for the purpose of receiving dividend income. The Judge erred, the Appellant argues, by finding a requirement in paragraph 18(1)(*a*) that an expense incurred for the purpose of gaining or producing income from the taxpayer's property may only be deducted from income if it is directly related to the property.

[10] In support of his argument, counsel relied on the decision of this Court in *Canada v. Byram*, 99 DTC 5117 (*Byram*). The issue in *Byram* was whether a taxpayer who had made an interest-free loan to a company in which he held shares could claim a capital loss on the loan under subparagraph 40(2)(*g*)(ii) of the ITA when the loan had been made for the purpose of earning dividends.

[11] Writing for the Court, McDonald J.A. stated (at para. 16) that it was not necessary "for the income to flow directly to the taxpayer from the loan" before the taxpayer could deduct a capital loss on the loan. He continued (at para. 17):

> Such an approach is consistent with commercial reality. Frequently, shareholders make such loans on an interest-free basis anticipating dividends to flow from the activities financed by the loan.

[12] However, McDonald J.A. also said (at para. 21):

> It is equally clear that the anticipation of dividend cannot be too remote. …. A deduction cannot be so far removed from its corresponding income stream as to render its connection to the anticipated income tenuous at best.

[13] He found that a loan by a shareholder was not too remote because shareholders are directly linked to the corporation's future earnings and its payment of dividends. It should be noted that in *Byram*, the taxpayer and members of his immediate family were the only shareholders in the company at all material times.

[14] While legal and factual distinctions between *Byram* and the present case can readily be drawn, *Byram* is relevant in that it recognizes that the connection between an expense incurred by a taxpayer and anticipated dividend income cannot be tenuous or remote. In *Stewart v. Canada*, 2002 SCC 46, [2002] 2 S.C.R. 645, the Court said (at para. 57):

> If the deductibility of a particular expense is in question, then it is not the existence of a source of income which ought to be questioned, <u>but the relationship between that expense and the source to which it is purported to relate</u>. (emphasis added)

[15] It may be relatively easy to establish a sufficiently close connection between an interest-free loan by a shareholder and an anticipated dividend. However, the same is not necessarily true of services provided gratuitously to a corporation by a shareholder. Much will depend on the particular facts.

[16] In the present case, the evidence of the precise nature of the services rendered by Mr Mullen was sketchy. At one point, the Judge remarked (at para. 33) that Mr Mullen's response "did not

elaborate in any great detail on his personal involvement." Further, following an explanation by Mr Mullen of what he did, the Judge said: "I was not clear exactly what this all meant." There were no agreements between the Appellant or Mr Mullen and the four corporations respecting the services, and some of the timesheets produced by Mr Mullen seem not to have been accurate, in that they showed he was working on his "day job" for the Mullen Group, a large and successful business, when he said that he was providing services to the other corporations (para. 39). His work for Lyncorp did not start until late on Friday afternoon (para. 10).

[17] Finally, unlike the situation in *Byram*, to permit the Appellant to deduct the expenses incurred in its provision of gratuitous services to the four corporations on the basis of anticipated dividends is not "consistent with commercial reality".

[18] In these circumstances, we are not persuaded that the Judge committed any error warranting our intervention when he concluded that the connection between the Appellant's claimed expenses and the shares in the corporations as a source of income was not sufficiently direct to fall within paragraph 18(1)(*a*). As the Judge pointed out, the direct connection was between the expenses and the business of the corporations.

ETA Appeal

[19] The question here is whether the Appellant is entitled to recover as an ITC the amount of GST collected from it by the supplier of the flight services that were used for Mr Mullen to visit the four corporations when providing business consulting services.

[20] A taxpayer is generally entitled to an ITC when it paid GST "for consumption, use or supply in the course of commercial activity": ETA, paragraph 169(1)(*c*). The phrase "commercial activity" is defined in subsection 123(1)of the ETA as "a business carried on by the person … except to the extent to which the business involves the making of exempt supplies by the person."

[21] The Judge rejected the Appellant's claim (at para. 77), on the ground that the purpose of the supply of services was related to the businesses of the four corporations, not the business of the Appellant. He determined (at para. 78) that the services were not supplied to the Appellant in the course of its commercial activity by reference to four factors: the purpose for the input; the person for whom the input was incurred; the context in which the input was incurred; and the case law on commercial activity.

[22] Whether the input was incurred in the course of commercial activity of the Appellant or of the four corporations is a question of mixed law and fact. Absent a readily extricable question of law, this Court can only interfere with the Judge's conclusion if he made a palpable and overriding error. I am not persuaded that he did.

[23] The Appellant argues that "business" is very broadly defined in subsection 123(1) and includes an "undertaking of any kind whatever", whether or not it is engaged in for profit. In my view, this does not meet the relevant objection: the "business", however broadly defined, must be that of the taxpayer.

Conclusion

[24] For these reasons, I would dismiss the appeal with costs.

"John M. Evans"
J.A.

“I agree
Carolyn Layden-Stevenson J.A.”

“I agree
Robert M. Mainville J.A.”

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

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