

Docket: 2004-3710(IT)G

BETWEEN:

SNC TECHNOLOGIES INC. (FORMERLY LES TECHNOLOGIES  
INDUSTRIELLES SNC INC.),

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

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Appeal heard on June 21, 2007 at Montreal, Quebec.

Before: The Honourable Justice Gaston Jorré

Appearances:

Counsel for the Appellant:	Wilfrid Lefebvre Dominic C. Belley
Counsel for the Respondent:	Pierre Cossette

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**JUDGMENT**

The appeal from the reassessments made under the *Income Tax Act* for the 1995, 1996, 1997 and 1998 taxation years is dismissed, with costs, in accordance with the attached Reasons for Judgment.

Signed at Montreal, Quebec, this 21st day of August 2008.

“Gaston Jorré”

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Jorré J.

Translation certified true

on this 16th day of July 2009.

Erich Klein, Revisor

Citation: 2008 TCC 461  
Date: 20080815  
Docket: 2004-3710(IT)G

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SNC TECHNOLOGIES INC. (FORMERLY LES TECHNOLOGIES  
INDUSTRIELLES SNC INC.),

Appellant,

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### **REASONS FOR JUDGMENT**

**Jorré J.**

#### Issue

[1] The appellant, SNC Technologies Inc., manufactured defence products for the Department of National Defence and received progress payments from the Department for the reimbursement of certain expenses incurred. Those progress payments were recorded as liabilities on the appellant's balance sheets.

[2] The issue is the following:

Was the Minister of National Revenue justified in adding to the appellant's taxable capital in calculating the tax on large corporations (Part I.3 of the *Income Tax Act* (the ITA)) the amounts recorded in the "progress payments on accounts payable" and "progress payments on inventory" accounts under liabilities on the appellant's balance sheets for the 1995 to 1998 taxation years?

[3] For the reasons that follow, I find that the amounts in question must be included in the appellant's taxable capital.

Facts

[4] The parties reached a partial agreement on the fact which is reproduced in part below:<sup>1</sup>

[TRANSLATION]

1. During the years in issue, namely the 1995, 1996, 1997 and 1998 taxation years, the appellant, a Canadian corporation, operated a business manufacturing defence products.
2. During those years, most of the appellant's contracts were with the Department of National Defence (. . . "DND").
3. The contracts between the appellant and the Government of Canada are "defence contracts" within the meaning of the *Defence Production Act* . . . .
4. Each year, the appellant and DND negotiated a comprehensive agreement governing most DND orders in a taxation year, as indicated in the comprehensive agreement for the 1998 taxation year, attached hereto as Appendix 1, and forming part hereof.
5. In accordance with the contracts, the appellant claimed from DND progress payments for the reimbursement of certain expenses incurred by presenting forms identified as "Claims for Progress Payment."
6. The contracts are cost-plus agreements.
7. At different times during a taxation year, DND placed orders with the appellant to put a product in production, which orders specified the quantity and the estimated cost of production.
8. Under the contracts between the appellant and DND, the latter undertook to make payments related to the contracts in the following situations:
  - A claim is submitted by the presentation of forms identified as "Claims for Progress Payment", supported by vouchers approved by DND, for the reimbursement of certain expenses incurred, including the reimbursement of intangible expenses such as labour costs and manufacturing overhead (progress payment). The amounts are included in the "progress payments on inventory" item.

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<sup>1</sup> Exhibit I-2.

- A claim is submitted for the reimbursement of progress payments made to authorized suppliers or subcontractors (progress payment). The amounts are included in the “progress payments on accounts payable” item.
  - Following invoicing by the appellant and after inspection of the finished products (final payment).
9. In accordance with the contracts entered into with DND, the appellant regularly submitted the “Claims for Progress Payment” forms for the manufacturing costs incurred, without the product being finished or physically transferred to DND, however.
  10. The amounts paid by DND pursuant to the “Claims for Progress Payment” included intangible expenses such as labour costs and manufacturing overhead.
  11. Progress payments, whether on inventory or accounts payable, did not usually include any element of profit.
  12. With respect to these payments, the appellant recorded the following amounts as liabilities on its balance sheets for the taxation years in issue, as indicated in the financial statements attached to this agreement as Appendix 2 and forming part hereof:

	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>
Progress payments on accounts payable	\$ 3,256,213	\$3,019,929	\$5,473,603	\$11,713,637
Progress payments on inventory	<u>\$46,941,675</u>	<u>\$68,310,727</u>	<u>\$21,503,276</u>	<u>\$78,603,587</u>
Total	\$50,197,888	\$71,330,656	\$26,976,879	\$90,317,224

13. The appellant did not report those amounts in its taxable capital in calculating Part I.3 tax for the taxation years in issue . . . .
14. The appellant received the progress payments listed in paragraph 12 at various stages of the production of products that were not yet finished, with the obligation to deliver the said products, when finished, within the deadline.
15. The amounts shown as liabilities on the appellant’s balance sheet under “progress payments on accounts payable” are of exactly the same nature as the amounts shown on the appellant’s balance sheet for all the years in issue under “progress payments on inventory”: they are amounts invoiced to the Government of Canada by the appellant with respect to supplies purchased by the latter in the performance of the said contracts with the Government of Canada.

