Docket: 2006-924(IT)G

BETWEEN:

VALIANT CLEANING TECHNOLOGY INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on May 28 and 29, 2008 at Windsor, Ontario

Before: The Honourable Justice Diane Campbell

Appearances:

Counsel for the Appellant:	Wilfrid Lefebvre, Q.C. Dominic C. Belley
Counsel for the Respondent:	Susan Shaughnessy

AMENDED JUDGMENT

The appeals from the determination made under the *Income Tax Act*, dated December 30, 2004, in respect of the taxation years ending on February 28, 2000 and February 28, 2002, are allowed, with costs based on one set of counsel fees, and the determination is referred back to the Minister of National Revenue for reconsideration and reassessment in accordance with the attached Reasons for Judgment.

This Judgment is issued in substitution for the Judgment dated November 21, 2008.

Signed at Ottawa, Canada, this **8th** day of **December** 2008.

"Diane Campbell"

Campbell J.

Citation: 2008 TCC 637
Date: 20081**208**
Docket: 2006-924(IT)G

BETWEEN:

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AMENDED REASONS FOR JUDGMENT

Campbell J.

[1] These appeals deal with the Appellant's taxation years ending February 28, 2000 and February 28, 2002.

[2] The Parties filed a Partial Agreed Statement of Facts, which I have attached to my Reasons as Schedule "A". The Appellant conceded that the initial investment amount of $1,031,450, in respect to the share purchase, together with the first two advances to its subsidiary of $780,150 and $531,930 for a total of $2,343,530, were capitalization activities (see diagram at paragraph 11 of the Partial Agreed Statement of Facts). In other words, they are strictly capital losses which may be deducted against capital gains. It is the losses with respect to the subsequent cash advances, totalling ~~$12,639,732~~ **$11,327,652**, that the Appellant is arguing should be properly treated as current in nature and, consequently, used to offset the Appellant's income.

[3] The issue before me is straightforward: whether the Appellant can treat the subsequent cash advances to its subsidiary as current or non-capital losses.

[4] The Appellant is involved in the business of designing and supplying highly sophisticated industrial pressure washers to the automotive industry. This equipment washes and cleans the assembly line components to remove all debris from the finished product. The Appellant is referred to as a Tier 1 supplier within the automotive industry. Its chief customer is Ford Motor Company ("Ford"). According to the evidence of Michael Solcz, Senior, the Appellant is one of only a few Canadian suppliers in this area of automotive activity and the only Tier 1 supplier in the Windsor area.

[5] In the 1990's each of the major automotive players, including Ford, implemented a globalization plan which involved reducing the number of Tier 1 suppliers that supplied each commodity worldwide within the industry. The Tier 1 suppliers were those companies that the major players called upon directly to fulfil certain contracts. The lower tiers, Tier 2 and Tier 3, supplied to the Tier 1 group. Certainly, according to the evidence, the best position to be in was Tier 1 in respect to both the volume of business and the revenue. Accompanying the decision to reduce the number of Tier 1 suppliers came a demand that the Tier 1 suppliers have a global presence not only in North America but also in Europe. The Appellant had already commenced its own globalization by establishing a presence in the United States ("U.S.") in the late 1980's.

[6] Over a number of months, meetings were held with the then current Tier 1 suppliers. Some of these Tier 1 suppliers abandoned the globalization plan because they were unable or unwilling to meet the demands. According to Michael Solcz, Senior, it was imperative that the Appellant remain a Tier 1 supplier as "… otherwise we will not have Ford as a customer" (Transcript page 135). It was also clear from his testimony that the Appellant possessed knowledge and certification concerning the washing technology that Europeans did not have and which would be valuable to Ford in its globalization plans. This would ensure global uniformity of equipment being produced in the automotive industry.

[7] The Appellant decided to retain its Tier 1 status and, consequently, Ford supplied it with European contacts for potential acquisitions in the Appellant's requirement to now establish itself in Europe. The first company acquired was in Belgium in 1995. The Appellant then focused on a United Kingdom ("U.K.") based industrial washer group, Reiss-Elan. That company was no longer interested in staying in the washer business and so became available to be purchased. Reiss-Elan had an established European base with Ford, BMW and Mercedes. It was acquired in 1996 and, subsequently, the Valiant Group in Canada incorporated

Valiant Elan Systems Limited (U.K.) ("Elan"). Elan became a subsidiary in the U.K. of Valiant Elan Systems Limited (Canada) which later changed its name to Valiant Cleaning Technology Inc., the Appellant in these appeals. For its customers and potential customers, this meant that the Appellant would more appropriately be able to service those customers in both North America and Europe.

[8] Between 1999 and 2001, the Appellant made cash advances to Elan to enable Elan to complete its ongoing contracts. At the date of the purchase of Elan, it was experiencing poor performance because, although it had ongoing projects, it was still unable to generate profits. By May 2000 the bank required the Appellant to re-capitalize Elan and advances were forwarded so that projects could continue to be completed. Elan's bank overdrafts were subsequently guaranteed by the Appellant in an effort to cover these operating costs. These financial transactions were outlined at paragraph 11 of the Partial Agreed Statement of Facts. According to Tony Parete (Executive Vice President), the advances were made so that projects that Elan had originally undertaken could be completed. The advances were used to purchase materials and pay for labour and overhead costs so that customers' contracts would not be abandoned. Mr. Parete explained that once an order was received from a customer, the washing equipment had to be designed, manufactured, shipped and, lastly, installed on the customer's floor. Between 1997 and 1998 the Appellant's financial statements show a considerable increase in the amount of the advances which Mr. Parete testified were the result of Elan's larger projects. Eventually these advances were converted to interest bearing notes receivable. When asked if these advances were an investment in the subsidiary, Mr. Parete stated that the advances were made "… to pay for work completed for the projects that they had in England … [including] current expenses." (Transcript page 223).

