Docket: 2007-3870(IT)G

BETWEEN:

GENEX COMMUNICATIONS INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

Appeal heard on June 11, 2009, at Quebec City, Quebec.

Before: The Honourable Justice Réal Favreau

Appearances:

Counsel for the appellant:	René Dion
Counsel for the respondent:	Nathalie Labbé

JUDGMENT

The appeal from the assessment made on October 19, 2006, under the *Income Tax Act* with respect to the appellant's taxation year ending August 31, 2003, is dismissed with costs, in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 16th day of November 2009.

"Réal Favreau"

Favreau J.

Translation certified true
on this 29th day of January 2010.

Erich Klein, Revisor

Citation: 2009 TCC 583
Date: 20091116
Docket: 2007-3870(IT)G

BETWEEN:

GENEX COMMUNICATIONS INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

REASONS FOR JUDGMENT

Favreau J.

[1] The appellant, a company that carries on broadcasting activities under FM broadcasting licences, is appealing from an assessment made on October 19, 2006, under the *Income Tax Act*, R.S.C. (1985), c. 1 (5th Supp.), as amended (the Act). By that assessment the Minister of National Revenue (the Minister) disallowed the deduction of $329,543 as a non-capital loss carry-back claimed by the appellant for its taxation year ending August 31, 2003.

[2] The dispute essentially turns on the concept of "commercial debt obligation," as defined in subsection 80(1) of the Act, and the effects of a waiver by shareholders of their right to claim repayment of advances granted to a company. What is involved is determining this was a forgiveness or the settlement of a commercial obligation.

[3] The origin of the non-capital losses claimed by the appellant was the balance of the non-capital-loss account of Corporation Showbizznet (Showbizznet), a Canadian-controlled private corporation, which operated an Internet site devoted to a performing arts magazine.

[4] Under an agreement entered into on August 23, 2002, the appellant acquired all the shares of Showbizznet in consideration of the sum of $1 and assumed all of its debts. Under that same agreement, the shareholders of Showbizznet waived repayment of the advances they had made to said company, which had not been repaid. As at August 23, 2002, those advances totalled $329,543 and Showbizznet's non-capital loss balance was $1,130,985.

[5] Following the acquisition of all the shares of Showbizznet by the appellant, Showbizznet was liquidated. At the hearing, counsel for the respondent conceded that the appellant continued to actively carry on Showbizznet's business and that the conditions for the application of subsection 88(1.1) and paragraph 111(1)(*a*) of the Act were complied with. Accordingly, as of August 31, 2002, that is, the date of the end of its fiscal year over the course of which the liquidation of Showbizznet took place, the appellant had at its disposal Showbizznet's non-capital loss balance as at August 23, 2002.

[6] As the operations of Showbizznet were in a deficit situation and Showbizznet was under-capitalized, the shareholders made advances to it on a regular basis so that it could continue its activities. Those advances were generally converted into Class "A" shares in Showbizznet's capital stock. And that is what happened on April 1, 2002, when the balance of the advances was $487,929: those advances were converted into Class "A" shares in Showbizznet's capital stock.

[7] The advances in the amount of $329,543 forgiven by the shareholders had been made by them between April 1, 2002, and August 23, 2002, the date on which the appellant acquired all of Showbizznet's shares.

[8] Counsel for the respondent conceded at the opening of the hearing that the advances forgiven did not involve any legal obligation to pay interest and that, in fact, no interest was paid on those advances even though certain corporate and financial documents indicated that interest was payable on the advances. It was further conceded that there was no agreement setting out the terms regarding repayment of the principal amount of the advances.

Applicable statutory provisions

[9] The first definition to consider is, of course, that of "commercial obligation" found in subsection 80(1) of the Act:

> **"commercial obligation"**

> “commercial obligation” issued by a debtor means
>
> (*a*) a commercial debt obligation issued by the debtor, or
>
> (*b*) a distress preferred share issued by the debtor.

[10] The concept of "commercial debt obligation" to which the definition of "commercial obligation" refers is also defined in subsection 80(1) of the Act:

> **"commercial debt obligation"** “commercial debt obligation” issued by a debtor means a debt obligation issued by the debtor
>
> (*a*) where interest was paid or payable by the debtor in respect of it pursuant to a legal obligation, or
>
> (*b*) if interest had been paid or payable by the debtor in respect of it pursuant to a legal obligation,
>
> an amount in respect of the interest was or would have been deductible in computing the debtor’s income, taxable income or taxable income earned in Canada, as the case may be, if this Act were read without reference to subsections 15.1(2) and 15.2(2), paragraph 18(1)(*g*), subsections 18(2), (3.1) and (4) and section 21.