16. The only difference between the “progress payments on accounts payable” and the “progress payments on inventory” is that the former involve goods ordered by the appellant but not delivered, for which the appellant must make payment.
17. During the years in question, the appellant adopted as a method of accounting with respect to its income the completed performance method, which consisted in reporting income generated from the contracts at the time of delivery of the finished products.
18. According to the appellant, the amounts received are progress payments that must be excluded from the calculation of income for the purposes of Part I tax and are not progress payments but rather income generated from sales for the purposes of calculating Part I.3 tax.
19. Those progress payments were not included in the income of the appellant, which reported its income, for accounting purposes, by adopting the completed performance method. According to the appellant, the income shown on the financial statements already took into account that non-inclusion and the progress payments are not part of its taxable income for the purposes of Part I of the Act.
20. Under the contracts entered into with DND, the latter only purchased products that were finished and not products that were at the manufacturing stage, even though DND made progress payments (advances) guaranteed by material already produced.
21. The contracts between the appellant and DND stipulated that the title to the goods covered by the “progress payments on accounts payable” was transferred to the Government of Canada at the time of payment, but also provided that the appellant retained possession of the products at the manufacturing stage, thus assuming the risks associated with the possession of the products and responsibility for the delivery of the product when it was finished.
22. [This paragraph contains contract provisions that are reproduced in paragraph 8 i) below.]
23. The transfer of property mentioned in paragraph 21 did not constitute acceptance by the Government of Canada of materials, work in process or finished work.
24. In calculating the appellant’s capital for the purposes of Part I.3 tax, the Minister of National Revenue included progress payments received for each of the years in issue as loans or advances . . . .

27. On February 5, 2003, the respondent issued a Notice of Reassessment to the appellant for its taxation year ending December 31, 1996, making therein the following changes to the calculation of Part I.3 tax:<sup>2</sup>

	<b>Reassessment</b>	<b>Amount Reported</b>	<b>Difference</b>
Taxable capital employed in Canada	\$ 164,843,318	\$93,212,662	\$ 71,630,656 <sup>3</sup>
Gross amount of Part I.3 tax	\$370,897	\$209,728	\$161,169
Surtax credit	<u>(\$225,611)</u>	<u>(\$209,728)</u>	(\$15,883)
Part I.3 tax	\$145,286	\$0	\$145,286
...			

[5] For all the years in issue, Note 6 to the financial statements<sup>4</sup> states as follows [TRANSLATION]: “The progress payments on inventory, in the amount of \$ . . . from the Government of Canada, are guaranteed by an assignment of inventory.”

[6] No evidence was presented pertaining to generally accepted accounting principles.

[7] The parties filed the eight appendices that form part of the partial agreement (Exhibit I-2). By consent, the respondent’s book of documents was filed (Exhibit I-1). A witness, Jacques Saint-Martin, an accountant, provided explanations with respect to the respondent’s book of documents. Excerpts from the examinations for discovery of Lyne Bouchard were filed by the respondent.

[8] It is useful to reproduce certain contract provisions<sup>5</sup> of which I have underlined certain parts:

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<sup>2</sup> Similar paragraphs exist for the other years involved in the dispute. I have reproduced one year as an example.

<sup>3</sup> There is a difference of \$300,000 between this amount and the total for 1996 in paragraph 12 of the partial agreement reproduced in paragraph 4 above. The \$300,000 is not related to the amounts in dispute and its addition is not objected to by the appellant.

<sup>4</sup> Note 5 to the 1995 financial statements.

<sup>5</sup> All these provisions are found in Appendix 1 to Exhibit I-2.

a) purpose of the contract:

**A.2** ...

2.1 To supply various types of ammunition (Small and Large Calibre) listed at Appendix "A" and related items for the Government fiscal year 1998/99. . .  
..

b) defence contract:

**A.6** ...

6.1 This Contract is a Defence Contract within the meaning of the Defence Production Act and shall be read accordingly.

c) Payments — fixed costs and overhead, variable costs:

**D.1 COST**

1.1 Fixed Overhead and General and Administrative Overhead Expenses

[The contract provides for a fixed amount every month.]

1.2 Related Profit on Fixed Expenses

[The contract provides for four fixed payments. The three first payments are to be made at the end of each of the first three quarters. The fourth is not payable until after final verification by the government, after agreement on costs, and after all the work has been completed under the comprehensive agreement.]

**D.2 PROGRESS PAYMENTS**

2.1 Progress payments for Variable Costs shall be made not more frequently than twice a month and will be made upon the following terms . . . .

...

2.4 For each unit delivered by the Contractor, the Profit on Variable Costs calculated in accordance with Appendix "C.1", will be payable upon delivery and acceptance by Canada.

2.5 Upon delivery and acceptance of the last item of the total items of each Work Order, any remaining balance of volume overheads on the Work Order, shall be claimable in full on a progress claim. . . .



