Docket: 2005-1829(IT)G

BETWEEN:

WILLIAM MERCHANT,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

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Appeals heard on December 9 and 10, 2008, at Toronto, Ontario
Before: The Honourable Justice Wyman W. Webb

Appearances:

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| Counsel for the Appellant: | James Rhodes |
| Counsel for the Respondent: | Brent E. Cuddy |

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**JUDGMENT**

The appeals from the assessments made under the *Income Tax Act* ("*Act*") for the 2000 and 2001 taxation years are allowed and the matter is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that there was no amount that was payable by the Appellant to Client Server Management, Inc. in 2000 or 2001 and hence the amount of $6,151.14 should not have been included in the income of the Appellant in 2000 pursuant to subsections 6(9) and 80.4(1) of the *Act* and the amount of $108,306.29 should not have been included in the income of the Appellant in 2001 pursuant to paragraph 6(1)(a) and subsection 6(15) of the *Act*.

Counsel for the Appellant had requested an opportunity to provide a submission on costs before an award of costs is made. As a result, the parties shall have 30 days from the date of this judgment to either submit their written

representations or to request a hearing on the issue of the amount of the costs that should be awarded to the Appellant. A hearing on this issue shall be held if either party should request such a hearing.

Signed at Ottawa, Ontario, this 22nd day of January 2009.

"Wyman W. Webb"

Webb J.

Citation: 2009TCC31
Date: 20090122
Docket: 2005-1829(IT)G

BETWEEN:

WILLIAM MERCHANT,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

**REASONS FOR JUDGMENT**

Webb J.

[1] The issue in this case is whether certain amounts that the Appellant had received in 1997, 1998 and 1999 were received by him as loans from his employer.

[2] The position of the Respondent is that the cheques that were issued by Client Server Management, Inc. ("CSM") and in relation to which there was no indication that any amounts had been deducted for income tax, premiums payable under the *Canada Pension Plan* ("CPP") or premiums payable under the *Employment Insurance Act*) ("EI") (these cheques are referred to herein as the "NSD cheques") represented loans that were advanced by CSM to the Appellant, and therefore the amount of such cheques would not be included in the income of the Appellant until the year in which salary or a "bonus" was paid by setting off the amount of the salary or "bonus" against the amount that the Respondent alleges was payable by the Appellant to CSM or the year in which the amount of the loan was forgiven. In this case, it is the position of the Respondent that a significant part of the amounts received as NSD cheques was not converted into salary or a bonus and was not forgiven until 2001. Hence the Respondent included the amount that the

Respondent alleged was forgiven in 2001 in the income of the Appellant for that year.

[3] It is the position of the Appellant that the NSD cheques were not received by the Appellant as loans, and therefore there was no debt that was forgiven in 2001. The logical extension of the Appellant's position is that these amounts should have been included in his income in the years in which they were received which would have been 1997, 1998 and 1999. Essentially, the Respondent (the Crown) was arguing that the tax on a significant part of these amounts could be deferred until 2001 when the debt was allegedly forgiven.

[4] There are two related amounts that were included in the income of the Appellant and that are the subject of these appeals. For the Appellant's 2000 taxation year, the amount of $6,151.14 was included in the Appellant's income as an interest benefit in relation to the alleged loan. For the Appellant's 2001 taxation year, the amount of $108,306.29 was included in the income of the Appellant on the basis that this was the amount of the loan that was forgiven in 2001. No interest was charged by CSM on the amounts identified as the amounts payable by the Appellant to CSM.

[5] The Appellant became an employee of CSM in 1997. Rick Penton was the sole shareholder of CSM. The Appellant knew Rick Penton prior to the Appellant commencing work with CSM in 1997. The Appellant and Rick Penton dealt with each other at arm's length.

[6] There were ongoing discussions between the Appellant and Rick Penton about the Appellant becoming a shareholder of CSM. Both parties were interested in the Appellant becoming a shareholder of CSM, although that transaction was never consummated. The Appellant would have had to pay for the shares that he would be acquiring. There was no indication of the actual amount that the Appellant would have been required to pay for the shares of CSM that he would be acquiring, but it was more than a nominal amount.

[7] In 1997, 1998 and 1999, the Appellant received cheques regularly from CSM. In 1997 and 1999, on some of the cheque stubs there was an indication that amounts had been deducted for income tax, CPP premiums and in 1997, EI premiums (no EI premiums were deducted in 1999). The balance of the cheques that the Appellant received in 1997 and 1999 were NSD cheques. In 1998, none of the cheque stubs for the cheques issued to the Appellant for that year indicated that any deductions had been taken for income tax, CPP premiums or EI premiums. Therefore all of the cheques that the Appellant received in 1998 were NSD cheques and therefore the

Respondent is alleging that all of the amounts received by the Appellant by cheque in 1998 were received by the Appellant as loans.