[9] By 1999, Elan was facing serious financial problems, again arising from difficulties in completion of its projects. These difficulties were numerous and were in respect to pricing and technical areas, such as engineering and design, and extended to the actual building of the washer equipment itself. On some occasions, Canadian employees travelled to the U.K. to assist in reworking the equipment. This increased costs and losses resulted. In addition some of the U.K. contracts were subsequently completed in Canada, negatively impacting upon Elan's ability to meet its financial obligations. Subsequent to the write-down of approximately $7.4 million in 2000, the decision was made to send new advances to Elan because, according to Mr. Parete, more projects had been received by Elan due to the confidence the customers had in the company. These new projects had to be

completed to preserve the Appellant's reputation within the automotive industry and particularly with Ford, or, the Appellant would, as Mr. Parete testified "… get reduced to a non-supplier" (Transcript page 231).

[10] According to Note 6 of the financial statements for the period ending February 28, 2001, the Appellant was showing its investment in Elan as zero. Mr. Parete testified that the investment's write-down to zero represented the cumulative effect of losses over a number of years and the decision that recovery would be impossible. By 2001, approximately $13.6 million had been written down. About this time, it was also decided to close down the U.K. operation because Elan was simply unable to generate profits from its projects.

[11] Toward the end of Mr. Parete's testimony, he proceeded to review the sales summaries for the Appellant in 1997, 1998 and 1999, identifying the many sales that were generated for the Appellant in Canada through the Appellant's U.K. presence.

[12] Until 2004, the Appellant characterized these losses as capital losses on its financial statements and reported them in the same manner. During a 2004 audit, these losses were re-characterized as current expenses pursuant to the advice of Nick Sauro (Chief Financial Officer) who had just been hired by the Valiant Group. When Canada Revenue Agency ("CRA") refused to consider the losses as current, the Appellant submitted a request for a Determination of Losses from the Minister which would enable the Appellant to submit Notices of Objection respecting the fiscal treatment of the losses.

[13] I heard from eleven witnesses, ten called by the Appellant, one called by the Respondent. Susan Swiatoschik, the Appellant's corporate comptroller, was involved in the preparation of the Appellant's tax returns and financial statements. She testified respecting the re-characterization of the losses in 2004 from capital losses to current expenses as well as the Appellant's purpose in making the advances. Nick Sauro also provided evidence in respect to the Appellant's purpose in continuing advances to a subsidiary that was in severe financial difficulties. Michael Solcz, Senior, the founder of the business, provided an interesting account of the history of the industry generally and the start-up and progress of his business from a small tool shop in the 1950's to a Tier 1 supplier to some of the automotive giants such as Ford and GM. He also testified respecting the purpose of these advances. His three sons, Michael, Jr., Len and Marty are all involved in the business and gave evidence regarding the move to globalization. Tony Parete, the Appellant's Executive Vice President and a key player in the decision to continue

to send advances to the subsidiary, testified regarding the purpose of the acquisition of the U.K. subsidiary and the subsequent advances to it. Dennis Staudt and Thomas O'Brien, both chartered accountants with Price Waterhouse Coopers, rendered audit opinions on the Appellant's financial statements and provided tax planning advice respectively during the years under appeal. Both witnesses testified respecting the treatment and re-characterization of the losses. Timothy Moore, the line operation supervisor with Ford Motor Company during the periods under appeal, testified respecting the meetings which occurred between Ford and its suppliers on the globalization requirement.

[14] The Respondent's witness, Stanley Kerr, financial analyst to Mr. Parete, identified several documents representing his projections of November 27, 2000 for the subsidiary, Elan.

[15] The Appellant's position is that the advances to Elan, with the exception of the concessions made at the commencement of the hearing, were integral to its income earning process. The expenditures were incurred by the Appellant on its own behalf but through the U.K. operations to establish a global presence so that it could maintain its Tier 1 status as a supplier in the automotive industry. The advances were made to Elan for the benefit or in the interests of the Appellant and more particularly to protect the Appellant's revenue stream in Canada. In so doing it was not attempting to invest in and capitalize the U.K. operation.