**D.4 . . .**

- 4.3 Progress payments shall be regarded as interim payments only and the Minister shall have the right to conduct interim cost and time verifications or audits and to make adjustments from time to time during the performance of the Work. Any overpayment whether resulting from such progress payments or otherwise shall be promptly refunded to Canada . . . .

d) payments to subcontractors:

**D.5 CONTRACTOR'S DOWNPAYMENTS TO SUBCONTRACTORS**

- 5.1 Following release of a Work Order for a requirement requiring a downpayment to its suppliers and submission of a duly completed claim for progress payment . . . the Contractor shall be allowed to claim for the downpayment to its suppliers. The Contractor certifies that, the funds to be paid in accordance with such claims for progress payment will be paid solely for the purpose of the Work Order. . . .
- 5.2 The Contractor shall not claim for payments in support of downpayments to subcontractors until an irrevocable Letter of Credit from a Canadian Bank in favour of Canada is in place and accepted by the Contracting Authority.

e) reduction or suspension of payments:

**D.7 REDUCTION OR SUSPENSION OF PAYMENT**

- 7.1 Notwithstanding anything contained in this Contract, if the Contracting Authority has determined that:
- a) the Contractor has failed to perform or discharge any term or condition of the Contract; or
  - b) the Contractor has failed to pay the cost of performance of the Contract on a current basis in the ordinary course of business including all payments to Suppliers and Subcontractors; or
  - c) the amount of the allowable costs incurred by the Contractor is less than the aggregate of the amount of progress payments made to the Contractor. Then, the Contracting Authority may reduce or suspend any payment otherwise payable to the Contractor, until the cause of such reduction or suspension has been resolved to the satisfaction of the Contracting Authority.

f) final payment:

**D.8** . . .

8.1 No final payment shall be made to the Contractor until:

- a) all commercial invoices, certificates of conformity and related documents have been submitted in accordance with this Contract;
- b) all such commercial invoices, certificates of conformity and related documents have been verified by DAPM-3 and the Contracting Authority; and
- c) the Contractor certifies that all the Work is free from claims, demands, charges, liens or other encumbrances, including those of any government, in respect of taxes, charges or otherwise.

g) acceptance:

**E.5** . . .

5.1 Acceptance of the deliverables shall be effected through the execution by a DND Representative of the Quality Assurance Certificate of Inspection and Release . . . . Acceptance and delivery are conditions precedent to the obligation of Her Majesty to pay the amount claimed in any progress claim or invoice submitted by the Contractor.

h) general conditions — definitions:

**GENERAL CONDITIONS DSS-MAS 9601**

**9601 01 (16/02/98) Interpretation**

In the *Contract*, unless the context otherwise requires . . .

“**Government Property**” means all materials, parts, components, specifications, equipment, software, articles and things supplied to the *Contractor* . . . for the purposes of performing the *Contract* and anything acquired by the *Contractor* in any manner in connection with the *Work* the cost of which is paid by *Canada* under the *Contract* and, without restricting the generality of the foregoing, includes Government Issue as defined in the *Defence Production Act*, R.S.C. 1985, c. D-1, Government Furnished Equipment and Government Supplied Materiel; . . .

“*Work*” means the whole of the activities, services, materials, equipment, software, matters and things required to be done, delivered or performed by the *Contractor* in accordance with the terms of the *Contract*. . . .

3. If the *Contract* is a defence *Contract* within the meaning of the *Defence Production Act*, R.S.C. 1985, c. D-1, it is subject to that Act and shall be governed accordingly. . . .

i) title:

### **GENERAL CONDITIONS DSS-MAS 9601<sup>6</sup>**

#### **9601 19 (04/01/94) Title**

1. Except as otherwise provided in the *Contract* including the intellectual property provisions, and except as provided in subsection 2, title to the *Work* or any part thereof shall vest in *Canada* upon delivery and acceptance thereof by or on behalf of *Canada*.
2. Except as otherwise provided in the intellectual property provisions of the *Contract*, upon any payment being made to the *Contractor* for or on account of materials, parts, work-in-process or finished work, either by way of progress payments or accountable advances or otherwise, title in and to all materials, parts, work-in-process and finished work so paid for shall vest in and remain in *Canada* unless already so vested under any other provision of the *Contract*.
3. Notwithstanding any vesting of title referred to in this section and except as otherwise provided in the *Contract*, the risk of loss or damage to the materials, parts, work-in-process or finished work or part thereof so vested shall remain with the *Contractor* until their delivery to *Canada* in accordance with the *Contract*. The *Contractor* shall be liable for any loss or damage to any part of the *Work* caused by the *Contractor* or any subcontractor after such delivery.<sup>7</sup>
4. Any vesting of title referred to in subsection 2 shall not constitute acceptance by *Canada* of the materials, parts, work-in-process or finished work, and shall not relieve the *Contractor* of its obligation to perform the *Work* in accordance with the *Contract*.
5. Where title to any materials, parts, work-in-process or finished work becomes vested in *Canada*, the *Contractor* shall, upon the *Minister's* request, establish to the *Minister's* satisfaction that the title is free and clear

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<sup>6</sup> The general conditions are part of the contract and start at page 53 (Appendix 1, Exhibit I-2).