[8] There was no indication that any of the NSD cheques were for advances of any future earnings of the Appellant for services that were to be rendered after the cheque was issued. The amount of several of the NSD cheques was approximately the same amount as the Appellant was paid on a net basis when source deductions were taken.

[9] In the accounting records of CSM, an amount equal to the amount of each NSD cheque was treated as a loan made to the Appellant. Therefore the shareholder's loan account for the Appellant (which was identified as a shareholder's loan account even though he was not a shareholder) shows that the amount of each NSD cheque was added to the amount that was payable by the Appellant to CSM. In 1998 and 1999, a portion of the amount stated to be payable by the Appellant was converted into salary and set off against the amount stated to be payable by the Appellant to CSM. Source deductions were not reflected in the shareholder's loan account as these amounts were not payable to the Appellant.

[10] It is the position of the Respondent that the accounting records of CSM accurately reflect that the NSD cheques represented loans being made by CSM to the Appellant and that the amount of each NSD cheque was properly added to the amount payable by the Appellant to CSM. It is the position of the Appellant that the accounting records do not reflect reality and that the NSD cheques were not issued as advances of loans that were repayable by the Appellant to CSM, but rather were part of the compensation paid by CSM to the Appellant.

[11] In *Trudel-Leblanc v. The Queen*, 2003 DTC 257, 2004 DTC 3188, [2005] 2 C.T.C. 2361, Justice Tardif stated that:

> 27 I strongly doubt that the accountants explained the consequences of incorporation. Too often, some accounting and tax professionals have a tendency to assume that the facts should be shaped by accounting entries whereas, in reality, the figures should reflect the facts, not the contrary.

[12] In *VanNieuwkerk v. The Queen*, 2003 TCC 670, [2004] 1 C.T.C. 2577, Associate Chief Justice Bowman (as he then was) stated that:

> 6 …. It has been said on many occasions in this Court that accounting entries do not create reality. They simply reflect reality. There must be an underlying reality that exists independently of the accounting entries.

[13] Accounting entries alone do not determine the tax consequences. It is the underlying reality that is relevant. It is therefore necessary to determine the underlying reality. It seems to me that there are three possible underlying realities in this case:

(a) the NSD cheques were issued by CSM to the Appellant as loans and were to be repaid by the Appellant from whatever sources the Appellant may have available to him;

(b) the NSD cheques were issued by CSM to the Appellant as loans and were to be repaid (and were only to be repaid) by the Appellant from salary or "bonuses" that would subsequently be paid by CSM; or

(c) the NSD cheques were issued by CSM to the Appellant as part of the compensation paid by CSM to the Appellant and were not issued as advances or loans.

[14] With respect to the first possibility, it does not seem reasonable to me that in this case the NSD cheques were issued as loans that the Appellant would be obligated to repay from any source. As noted above, there was no indication that any of the NSD cheques represented advances of salary that the Appellant had not earned at the time that such cheques were issued. If the NSD cheques were issued as loans, this would mean that for the entire 1998 year the Appellant would not have received any regular compensation for the services that he rendered and he would not have received any compensation at all if a portion of the amount had not been converted into salary on December 31, 1998. The Appellant could not control whether salary or a "bonus" would be paid. In this case, on December 31, 1998 the amount of $31,721.10 was set off against the amount that was shown as payable by the Appellant. This $31,721.10 together with the amount determined for income tax and CPP premiums (no EI premium amount is shown on the T4 slip for 1998), was treated as salary paid to the Appellant. The amount determined for income tax and the CPP premium was $31,256.57 (based on the T4 slip for 1998) and therefore the stated employment income of the Appellant for 1998 (based on the T4 slip for 1998) was $62,977.67. The amount deducted for income tax was approximately 48% of the stated employment income which presumably would have resulted in a significant income tax refund if the Appellant did not have any other income in 1998.

[15] The total amount of the NSD cheques for 1998 was $79,000. In the letter dated April 18, 1997, Rick Penton indicated that the Appellant's annual salary would be

$92,000. Rick Penton indicated that he was happy with the Appellant's performance and that the Appellant was probably the highest revenue producer for CSM in 1998. Therefore there is no reason to believe that the Appellant was not earning his salary throughout 1998.

[16] The Appellant was not a shareholder and this case is to be distinguished from cases in which shareholders of closely held private corporations may borrow funds from their company that will be repaid from future bonuses or dividends. As an employee in this case, the only means by which the Appellant could be compensated would be by salary or bonus. Furthermore, since the Appellant did not control CSM, he could not control the timing of the payment of salary or "bonuses". Since the Appellant did not own any shares of CSM, he would not have been entitled to receive any dividends nor would he benefit from any increase in value of the shares as a result of taking a reduced or no salary. The proposition that in 1998 each cheque that he received represented a loan that he would have to repay from any source and therefore if no salary or bonus would have been paid by year end (which the Appellant could not control), that he would have worked for the entire year for no pay, in my opinion, has no merit.