[16] The Respondent's position is that the cash advances were properly characterized initially by the Appellant as capital losses in its accounting and tax treatment of these amounts. The nature of the losses cannot be altered and neither can the legal nature of the relationship between the Appellant and Elan as two separate legal entities. Form matters in income tax issues and the Appellant held shares and interest bearing notes which were capital in nature. It was a simple business decision by the Appellant to expand globally, to acquire the subsidiary and to loan it working capital to continue its business. The Respondent claims these are the same facts as those in the cases of *Stewart & Morrison Limited v. Minister of National Revenue*, 72 DTC 6049, and *Cathelle Inc. v. The Queen*, 2005 DTC 858. Even if the Appellant was compelled to establish a global presence in Europe, it must have intended a long term presence and therefore the advances to Elan were on capital account and cannot be considered a business expense for the purpose of earning income. The Appellant does not fall within the recognized exceptions to the general presumption that losses of the nature at issue in these appeals are on capital account. The advances cannot be matched to the Appellant's

income and are therefore capital outlays in the form of shares and notes. More precisely the Respondent contends at paragraph 25 of its Reply that:

> Appellant is neither a money lender, did not extend credit to a client and did not hold shares and notes issued by its U.K. subsidiary as a trader in such assets or part of an adventure in the nature of trade.

[17] Finally, the Respondent contends that the Appellant chose to acquire a separate legal entity by investing in Elan's shares and establishing notes receivable when it could have set up its own European branch operation, enabling it to include income/loss from that branch operation in its Canadian income.

Analysis

[18] The determination of whether an expenditure will be on capital or current account is for the most part a factually driven issue. The Appellant has conceded that the initial investment in the shares of Elan in 1996 as well as the first two advances were on capital account for the purpose of expansion into the U.K. The Appellant states that the intent, respecting the initial acquisition and the first two investments, was to obtain a benefit for both the Canadian operation and the U.K. operation by virtue of income generation in the subsidiary, Elan. The question then becomes: Did the Appellant's intent subsequently change with regard to the subsequent advances made between 1999 and 2001 so that they could then be properly characterized as being on current account? This requires a finding that these advances, although filtered through the U.K. operation, were in reality for the benefit of the Canadian operation.

[19] The Appellant faces two problems here. First, the advances were initially treated as capital outlay both in its accounting records and in its tax returns. As a result of a change in the corporate administrative personnel, they were re-characterized as non-capital losses. Second, the advances were made to a separate and distinct legal entity in the U.K. over a number of years and in which it held shares and notes.

[20] In my review of the facts and the general principles to be considered, I have concluded that the Appellant has successfully overcome both these hurdles. The evidence is uncontradicted that the Appellant was required to secure a global footprint not only in the U.S. but in Europe if it was to remain a Tier 1 automotive supplier. Business decisions were made to forge ahead with the globalization plan, which to a large extent, had been forced upon all Tier 1 suppliers by the large

automotive players. A business decision had to be made to either climb onboard the global train, that the automotive giants had orchestrated and superimposed, or stay behind as Tier 2/Tier 3 suppliers. To compete and to protect its revenue stream, particularly with its largest customer, Ford, the Appellant took its seat on that global train and through Ford's suggestion eventually purchased the U.K. operation, Elan. Clearly at the outset, the Appellant intended to expand into the U.K. market by way of its investment in Elan. The share purchase and those first two advances are rightly characterized as capital expenditures. There is little doubt that these first cash injections were to capitalize the subsidiary's operations. It must be remembered that from the outset Elan was experiencing some financial difficulties and required these advances. It had the project contracts and customers but remained unable to generate profit for a number of reasons. However, the evidence suggests that the Appellant made a business decision to have these companies come together with a global view to expansion of services to a wider band of customers.

[21] Initially these companies were "a good fit" (Transcript page 137) and the purchase of Elan allowed the Appellant to put another piece of the puzzle in place in meeting Ford's larger plan. In the first ten months of Elan's operation after the purchase it was in a break-even situation, according to Mr. Parete, but more importantly, it had a backlog of projects waiting in the wings. So the decision to forward two larger advances to Elan is no surprise and the Appellant made the appropriate call in my opinion that these advances would be on capital account. However, as may often occur in the business world, the best laid plans do not materialize. Elan experienced mounting financial difficulties, although it retained projects and customers. Ordinary business sense and common sense would suggest that the Appellant would take stock of its losses and close Elan, but it did not. It continued to infuse Elan with large advances. To answer the question "why?", it is imperative to look at the history of these advances in the larger context of what was occurring generally with both the Appellant and Elan.

[22] I believe that these advances changed in nature from being initially on capital account to expenditures made solely for the purpose of protecting the revenue stream of the Canadian operation. In this respect, I consider this case unique to its particular facts. In deciding that these advances changed in nature over a period of time, I am in no way suggesting that this decision be used to allow a window of opportunity for deductibility of financing activities between a Canadian parent company and its foreign subsidiary.

[23] To determine the dominant nature of these advances and for whose benefit they were incurred, jurisprudence instructs that I look for evidence of both objective and subjective factors. Key to the subjective factor is the Appellant's intent in making the expenditures. Obviously there should then be objective factors which will confirm that intent. The Respondent asks that I look at the accounting and tax treatment to ascertain objectively this intent. The Supreme Court of Canada in the following three decisions:

1. *Canderel Limited v. The Queen*, [1998] 1 S.C.R. 147;
2. *Ikea Ltd. v. The Queen*, 98 DTC 6092; and
3. *Toronto College Park Ltd. v. The Queen*, [1998] 1 S.C.R. 183,

has unequivocally stated that generally accepted accounting principles ("GAAP") are interpretive tools only, which may or may not reflect a taxpayer's fiscal reality. Respondent conceded that financial statements and tax returns are not necessarily indicative in every situation of what a taxpayer's intent is. They may be useful but they are not rules of law and will never be absolutely determinative.