<sup>7</sup> See also paragraphs 2.1 and 2.2 at page 37 of the contract (Appendix 1, Exhibit I-2).

of all claims, liens, attachments, charges or encumbrances and shall execute such conveyances thereof and other instruments necessary to perfect that title as the *Minister* may request.

6. If the *Contract* is a defence *Contract* within the meaning of the *Defence Production Act*, R.S.C. 1985, c. D-1, title to the *Work* or to any materials, parts, work-in-process or finished work shall vest in *Canada* free and clear of all claims, liens, attachments, charges or encumbrances, and the *Minister* shall be entitled at any time to remove, sell or dispose of it or any part of it in accordance with section 20 of that Act. . . .

#### **9601 21 (04/01/94) Government Property**

1. Unless otherwise provided in the *Contract*, all *Government Property* shall be used by the *Contractor* solely for the purpose of the *Contract* and shall remain the property of *Canada*, and . . . .
2. The *Contractor* shall take reasonable and proper care of all *Government Property* . . . and shall be responsible for any loss or damage resulting from its failure to do so other than loss or damage caused by ordinary wear and tear.
3. All *Government Property*, except such as is installed or incorporated into the *Work*, shall, unless otherwise specifically provided in the *Contract*, be returned to *Canada* on demand. . . .

j) default by the contractor:

#### **9601 26 (04/01/94) Default by the Contractor**

1. Where the *Contractor* is in default in carrying out any of its obligations under the *Contract*, the *Minister* may, upon giving written notice to the *Contractor*, terminate for default the whole or any part of the *Contract*, either immediately, or . . . .
2. Where the *Contractor* becomes bankrupt or insolvent, makes an assignment for the benefit of creditors, or . . . the *Minister* may, to the extent permitted by the laws of *Canada*, upon giving notice to the *Contractor*, immediately terminate . . . .
3. Upon the giving of a notice provided for in subsection 1 or 2, the *Contractor* shall have no claim for further payment other than as provided in this section, but shall be liable to *Canada* for any amounts, including milestone payments, paid by *Canada* and for all losses and damages which may be suffered by *Canada* by reason of the default or occurrence upon which the notice was based, including any increase in the cost incurred by

*Canada* in procuring the *Work* from another source. The *Contractor* agrees to repay immediately to *Canada* the portion of any advance payment that is unliquidated at the date of the termination. Nothing in this section affects any obligation of *Canada* under the law to mitigate damages.

4. Upon termination of the *Contract* under this section, the *Minister* may require the *Contractor* to deliver to *Canada*, in the manner and to the extent directed by the *Minister*, any completed parts of the *Work* which have not been delivered and accepted prior to the termination and any materials, parts, plant, equipment or work-in-process which the *Contractor* has acquired or produced specifically in the fulfilment of the *Contract*.
5. Subject to the deduction of any claim that *Canada* may have against the *Contractor* arising under the *Contract* or out of the termination, *Canada* shall pay or credit to the *Contractor* the value, determined on the basis of the *Contract* Price including the proportionate part of the *Contractor*'s profit or fee included in the *Contract* Price, of all completed parts of the *Work* delivered to *Canada* pursuant to a direction under subsection 4 and accepted by *Canada*, and shall pay or credit to the *Contractor* the cost to the *Contractor* that the *Minister* considers reasonable in respect of all materials, parts, plant, equipment or work-in-process delivered to *Canada* pursuant to a direction under subsection 4 and accepted by *Canada*, but in no event shall the aggregate of the amounts paid by *Canada* under the *Contract* to the date of termination and any amounts payable pursuant to this subsection exceed the *Contract* Price.
6. Title to all materials, parts, plant, equipment, work-in-process and finished work in respect of which payment is made to the *Contractor* shall, upon such payment being made, pass to and vest in *Canada* unless already so vested under any other provision of the *Contract*, and such materials, parts, plant, equipment, work-in-process and finished work shall be delivered . . .

[9] Jacques Saint-Martin testified, providing explanations regarding the table he prepared (found at Tab 7 of Exhibit I-1). The purpose of the table is to reconcile the source of the progress payments shown on the balance sheet with the following three sources:

- a) the progress payments received on accounts payable,
- b) the portion of the progress payments on inventory that is reflected in the progress payments (clause D.2 of the contract); and
- c) the portion of the progress payments on inventory that are reflected in the fixed costs (clause D.1 of the contract).

[10] Mr. Saint-Martin was unable to completely reconcile the sum of \$78 million shown on the 1998 balance sheet as “progress payments on inventory” with the documents he received from the appellant; he was, however, able to establish that more than \$30 million came from progress payments. We can conclude that the progress payment amounts for fixed costs were also significant.

### Statutory provisions

[11] The tax on large corporations<sup>8</sup> applies to certain corporations. This tax is a specified percentage of “taxable capital.” The “taxable capital” is equal to the corporation’s “capital” less the “capital deduction.”<sup>9</sup>

[12] In the case of corporations that are not financial institutions, “capital” is defined in subsection 181.2(3) of the ITA and includes, *inter alia*, in paragraph (c):

(c) the amount of all loans and advances to the corporation at the end of the year.