[17] As a result, I conclude that this was not the reality in this situation and therefore there is no basis to find that the NSD cheques were issued as loans that had to be repaid by the Appellant from any source.

[18] The second possible reality is that the NSD cheques were issued as loans that were to be repaid from salary or "bonuses" that would be subsequently paid by CSM. It must be remembered that in this case, it was the Respondent (the Crown) that was arguing that the amount should not have been included in the income of the Appellant until 2001. It would seem as a logical extension of this that the Crown would be advocating that an employer and an employee could agree to defer the requirement to remit source deductions until a time that was more convenient for the employer (and, if it is not in the same calendar year, defer the recognition of the income amount for the employee until a later year). If an employee and his or her employer could agree that the employer can make monthly "payments" to the employee for services currently being rendered or that have been rendered for the same net amount that the employee would otherwise have received (if source deductions would have been taken) and treat such amounts as loans or advances that would be repaid (and only be repaid) on some subsequent date from salary or "bonuses" paid by the company, then the employer and employee could effectively agree to defer the requirement to remit the income tax, CPP premiums and EI

premiums until a later date that would be more convenient for the employer. If the Respondent is to be successful in this matter, this would have to be the conclusion.

[19] Counsel for the Respondent had argued that this case could be distinguished from a general case where an employer and an employee agree to defer the remittance of source deductions by treating the "payments" as loans, on the basis that, in this case, the Appellant intended to become a shareholder. However since the *Income Tax Act* ("*Act*") will apply to a particular person based on what that person does, not on what that person intended to do, the unfulfilled intention of the Appellant (and Rick Penton) for the Appellant to become a shareholder cannot alter the application of the *Act*. It is what actually happened in this case that matters, not what the parties intended to happen.

[20] On several of the NSD cheques, the amount was identified as an "advance". I do not agree that simply calling a payment for services that have been rendered an advance can make the payment a loan and hence allow an employer and an employee to defer the recognition of the amount paid as income until the loan is repaid. If the true intention of the parties was that the amounts received were advances of salary or other compensation that would be repaid by the employee from a subsequent salary amount or "bonus" that would be paid by the employer (and only be repaid from this source) the parties did not intend to create a true creditor-debtor relationship. If the parties would have intended to create a true creditor-debtor relationship then the employer would have the right to recover from the employee the amount owing if no salary or "bonus" was declared even though the services to which the advance relates have already been rendered. The employee may also have a separate claim for compensation for services rendered, which may or may not offset the claim of the employer. If the intention was that the amounts would be repaid from salary or bonuses that would be later paid by the employer and only from such salary or bonuses (and therefore if no salary or bonuses are paid the employee would have no liability), the employer and the employee would not be intending to create a true debtor-creditor relationship.

[21] In *Continental Bank of Canada and Continental Bank Leasing Corporation v. The Queen*, 94 DTC 1858, Justice Bowman (as he then was) stated that:

> So far as the broader question of substance versus form is concerned, we should at least be clear on what we are talking about when we use the elusive expression 'substance over form'. Cartwright, J. (as he then was) said in *Dominion Taxicab Assn. v. M.N.R.*, 54 DTC 1020 at p. 1021:

> > It is well settled that in considering whether a particular transaction brings a party within the terms of the Income Tax Acts [ sic ] its substance rather than its form is to be regarded.
>
> His Lordship did not elaborate but in light of other authorities I do not think that his words can be taken to mean that the legal effect of a transaction is irrelevant or that one is entitled to treat substance as synonymous with economic effect. The true meaning of the expression is, I believe, found in the judgment of Christie, A.C.J.T.C.C. in *Purdy v. M.N.R.*, 85 DTC 254 at p. 256, where he said:
>
> > It must be borne in mind that in deciding questions pertaining to liability for income tax the manner in which parties to transactions choose to label them does not necessarily govern. What must be done is to determine what on the evidence is the substance or true character of the transaction and render judgment accordingly.
> >
> > Viscount Simon in delivering the judgment of the House of Lords in Commissioners of Inland Revenue v. Wesleyan and General Assurance Society (1948), 30 T.C. 11, said at page 25:
> >
> > > It may be well to repeat two propositions which are well established in the application of the law relating to Income Tax. First, **the name given to a transaction by the parties concerned does not necessarily decide the nature of the transaction. To call a payment a loan if it is really an annuity does not assist the taxpayer, any more than to call an item a capital payment would prevent it from being regarded as an income payment if that is its true nature. The question always is what is the real character of the payment, not what the parties call it.**
>
> (emphasis added)

[22] In a situation where a cheque is issued (or cash is disbursed) to an employee in relation to services that have been rendered and the transaction is labelled as an advance or a loan but in reality the employee is only obligated to repay the amount, without interest, from subsequent salary or “bonuses” paid by the employer, in my opinion, the real character of the amount received is that it is received as a payment of compensation and not a loan. There is no true intention that the employee will have to repay the amount from any source other than the future “payments” to be made by the employer.