[24] The evidence of all the Appellant's witnesses definitively establishes that there was a decision to continue the advances when it was an absolute given that they would never be recovered in terms of repayment. The last advances in particular were written off almost immediately. I cannot look at the paper treatment of these losses in a vacuum. If I were inclined to do so, which I am not, I would be ignoring the objective evidence of a parade of witnesses who all confirmed that these advances were made to protect the revenue in the Canadian operation. From 1999 onward, they were not made to ensure the continuing successful existence of Elan, which would translate into obtaining an advantage in the U.K. of an enduring nature. Ms. Swiatoschik, in cross-examination, testified that the reasons for the advances changed from "true advances" in the initial years to needing to "save face with a customer" and to preserve the reputation of the Valiant group in latter years (Transcript pages 81-82). Michael Solcz, Senior, when questioned on the necessity of making these advances stated: "We had no choice otherwise we lose our business <u>here</u>" [in Canada] (emphasis and explanation added) (Transcript page 139). Mr. Solcz went on to state:

> So we had no choice because if we don't complete it what happens to us by General Motors or Ford, you know, there was a threat of closing us down and there was no way that we could afford to be out of business.
> (Transcript page 144).

Tony Parete (Executive Vice President) also confirmed that the Valiant group felt it had no choice but to complete the U.K. projects to save its reputation. At page 229 of the Transcript he states:

> … we have to complete the projects. We couldn't let the customer down because when they want to launch a program they're dependant on all their suppliers and if you don't meet the requirement of that launch, I mean, they'll reduce you as a supplier real quick if they can't depend on you. So we had to ensure that we met our requirements.

[25] The Supreme Court of Canada in *Shell Canada Limited. v. The Queen et al.*, 99 DTC 5669, provides two caveats to the general rule that the economic reality of a transaction takes precedence over the legal form:

1. Economic reality can never be used to re-characterize a taxpayer's *bona fide* legal relationship. Re-characterization is only permissible if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect.

2. Where the provision at issue is clear and unambiguous, its terms must simply be applied. Elan was maintained as a separate U.K. entity from the Appellant. The Respondent uses this legal relationship as its basis to claim that the advances were capital because they were made solely for the share acquisition and the benefit of Elan. However, Chief Justice McLachlin in *Shell* states at paragraph 47:

> … Yet, as Dickson, C.J. made clear in *Bronfman Trust*, *supra*, at p. 46, the reason for a particular method of *borrowing* is irrelevant to a proper consideration of s. 20(1)(*c*)(i). The issue is the *use* to which the borrowed funds are put. It is irrelevant why the borrowing arrangement was structured the way that it was or, indeed, why the funds were borrowed at all.

This quote makes it clear that the use of the funds is of utmost importance in a determination of deductibility. My conclusion in these appeals that, on a balance of probabilities, the dominant purpose of advancing the funds was to safeguard the Appellant's stream of income as the primary use of the funds, is in line with this Supreme Court statement in *Shell*. Protecting this stream of income of course involves, as the witnesses suggest, keeping its customer base happy and saving its reputation. In focusing on these end results, it protected its Tier 1 status - its ultimate goal. There was no benefit to Elan or if there was, it was of a secondary nature only and very minor since Elan was on the road to bankruptcy.

[26] The Respondent referred me to the case of *Stewart & Morrison Ltd. v. M.N.R.*, [1974] S.C.R. 477*,* where advances to an American subsidiary were treated as loans on the books and were found to provide working capital to enable it to get started and to continue to operate. At first glance, these facts would appear to mirror the facts in these appeals. However, as all of these cases are factually driven, there are factors which distinguish it from the case before me. In *Stewart & Morrison* the Appellant taxpayer set up an American subsidiary to carry on business in its own name and to be a source of income and profit for the Appellant taxpayer. In contrast, Elan was already established in the U.K. with its own customer base and projects or jobs in progress. The advances to Elan covered the operational costs to ensure those projects were completed, the customer base satisfied and the reputation of the Valiant Group preserved. However, the long term predominant feature was to preserve Valiant's Tier 1 status and thus its income stream – its very livelihood. The facts in *Stewart & Morrison* are not the same. The taxpayer there decided to expand globally by entering the U.S. market but it failed. The conclusion in that case with those facts was correct – that the advances were of a capital nature because the expectation was that the U.S. subsidiary would be successful and endure as a profit making operation. That is not the case in the facts before me when in 1999 it was clearly evident that Elan could never hope to survive financially. With no hope or expectation that Elan could become a viable U.K. operation why would the Appellant continue to pay such enormous advances to Elan? Surely it could never have intended to salvage an operation with no future. To suggest that an otherwise successful business operation would continue to throw huge sums of money in Elan, which was close to financial ruin, is ludicrous. It would be akin to boarding that global train set in motion by the automotive giants, realizing their ticket was taking them in the opposite direction of where they intended to go and yet not getting off at the very first available stop. There can only be one business purpose, as all of the testimony suggests, and that is to ensure that those contracts were completed by Elan so that the Canadian operation could be protected in respect to reputation, revenue and Tier 1 status. That is the ultimate intent behind the use of these borrowed funds. The evidence fully supports my finding that these advances were of no benefit to Elan.