[13] No other element of the subsection is pertinent to this dispute and the sole issue is whether the amounts in question are “advances” within the meaning of subsection 181.2(3) of the ITA.

[14] Subsection 181(3) of the ITA must also be taken into account in analyzing this issue. The relevant portions of that subsection read as follows:

(3) For the purposes of determining the carrying value of a corporation’s assets or any other amount under this Part in respect of a corporation’s capital . . .

. . .

(b) . . . except as otherwise provided in this Part, the amounts reflected in the balance sheet

(i) presented to the shareholders of the corporation . . . or, where such a balance sheet was not prepared in accordance with generally accepted accounting principles or . . . the amounts that would be reflected if such a balance sheet had been prepared in accordance with generally accepted accounting principles . . . .

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<sup>8</sup> Part I.3 of the ITA.

<sup>9</sup> Sections 181.1 and 181.2 of the ITA.

[15] Finally, section 20 of the *Defence Production Act* provides as follows:

20 If, by the terms of a defence contract, it is provided that title to any government issue or building furnished or made available to a person or obtained or constructed by the person with money provided by Her Majesty . . . remains vested or vests in Her Majesty . . . free and clear of all claims, liens, prior claims or rights of retention within the meaning of the *Civil Code of Québec* or any other statute of the Province of Quebec, charges or encumbrances, then, despite any law in force in any province,

(a) the title to the government issue or building remains vested or vests in accordance with the terms of the contract free and clear of all claims, liens, prior claims or rights of retention within the meaning of the *Civil Code of Québec* or any other statute of the Province of Quebec, charges or encumbrances; and

(b) subject to any provisions in the contract, Her Majesty or the associated government in whom the title is vested is entitled at any time to remove, sell or dispose of the government issue or building.

[16] The same Act defines “government issue” and “defence supplies” as follows in section 2:

“government issue” means machinery, machine tools, equipment or defence supplies furnished by the Minister . . . or acquired or purchased on behalf of Her Majesty . . . with funds provided by the Minister . . . .

“defence supplies” means

(a) arms, ammunition, implements of war, vehicles, mechanical and other equipment . . . articles, materials, substances and things required or used for the purposes of the defence of Canada or for cooperative efforts for defence being carried on by Canada . . .

. . .

(c) articles, materials, substances and things of all kinds used for the production or supply of anything mentioned in paragraph (a) or (b) or for the construction of defence projects.

### Parties’ positions

[17] The appellant submits that the progress payments received on accounts payable, as well as the portion of the progress payments on inventory that is reflected in the portion of the progress payments related to the cost of inventory (clause D.2 of the contract<sup>10</sup>), are not “advances,” and therefore, are not to be taken into account in calculating the taxable capital under paragraph 181.2(3)(c) of the ITA. On the other

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<sup>10</sup> See paragraph 8 c) above.

hand, the appellant recognizes that the portion of the progress payments on inventory related to the fixed costs must be included in calculating the capital (clause D.1 of the contract<sup>11</sup>).

[18] According to the appellant, the amounts in question represent the acquisition cost paid by Canada to obtain title to the materials, parts or finished products purchased by SNC, to the work in process and, ultimately, to the finished products before acceptance and delivery of the end product (hereinafter: inputs and intermediate products). Accordingly, the amounts cannot be “advances.”

[19] The respondent submits, first, that, considering the balance sheet and subsection 181(3) of the ITA, the amounts in question are advances and, second, that the progress payments in question are not derived from sales and are advances, even if subsection 181(3) is disregarded. The respondent also submits that what we have here is a guarantee and not an absolute transfer of title.

### Analysis

[20] There are accordingly two questions to consider:

- a) If subsection 181(3) of the ITA is disregarded, are the amounts in question payments for the acquisition of inputs and intermediate products that cannot be considered “advances”?
- b) Must those amounts be treated as advances under subsection 181(3) of the ITA?

The resolution of this dispute is to be found in the answer to the second question. The analysis of that question begins at paragraph 38 below.

### Acquisition/sale?

[21] The contract herein is quite unique in that it provides that all inputs and intermediate products become the property of Canada as soon as the appellant receives the progress payments related to the purchases or work in question.<sup>12</sup> The result of the contract, as well as of section 20 of the *Defence Production Act*, is that those goods, once acquired by Canada, cannot in any case become the property of the appellant.

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<sup>11</sup> See paragraph 8 c) above.

<sup>12</sup> Provision 9601 19 of the contract; see paragraph 8 i) above. See also the definition of “*Government Property*” in provision 9601 01, page 60 of the contract, Appendix 1, Exhibit I-2.



[22] Are the amounts in question payments for the progressive acquisition of all the goods as they are purchased or manufactured? Is there a sort of ongoing sale of all the goods?