[23] In *Meredith v. The Queen*, [1994] 1 C.T.C. 2538, 94 DTC 1271, Justice Kempo made the following comments:

> **41** Where there is no measurable degree of certainty concerning the earning and receipt of the future income, the advances made may indeed be more accurately characterized as a loan. **For the advances here to be considered income receipts, the**

> **Court must be able to find that under and by virtue of his contract of employment the Appellant was entitled to commission based income and to advances on possible future earnings from time to time repayable solely out of that source which is to say that the future income if earned was to be the source and security for repayment with no liability to repay if it proved to be inadequate. If the latter represented the true situation then the recipient would enjoy receipt of these advances as a form of wages, salary or other remuneration within the meaning of subsection 5(1) of the Act.**
>
> **42** It seems to me that if a commissioned sales person may be expected to earn commission income in the future, and to help out in the meantime the employer pays advances in anticipation that sale events will happen, those amounts may appropriately be treated as short term loans. This was noted to be an accurate description of that kind of situation in Associated Investors of Canada Ltd. v. M.N.R., 67 D.T.C. 5096 (Ex. Ct.) at 5100. In my view it is just as easy as not to say of an advance received made by an employee that it may be had as a loan accompanied by an implied understanding that if the future commission sales do not occur then it must otherwise be repaid.
>
> (emphasis added)

[24] If advances of future earnings are to be included in income if the advances are only to be repaid from such future earnings, then advances of compensation for services already rendered that will only be repaid from future salary or "bonuses" subsequently paid by an employer must be included in income when received. The true character of such "advances" is that they are payment of compensation for services that have been rendered. In this case, I find that the NSD cheques were all issued in relation to services that had been rendered before such cheques were issued.

[25] Hence, in my opinion, if the reality is as described in the second scenario, the amounts would be included in the income of the Appellant when received and no amount would be included in the income of the Appellant in 2001 as a result of the alleged forgiveness of debt as there would not be any debt owing by the Appellant to CSM in 2001 as the true character of the NSD cheques was that these cheques were issued as payment of salary and were not issued as loans. As well no amount should have been included in the income of the Appellant for 2000 pursuant to subsections 6(9) and 80.4(1) of the *Act*.

[26] The third possible reality is that the NSD cheques were issued as part of the compensation paid by CSM to the Appellant and not as loans or advances. This would lead to the same result as the second scenario and no amount would be included in the Appellant's income in 2000 in relation to the alleged interest benefit and no amount would be included in the Appellant's income in 2001 in relation to the

alleged debt forgiveness but rather the amounts would be included in the income of the Appellant in the years in which such amounts were received.

[27] In this particular case it is not clear whether the reality was that reflected in the second scenario or the third scenario, but since neither of these realities would have resulted in the amounts as assessed in relation to the "shareholder's loan" being included in the Appellant's income in 2000 or 2001, it is irrelevant which is the actual reality. The only issue before me is whether the assessments for 2000 and 2001 are correct.

[28] As a result, the appeals are allowed and the matter is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that there was no amount that was payable by the Appellant to CSM in 2000 or 2001 and hence the amount of $6,151.14 should not have been included in the income of the Appellant in 2000 pursuant to subsections 6(9) and 80.4(1) of the *Act* and the amount of $108,306.29 should not have been included in the income of the Appellant in 2001 pursuant to paragraph 6(1)(a) and subsection 6(15) of the *Act*.

[29] Counsel for the Appellant had requested an opportunity to provide a submission on costs before an award of costs is made. As a result, the parties shall have 30 days from the date of this judgment to either submit their written representations or to request a hearing on the issue of the amount of the costs that should be awarded to the Appellant. A hearing on this issue shall be held if either party should request such a hearing.

Signed at Ottawa, Ontario, this 22nd day of January 2009.

"Wyman W. Webb"

Webb J.

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| COURT FILE NO.: | 2005-1829(IT)G |
| STYLE OF CAUSE: | WILLIAM MERCHANT AND HER MAJESTY THE QUEEN |
| PLACE OF HEARING: | Toronto, Ontario |
| DATE OF HEARING: | December 9 and 10, 2008 |
| REASONS FOR JUDGMENT BY: | The Honourable Justice Wyman W. Webb |
| DATE OF JUDGMENT: | January 22, 2009 |

APPEARANCES:

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| Counsel for the Respondent: | Brent E. Cuddy |

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