[27] *Stewart & Morrison* distinguishes the decision in *L. Berman & Co. Ltd. v. Minister of National Revenue*, 61 DTC 1150, where payments were made to the suppliers of the subsidiary for the purpose of protecting its own goodwill since the subsidiary had defaulted on its obligations to those suppliers. There are striking factual resemblances between *Berman* and the present appeals. Several statements

by Thorson, P. are particularly relevant to my conclusions. At page 1154, with regard to the importance to be afforded accounting methods in determining deductibility, he states:

> I can see no object in going into the books of account except as to the payments in question. Indeed, the question before the Court is not how the transactions between the appellant and United were recorded but what the true nature of the payments in question was and what purpose they served in the appellant's business including its Toronto venture.

[28] The distinguishing factor in *Berman* is that the advances were made directly to the subsidiary's suppliers to preserve its reputation and ongoing commercial relationship with them whereas in the case before me advances were made directly to Elan so it could complete its projects. I do not believe that this distinction is significant, as Valiant obtained the same result indirectly by sourcing the payments to Elan. In *Berman*, although the subsidiary remained a separate legal entity, as in the present appeals, Thorson, P. concluded at page 1154 that the subsidiary was for all practical purposes a branch of *Berman* which was incorporated "… to extend the appellant's china and glass import business in Eastern Canada". L. Berman & Co. made a decision to maintain the subsidiary's suppliers because they "… helped the appellant in the Canadian market." (page 1155). This is analogous to the Appellant's intention in the present appeals where advances went to Elan beginning in 1999 to complete its contracts even though it could never be a viable European operation for the Appellant. Completion of those contracts had a direct economic impact on the Appellant's revenue, reputation, livelihood and future. This is much the same scenario as in *Berman*.

[29] Thorson, P. in *Berman* at pages 1156-1157 cites the 1924 case of *Robert Addie & Sons' Collieries, Limited v. Commissioners of Inland Revenue*, (1924) S.C. 231-235, as authority for the test of deductibility of expenses:

> What is "money wholly and exclusively laid out for the purpose of the trade" is a question which must be determined upon the principles of ordinary commercial trading. It is necessary, accordingly, to attend to the true nature of the expenditure, and to ask oneself the question, Is it part of the Company's working expenses; is it expenditure laid out as part of the process of profit earning?

[30] J. Lamarre-Proulx in *Cathelle Inc. v. Canada*, 2005 DTC 858, concluded that loans to a subsidiary were made for the purpose of providing it with working capital as in *Stewart & Morrison*. Again this case can be distinguished on the facts because the loans were made in the expectation that the subsidiary would be a

continuing profitable and viable operation for its parent company. That is contrary to my finding in the case at bar. The decision in *Cathelle* distinguished both *Berman* and the case of *The Queen v. F.H. Jones Tobacco Sales Co. Ltd.*, 73 DTC 5577. J. Lamarre-Proulx distinguished *Jones Tobacco* because the payments, in respect to the guarantees of customer loans, were made to protect a direct source of income where the customer promised in return to deal with *Jones Tobacco*. At page 5580 of *Jones Tobacco*, Noël A.C.J. made the following comments:

> … The Court must consider the situation from a businessman's point of view, and not dwell on technicalities which may be relevant in other types of proceeding in which, for instance, the company challenged the existence of the obligation, but which have no relevance here. The payment … by the *Jones* company was undoubtedly made for commercial reasons, in accordance with ordinary business principles.

Again this is a factually similar situation because the survival of the customer base was absolutely linked to the income stream of *Jones Tobacco*. In the present case the sole purpose in continuing advances to Elan was to ensure contract performance in a subsidiary that was clearly on a path to failure. The purpose was not to enhance or protect anything of an enduring nature in Elan but rather to protect the Appellant's Tier 1 status and ultimately ensure its survival within the automotive industry.

[31] J. Lamarre-Proulx relied on the comments of Strayer, J. in *Morflot Freightliners Limited v. The Queen*, 89 DTC 5182, where he stated at pages 5184-85:

> Normally payments made by a parent company to a subsidiary to help finance the operations of a subsidiary are regarded as capital payments ...
>
> It has frequently been said in cases of this nature that one must try to characterize a situation from a practical business point of view to determine the intent with which the money was provided... . I believe the critical distinction here is as between the preservation of an enduring asset on the one hand and the expenditure of money for direct and more immediate gaining of profit through sales, or, as in this case, the earning of commissions ...

In *Morflot*, Strayer, J. concluded that advances to a legally separate subsidiary were made:

> … with a long-term objective in mind, namely, to preserve for the indefinite future its U.S. subsidiary as a viable contracting party, through which its agency responsibilities ... could be carried out …

(Page 5185)

Again this is clearly a different factual conclusion than the facts in the present appeals. When Valiant made the subsequent advances beginning in 1999 there was no expectation that Elan would continue as a viable entity and certainly no expectation that those advances would ever be repaid.