[23] The following factors support such an interpretation:

- a) as described in paragraph 21 above:
  - i) the ongoing acquisition of title to inputs and intermediate products, which acquisition takes place before the government accepts anything;
  - ii) the fact that the contract does not provide for any circumstances under which title to the goods could vest in the appellant;
- b) section 20 of the *Defence Production Act* providing that Canada is free to remove or dispose of the goods;
- c) the fact that the contract provides that, when ammunition is sold to third parties other than Canada (a situation that does not apply in the present case), the appellant acquires title to the ammunition just before the completion of the sale by the appellant to the third party.<sup>13</sup>

[24] However, the following factors must also be taken into consideration:

- a) it is stipulated in the contract<sup>14</sup> that the progress payments are interim payments that are subject to verification and adjustment; there is therefore a possibility of reimbursement;
- b) the appellant cannot claim amounts related to the payments made to subcontractors until an irrevocable letter of credit in favour of Canada has been issued; the respondent contends that this is a form of guarantee;<sup>15</sup>
- c) acceptance and delivery are preconditions to any obligation to pay any amount claimed as a progress payment;<sup>16</sup>
- d) in provision 9601 19, paragraph 4, of the contract, it is provided that the acquisition of title to inputs and intermediate products by Canada does not constitute an acceptance of the goods;
- e) the purpose of the contract is to sell ammunition and not inputs or intermediate products in the ammunition manufacturing process;

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<sup>13</sup> See clause 2.1 of the contract, page 37, Exhibit I-2, Appendix 1.

<sup>14</sup> Clause D.4.3 of the contract, page 23, Appendix 1, Exhibit I-2.

<sup>15</sup> Clause D.5.2 of the contract, page 23, Appendix 1, Exhibit I-2.

<sup>16</sup> Clause E.5.1 of the contract, page 26, Appendix 1, Exhibit I-2.

- f) in the normal course of things, Canada would never take possession of inputs and intermediate products that are transformed during the production of goods;
- g) the fact that the risk is on the appellant until delivery.<sup>17</sup>

[25] In both civil law and common law, the basic components of a sale are the same.<sup>18</sup> It is a contract whereby the vendor and the purchaser agree to the transfer of the ownership of property to the purchaser by the vendor in consideration of a price in money to be paid by the purchaser.

[26] Although the purpose of the contract herein is the supply of ammunition and not of inputs and intermediate products, the provisions of the contract very clearly state that there is to be a transfer of ownership of the inputs and intermediate products in consideration of the payment of a sum of money. Although the consideration may be adjusted after verification, there is nonetheless a consideration. There is therefore a sale. It is not a guarantee.

[27] The other considerations listed in paragraph 24 do not change this finding.

- a) The progress payments, which represent the price at each step in the acquisition of inputs and intermediate products are not fixed, but are determinable. Given that they are determinable, it is normal that there could be adjustments, but that does not alter their nature.
- b) That acquisition is not acceptance does not change the fact that there is a sale, considering that nowhere is it provided that the appellant can acquire ownership of the ammunition.<sup>19</sup>
- c) As for the risk, it is possible for two parties to agree to have the person who has possession of the property assume the risk in the owner's place.
- d) Likewise, the purchaser of an input or intermediate product is entirely free to give it to another person to transform it.
- e) As for the payments made to subcontractors, the mere fact that they are subject to the issuance of a letter of credit does not alter the fact that there is a sale. There is however a specific aspect of progress payments to suppliers that I will address in paragraph 35 below.

[28] Clause E.5.1<sup>20</sup> seems to run counter to the concept of a sale. It stipulates that delivery and acceptance are conditions precedent to any obligation to make a

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<sup>17</sup> Provision 9601 19, paragraph 4, of the contract (see paragraph 8 i) above).

<sup>18</sup> The contract (Appendix 1, Exhibit I-2) provides in clause A.7, page 12, that the applicable law is Ontario law.

<sup>19</sup> In the present case, there are no transactions involving sales to third parties.

progress payment. Considering that acceptance and delivery occur only with respect to the finished product, that would imply that all progress payments made prior to acceptance would be voluntary.

[29] Reading the contract as a whole, specifically clauses D.2, D.3 and D.4,<sup>21</sup> it is impossible for me to conclude that the progress payments are voluntary prior to acceptance. With the exception of the profit related to the variable cost that is payable only after delivery and acceptance,<sup>22</sup> the contract states that there is an obligation to make the progress payments over a fixed period,<sup>23</sup> provided that the appellant meets the various conditions, in particular with regard to documentation. The payments may then be verified and, possibly, reimbursed, but that does not release Canada from its obligation to make the payments.

[30] The payments in question also serve to finance the overall process of the production of the ammunition that is the object of the contract. This is not inconsistent with the fact that they are consideration for the purchase of inputs and intermediate goods.

[31] The parties brought to my attention most interesting case law concerning Part I.3 of the ITA.<sup>24</sup> In light of my conclusion that the answer to the second question contains the resolution of this dispute, I will simply make two comments. First, once a sale has actually taken place, that case law cannot lead to the conclusion that there

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<sup>20</sup> Page 21 of the contract (see paragraph 8 g) above).

<sup>21</sup> Exhibit I-2, Appendix 1, pages 20 to 23.

<sup>22</sup> Clause D.2.4 of the contract, p. 21, Appendix 1, Exhibit I-2.

<sup>23</sup> Clause D.4.1 of the contract, p. 22, Appendix 1, Exhibit I-2.