[32] In *Easton et al. v. The Queen et al.*, 97 DTC 5464, Robertson, J. at page 5468, referred to two exceptions, alluded to previously in my reasons, to the general rule that an advance or outlay on behalf of a corporation will be treated as a loan for the purpose of providing working capital:

> There are two recognized exceptions to the general proposition that losses of the nature described above are on capital account. First, the taxpayer may be able to establish that the loan was made in the ordinary course of the taxpayer's business. The classic example is the taxpayer/shareholder who is in the business of lending money or granting guarantees. <u>The exception, however, also extends to cases where the advance or outlay was made for income-producing purposes related to the taxpayer's own business and not that of the corporation in which he or she holds shares</u>. For example, in *L. Berman & Co. Ltd. v. M.N.R.*, [1961] C.T.C. 237 (Ex.Ct.) the corporate taxpayer made voluntary payments to the suppliers of its subsidiary for the purpose of protecting its own goodwill. The subsidiary had defaulted on its obligations and as the taxpayer had been doing business with the suppliers it wished to continue doing so in future. [*Berman* was cited with apparent approval in the Supreme Court decision in *Stewart & Morrison Ltd. v. M.N.R.*, [1974] S.C.R. 477 at 479].
>
> The second exception is found in *Freud*. Where a taxpayer holds shares in a corporation as a trading asset and not as an investment then any loss arising from an incidental outlay, including payment on a guarantee, will be on income account. This exception is applicable in the case of those who are held to be traders in shares.
>
> (Emphasis added)

Although the Respondent only briefly referenced these exceptions, I believe that the Appellant falls squarely within the confines of this first exception. First, the above passage cites with approval the decision in *Berman* which I believe is on “all fours” factually with this case. The sentence, for which I have added my own emphasis, indicates that the Federal Court of Appeal has expanded this first exception beyond a money lending business to a situation where it can be established that a payment is made for the benefit of the income producing process of the business that makes the payment. Based on my factual conclusions the Appellant fits within this first exception. In summary those factual conclusions are:

1. Major automotive players, such as Ford and GM, made the decision to reduce the number of 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.

2. Maintenance of Tier 1 status was essential to the survival of the Canadian operations.

3. The Appellant made a business decision to retain Tier 1 status and expand globally.

4. A presence in the U.K. was essential to this expansion and Ford put the Appellant in touch with a U.K. corporation, Reiss-Elan.

5. Advances made in 1999, and subsequent thereto, were made to purchase material, pay labour and cover other operating expenses for contracts to which the subsidiary was already a party.

6. Advances were made even when it was clear that Elan was headed for bankruptcy or at the very least, closure of its operations.

7. The only reason, for the making of such payments of the U.K. operational expenses in the face of its insurmountable financial difficulties, in terms of common sense and commercial realities, had to be to protect its Tier 1 status and its own economic viability within the industry.

[33] The Respondent also maintains that in order to be deductible the advances would need to result in a direct source of income for the Appellant and that there is a lack of direct benefit to the Appellant here. However, case law indicates that the source need not be a direct one. In the case of *Minister of National Revenue v. Algoma Central Railway*, 68 DTC 5096, the taxpayer sought to increase its business income by a most indirect method of surveying mining possibilities in the geographical area of its transportation system, in the hope of using favourable results from the surveys to draw industrial development which would in turn lead to increased business activity and therefore income. This would certainly appear to be an indirect expenditure which nevertheless was allowed as a deduction by the Supreme Court of Canada. The Respondent makes the point that through the advances, Elan was generating its own income and accounts receivable which in turn were being used to pay down its bank debt, a loan which would be guaranteed

by the Appellant. However, the Respondent in making that assertion relies heavily on financial statements which are not necessarily an accurate picture of the fiscal circumstances of either the Appellant or Elan. Although the evidence was inconclusive, there may have been one area that favoured some capital investment on the part of the Appellant. Elan did more than complete ongoing projects. According to the evidence it took on new contracts in this period. It was unclear what percentage, if any, of the advances went toward the new contracts. I also have Mr. Sauro's evidence that the contracts to be completed by Elan were with American clients of the Canadian operations. The non-performance of those contracts would therefore have a direct impact on the Appellant's operations in Canada. In addition, all of the evidence supports my conclusion that loss of the Tier 1 status would directly and severely impact upon the Canadian operation. However, in concluding that the dominant purpose or intent of the advances to Elan was to protect the Appellant's income stream, even if the evidence supported a secondary effect of the advances in respect to the new contracts, it would not be fatal to that deductibility. The cases of *B.P. Australia Ltd. v. Commissioner of Taxation of the Commonwealth of Australia*, [1966] A.C. 224, and *Robinson (Inspector of Taxes) v. Scott Bader Co. Ltd.*, [1981] 2 All E.R. 1116 (C.A.), although both factually different, provide some of the general principles to be utilized in determining the deductibility of losses. The *Bader* case talks of the importance of identifying for whose benefit advances are made. Canadian courts, including the Supreme Court of Canada in *Algoma Central Railway*, have often quoted the following from the decision of Dixon, J. in *B.P. Australia* at page 264:

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

The decision went on to quote Dixon, J. in *Hallstroms Pty. Ltd. v. Federal Commissioner of Taxation*, (1946) 72 C.L.R. 634:

> That answer:

> "depends on what the expenditure is calculated to effect from a practical business point of view rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process."
> (Page 264)

Lord Pearce in *B.P. Australia* summarized the Appellant's position in that case as follows:

> The advantage which B.P. sought was to promote sales and obtain orders for petrol by up-to-date marketing methods, … Since orders were … only obtainable from tied retailers, it must obtain ties with retailers. Its real object, however, was not the tie but the orders which would flow from the tie. To obtain ties it had to … [pay] out sums for a period of years …. The payment of such sums became part of the regular conduct of the business. <u>It became of the current necessities of the trade</u>.
> (Page 265) (Emphasis added)

Lord Pearce dissected the transaction to discover the true purpose of the expenditure. In doing so, he looked at the exact *raison d'être* of the payments made by *B.P. Australia*. On their face the payments appeared to be for the purpose of establishing ties to retailers but looking further he found that their fundamental nature was to secure orders through those retailer ties.