<sup>24</sup> The parties provided me with books containing the following case law and authorities: *CUQ v. Corp. Notre-Dame de Bon-Secours*, [1994] 3 S.C.R. 3, *Oerlikon Aérospatiale Inc. v. The Queen*, 99 DTC 5318, 97 DTC 962, *Controlled Foods Corp. Inc. v. The Queen*, [1981] 2 F.C. 238, *Upper Lakes Shipping Limited v. The Minister of Finance*, 98 DTC 6264, *London Life Insurance Company v. The Queen*, 2000 DTC 1774, *Autobus Thomas Inc. v. The Queen*, 2000 DTC 6299, *PCL Construction Management Inc. et al. v. The Queen*, 2000 DTC 2624, *The Royal Trust Company et al. v. The Queen*, 2001 DTC 52, *The Queen v. The Manufacturers Life Insurance Co.*, 2001 DTC 5396, *Federated Co-operatives Limited v. The Queen*, 2001 DTC 5414, *QEW 427 Dodge Chrysler (1991) Inc. v. Ontario (Minister of Revenue)*, 49 O.R. (3d) 776, *QEW 427 Dodge Chrysler (1991) Inc. v. Ontario (Minister of Revenue)*, 59 O.R. (3d) 460, *Canadian Forest Products Ltd. v. The Queen*, 2004 DTC 2869, *Ford Credit Canada Limited v. The Queen*, 2006 DTC 3424, 2007 FCA 225, *Monarch Life Assurance Co. c. Continental Insurance Co.*, [1980] C.A. 7, *Marcelon Inc. c. Québec (sous-ministre du Revenu)*, [1991] R.D.F.Q. 3, *Simpsons Ltd. c. Québec (sous-ministre du Revenu)*, [1992] R.D.F.Q. 19, *Crédit-Bail Banque Nationale Inc. c. Québec (Sous-ministre du Revenu)*, [1993] R.D.F.Q. 10, *Les journaux Trans-Canada (1996) Inc. c. Sous-ministre du Revenu du Québec*, [2004] J.Q. n° 13447 (C.A.), *Canfor Ltd. v. British Columbia (Minister of Finance)*, [1976] C.T.C. 429, *British Columbia (Minister of Finance) v. Canfor Ltd.*, [1977] C.T.C. 269, *Canfor Ltd. v. British Columbia (Minister of Finance)*, [1978] 1 S.C.R. 1047, *The Queen v. Savage*, [1983] 2 S.C.R. 428, *Transcanada Pipelines Ltd. v. Ontario (Minister of Revenue)*, [1992] O.J. No. 2592 (QL), *Harold Gross Machinery Inc. v. Ontario (Minister of Finance)*, 162 D.L.R. 4th 509, *Hewlett Packard (Canada) Ltd. v. The Queen*, 2004 DTC 6498, *Alberta (Treasury Branches) v. Canada (Minister of National Revenue)*, [1996] 1 S.C.R. 963, N. Prieur, *La mesure du capital versé et du capital imposable : une norme comptable, légale ou fiscale?* (2004) R.P.F.S. 81.

was an advance—again leaving aside subsection 181(3) of the ITA. Second, the facts in the present case are quite unique. I note that in *Oerlikon Aérospatiale Inc. v. Canada*,<sup>25</sup> the contractual relationship was different.<sup>26</sup>

[32] To conclude, I agree with the appellant that the progress payments are payments made in consideration of the acquisition of inputs and intermediate products. This may seem surprising in that Canada's ultimate purpose was the purchase of ammunition. However, it is the result of the specific contractual structure that Canada put in place—no doubt in order to have the greatest amount of control possible over ammunition and anything that could be used to manufacture ammunition.

[33] Leaving aside subsection 181(3) of the ITA, we could conclude that the amounts in question were payments and that, therefore, they could not be advances.

[34] Nevertheless, even if that did resolve the issue, certain nuances would have to be taken into account in making a reassessment.

[35] First, the situation regarding the progress payments on accounts payable is different from that with respect to the progress payments on inventory that are reflected in the progress payments. The amounts are related to goods ordered by the appellant, but not delivered.<sup>27</sup> The contract between the government and the appellant is not binding on the subcontractors. Consequently, none of the provisions stipulating that Canada acquires title to the goods can have effect until the property is transferred from the subcontractors to the appellant. The Minister would have to determine which portions of those progress payments, at the end of the fiscal year, represent amounts laid out for goods that are no longer the property of the supplier; only those portions would be excluded from capital.

[36] Second, as the appellant has conceded, it would also be necessary to apportion the progress payments on inventory between the portion related to fixed costs and the portion related to inventory; only the portion related to inventory would be excluded.

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<sup>25</sup> [1999] F.C.J. No. 496, 99 DTC 5318.

<sup>26</sup> In *Oerlikon*, there was no transfer of ownership of inputs and intermediate goods; moreover, the argument put forward by *Oerlikon* was completely different.

<sup>27</sup> Paragraph 16 of the partial agreement on the facts (see paragraph 4 above).

[37] Finally, we would have to take into account the concession made by the appellant in recognizing that the Minister was correct in adding to capital for the 1996 fiscal year an amount of \$300,000 that is not related to this dispute.<sup>28</sup>

Subsection 181(3) and accounting treatment

[38] The progress payments in question were included on the balance sheet as advances and were not treated as income in the financial statements. The respondent contends that, accordingly, subsection 181(3) of the ITA has the effect of including those amounts in capital for the purposes of the tax on large corporations.

[39] The appellant responds that Note 6 to the balance sheet, which note is part of the financial statements, clearly indicates that there was a transfer of goods and that the inventory in question no longer belongs to the appellant. The balance sheet presented stems from the fact that the taxpayer uses the completed performance method to report its income. As for the fact that Note 6 also mentions a guarantee, the appellant submits that one must look at the contract and determine its true nature.

[40] The appellant also submits that it is necessary to consider this issue in the specific context of defence, taking into account not only section 20 of the *Defence Production Act*, but also the will of the government to exercise the greatest amount of control possible over hazardous materials, namely ammunition.

[41] Before considering those submissions, it would be useful to look at the applicable law.

[42] Subsection 181(3) of the ITA provides for the use of amounts

. . . reflected in the balance sheet . . . presented to the shareholders of the corporation . . . or, where such a balance sheet was not prepared in accordance with generally accepted accounting principles or . . . the amounts that would be reflected if such a balance sheet had been prepared in accordance with generally accepted accounting principles . . . .

[Emphasis added.]

One must therefore take the balance sheet as the starting point unless it is demonstrated that the balance sheet is not consistent with generally accepted accounting principles.

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<sup>28</sup> See Note 3 above.

[43] In the decision *Ford Credit Canada Ltd. v. Canada*,<sup>29</sup> of the Federal Court of Appeal, Ryer J.A. wrote as follows:

27 . . . provided that the balance sheet in question has been prepared in accordance with GAAP and otherwise complies with the specific provisions of Part I.3, that balance sheet must be accepted for the purposes of the determination of the LCT liability of the corporation.

28 This is not to say that the Minister or the courts are precluded from any consideration of a balance sheet that is said to have been prepared in accordance with GAAP.<sup>30</sup> It would always be open to the Minister to argue that the balance sheet description of a particular item was not in fact in accordance with GAAP. The courts would then be required to adjudicate the question, having regard to expert accountancy evidence. . . .

30 It is undisputed that the amounts reflected in the balance sheets of Ford Credit in respect of the Class C Shares . . . were properly characterized as liabilities of Ford Credit under GAAP. Moreover, there was no suggestion that any provision of Part I.3 specifically mandated an alternate characterization. Accordingly, for the reasons given, those amounts are not required to be included in the capital of Ford Credit, for the purposes of Part I.3 of the ITA, in any of those taxation years.

[44] Accordingly, the balance sheet has to be used to calculate the tax on large corporations,

- a) unless another specific provision respecting the tax on large corporations applies; or
- b) unless the evidence establishes that the balance sheet is not consistent with generally accepted accounting principles.

[45] Here, there is no other provision that applies and there is no accounting evidence that the appellant's balance sheet was not prepared in accordance with generally accepted accounting principles.

[46] What is the impact of Note 6 to the financial statements? Note 6 is contradictory; it speaks of a "transfer", which appears to suggest a sale of inventory; however, it also speaks of a guarantee, which appears to suggest that what is involved is a means of financing and that the appellant did not do everything that was required

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<sup>29</sup> 2007 FCA 225. See also paragraphs 20 to 24 of the decision.

<sup>30</sup> In French, this sentence reads as follows: "Cela ne signifie pas que le ministre ou les tribunaux ne peuvent pas procéder à un examen des bilans établis conformément aux PCGR."

in order for the progress payments in question to be considered income. Note 6 does not settle the debate.

[47] What is significant is the very fact that the progress payments in question were recorded as a liability on the balance sheet rather than being treated as income. That was an accounting choice; the evidence does not allow us to know the accounting reasons behind that choice. Subsection 181(3) dictates that the balance sheet must be accepted.

[48] It is perhaps surprising that, leaving aside subsection 181(3) of the ITA, the result is different from that which would be obtained through the application of that subsection, but that is the consequence of the choice made by Parliament.<sup>31</sup>

[49] I must conclude that for the purposes of the tax on large corporations, the Minister was correct in adding to the appellant's taxable capital the amounts recorded in the "progress payments on accounts payable" and "progress payments on inventory" accounts under liabilities on the appellant's balance sheets for the 1995 to 1998 taxation years.

[50] Accordingly, the appeal must be dismissed. Before signing the judgment, I will ask the Registry to contact the parties to ask them if they would like to make any submissions on the matter of costs.

[51] Finally, I would like to thank counsel for the parties for their excellent presentation of the case.

Signed at Ottawa, Canada, this 15th day of August 2008.

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"Gaston Jorré"

Jorré J.

Translation certified true

on this 16th day of July 2009.

<sup>31</sup> See paragraph 20 of the decision of Ryer J.A. in *Ford Credit Canada Ltd. v. Canada*, 2007 FCA 225.

Erich Klein, Revisor



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(FORMERLY LES TECHNOLOGIES  
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MAJESTY THE QUEEN

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