[34] What then was the true purpose of the advances to Elan? All of the Appellant's witnesses provided the same evidence, which remained unchallenged on cross-examination, and that was: the immediate need to retain its status as a Tier 1 supplier in the face of a massive globalization effort by the major automotive players. The methods employed to maintain its Tier 1 status, including the completion of Elan's contracts by sending advances to that subsidiary, had the fundamental purpose of securing its Canadian stream of income and therefore its economic survival. The dominant feature of these advances therefore points to a "current necessity", which counters any secondary or contrary indications pointing to capital outlay.

[35] Finally my decision in *Excell Duct Cleaning Inc. v. The Queen*, 2006 DTC 2040, clarified that <u>protecting</u> existing goodwill and increasing profitability go to the income nature of an expense while <u>increasing</u> goodwill will relate to a purpose which will be capital in nature. Although not cited by either party, that decision clearly has application to the issue in this appeal. The Appellant's actions in advancing the subsequent funds to Elan were always viewed as protection of its reputation and Tier 1 status and thus its income stream – that is, protecting its existing goodwill and profitability. *Excell Duct Cleaning* reiterates

that loans made in an effort to “preserve an ongoing source of … income” will be treated as deductible.

[36] In summary, although there exist vaguer and secondary indications pointing in a capital outlay direction, when I consider all of the evidence in the context of what the advances, on a balance of probabilities, were meant to achieve, from both a business and practical evaluation, I conclude that they were made to protect the Appellant’s stream of income and its future as a Tier 1 supplier. In arriving at this conclusion, I have made factual findings based on common sense and the uncontradicted evidence of approximately ten witnesses, all of whom confirmed essentially the same purpose to these advances. The commercial realities within which it was operating at the time dictated that the Appellant, from both a business perspective and common sense approach, make a calculated business decision to either shut down Elan in 1999 and risk losing its Tier 1 status within the industry or continue the advances to ensure its survival, protect that status and therefore its income stream.

[37] For these reasons the appeals are allowed. The Appellant is entitled to costs on the basis of one set of counsel fees.

Signed at Ottawa, Canada, this **8th** day of **December** 2008.

"Diane Campbell"

Campbell J.

Schedule "A"

2006-924(IT)G

TAX COURT OF CANADA
(General Procedure)

BETWEEN:

VALIANT CLEANING TECHNOLOGY INC.

Appellant,

and

HER MAJESTY THE QUEEN

Respondent.

PARTIAL AGREED STATEMENT OF FACTS

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2006-924(IT)G

TAX COURT OF CANADA
(General Procedure)

BETWEEN:

VALIANT CLEANING TECHNOLOGY INC.

Appellant,

and

HER MAJESTY THE QUEEN

Respondent.

PARTIAL AGREED STATEMENT OF FACTS

THE PARTIES, THROUGH THEIR UNDERSIGNED ATTORNEYS, AGREE ON THE FOLLOWING FACTS:

1. During the relevant period, the Appellant, Valiant Cleaning Technology Inc., was involved in the design, engineering and installations of assembly line cleaning technologies for the automotive industry.

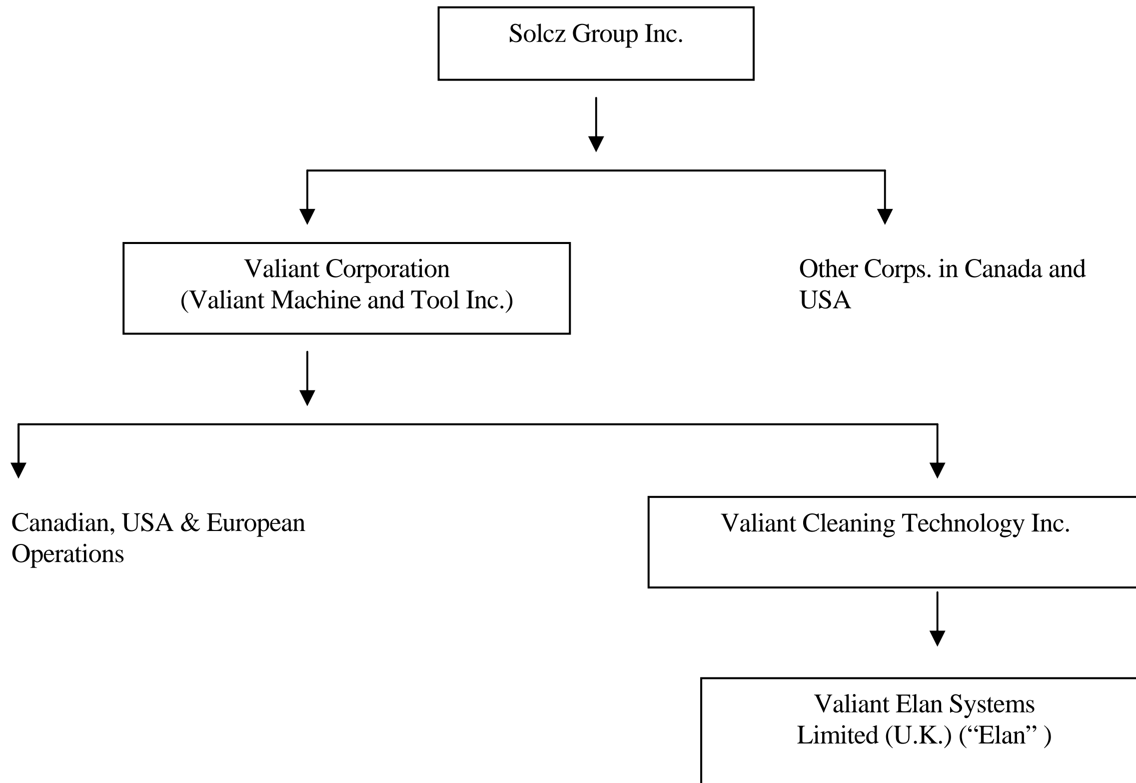
2. The Appellant provided cleaning solutions for products manufactured prior to assembly or along the assembly line process.

3. The cleaning solutions involve high and low pressure washing for the purpose of removing dirt, dust and metal filings from the product manufactured.

4. The Appellant is considered a “Tier 1” supplier in the automotive industry.

SIMPLIFIED CORPORATE CHART

5. During the relevant period, the Appellant was part of a group of corporations (the "**Valiant Group**") which may be illustrated as follows:



6. As shown in the above chart, during the relevant period, the Appellant owned all of the shares of Valiant Elan Systems Limited ("**Elan**"), a corporation resident of the United Kingdom ("**U.K.**").

AUDIT

7. In 2004, the Appellant was subject to a review carried out by a representative of the Minister of National Revenue (the "**Minister**"), Mr. William Cornies following an audit of Valiant Corporation.

8. The review focused strictly on the nature of certain financial transactions carried out between the Appellant and Elan, its subsidiary.

9. The review was the result of a request made by the Appellant to recognize previously reported capital losses and re-characterize them as non-capital losses.

TRANSACTIONS SUBJECT TO THE AUDIT

10. In 1996, the Valiant Group had acquired U.K.-based Reiss Elan, subsequently known as Valiant Elan Systems Limited (Elan).

11. For the years ended February 28th, 1997 to 2002, the Appellant reported the following in its audited financial statements with respect to Elan and it its income tax returns for the relevant taxation years:

Years ended February 28th	Shares in Elan	Advances to Elan Notes Receivable	Write down of investment in Elan:	Capital Loss Reported on Income Tax Return
02/1997				
Investment: 10,000 common shares and 490,000 5% cumulative redeemable preference shares	$1,031,450			
Notes receivable **(as restated in 1998 financial statements)**		$780,150		
02/1998				
Advances:		$531,930		
02/1999				
Advances:		$2,444,810		
Allowance with respect to Notes Receivable:			$3,400,000	
Write-down of investment:			$1,000,000	
02/2000				
Advances:		$2,654,445		
Conversion of notes to preference shares:	$6,251,000	($6,251,000)		
Write-down of investment:			$3,042,785	
Capital loss reported on T-2 income tax return				$6,251,000
02/2001				
Advances:		$6,228,397		
Write-down of investment:			$6,228,397	
02/2002				
Capital loss reported on T-2 income tax return:				$7,420,182
TOTAL:	$7,282,450	$6,388,732	$13,671,182	$13,671,182

12. Elan was put into administration effective March 29, 2001 as part of the formal plan to wind-up its operations.

NOTICES OF DETERMINATION OF A LOSS

13. On December 30, 2004, subsequent to the review, the Minister issued Notices of Determination of a Loss bearing numbers 64957, 64958, 64959 and 64960, in respect of taxation years of the Appellant ending on February 28, 2000, February 28, 2001, February 28, 2002 and November 30, 2002, under which the Minister considered the losses incurred by the Appellant as capital losses incurred in its taxation years ending February 28, 2000 and February 28, 2002 as reported by the Appellant.

14. On February 17, 2005, the Appellant duly filed Notices of Objection against the Notices of Determination of a Loss.

15. On October 17, 2005, the Minister issued its Notice of Confirmation under which it confirmed the Notices of Determination of a Loss.

ISSUE TO BE DECIDED

16. The issue to be decided is whether the losses, or any part thereof, incurred by the Appellant for the taxation years ending February 28, 2000 and February 28, 2002 in the amounts of $6,251,000 and $7,420,182 respectively with respect to Elan are non-capital losses or capital losses.

17. The Appellant submits that said losses should be characterized as non-capital losses.

18. The Respondent submits that said losses should be characterized as capital losses.

Montreal, May 15, 2008

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COURT FILE NO.:	2006-924(IT)G
STYLE OF CAUSE:	Valiant Cleaning Technology Inc. and Her Majesty the Queen
PLACE OF HEARING:	Windsor, Ontario
DATES OF HEARING:	May 28 and 29, 2008
REASONS FOR JUDGMENT BY:	The Honourable Justice Diane Campbell
DATE OF AMENDED JUDGMENT:	**December 8**, 2008

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