[11] For the purposes of the application of section 80 of the Act, "forgiven amount" in respect of a commercial obligation is the amount determined by the formula A – B, where A is the lesser of the amount for which the obligation was issued and the principal amount of the obligation (that is, in the present case, $329,543) and B is the total of the amounts listed in paragraphs (*a*) to (*l*) of the definition of "forgiven amount" in subsection 80(1) of the Act. Since the amounts listed under item B are not applicable to the present case, the forgiven amount of the advances is the principal of the advances.

[12] Subsection 80(2) of the Act specifies how the debt forgiveness rules must be applied. Paragraph (*a*) of this subsection is particularly pertinent:

> (*a*) **[when obligation settled]** -- an obligation issued by a debtor is settled at any time where the obligation is settled or extinguished at that time (otherwise than by way of a bequest or inheritance or as consideration for the issue of a share described in paragraph (*b*) of the definition “excluded security” in subsection (1)).

[13] The impact of the settlement of a commercial obligation on non-capital losses is set out in subsection 80(3) of the Act:

> (3) **Reductions of non-capital losses** -- Where a commercial obligation issued by a debtor is settled at any time, the forgiven amount at that time in respect of the obligation shall be applied to reduce at that time, in the following order,
>
> (*a*) the debtor's non-capital loss for each taxation year that ended before that time to the extent that the amount so applied
>
> (i) does not exceed the amount (in subsection (4) referred to as the debtor's "ordinary non-capital loss at that time for the year") that would be the relevant loss balance at that time for the obligation and in respect of the debtor's non-capital loss for the year if the description of E in the definition "non-capital loss" in subsection 111(8) were read without reference to the expression "the taxpayer's allowable business investment loss for the year", and
>
> (ii) does not, because of this subsection, reduce the debtor's non-capital loss for a preceding taxation year.

[14] The deduction of interest on borrowed money is provided for in subparagraph 20(1)(*c*)(i) of the Act:

> **20 (1) Deductions permitted in computing income from business or property** -- Notwithstanding paragraphs 18(1)(*a*), (*b*) and (*h*), in computing a taxpayer's income for a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonably be regarded as applicable thereto
> . . .
>
> (*c*) **Interest** -- an amount paid in the year or payable in respect of the year (depending on the method regularly followed by the taxpayer in computing the taxpayer's income), pursuant to a legal obligation to pay interest on
>
> (i) borrowed money used for the purpose of earning income from a business or property (other than borrowed money used to acquire property the income from which would be exempt or to acquire a life insurance policy).

Analysis

[15] Counsel for the appellant submits that the advances made by the shareholders to Showbizznet are not a commercial debt obligation owing to the fact that the shareholders had no legal obligation to pay interest on the advances, that no interest was in fact paid on the advances, and, lastly, that the intention of Showbizznet and its shareholders was to convert the advances into Class "A" shares in Showbizznet's capital stock. Accordingly, section 80 of the Act cannot be applied in respect of the amount forgiven on the advances.

[16] For her part, counsel for the Respondent contends that even though there was no interest on the advances, those advances were nevertheless a commercial debt obligation within the meaning of the definition in subsection 80(1) of the Act because Showbizznet could have claimed a deduction for the interest under paragraph 20(1)(*c*) of the Act if interest had been paid or payable by Showbizznet under a legal obligation. Counsel for the respondent refers, moreover, to the English definition of "commercial debt obligation" in interpreting paragraph (*b*) of the French version of that definition ("créance commerciale"), which, according to her, deals with interest-free debt obligations, hence, debt obligations for which there is no legal obligation to pay interest.

[17] The main issue to be determined is whether the definition of "commercial debt obligation" includes advances entailing no legal obligation to pay interest.

[18] Since no case law could be found on interest-free loans in the context of the definition of "commercial debt obligation" in subsection 80(1) of the Act, we must therefore rely on a literal interpretation of the wording of the Act and on legal writings.

[19] The text of paragraph (*b*) of the definition of "commercial debt obligation" is confusing as to whether the legal obligation to pay interest is part of the legislator's assumption or rather a requirement that must be met even if interest was not paid or payable by the debtor. To facilitate understanding of the appellant's argument, here again is paragraph (*b*):

> (b) if interest had been paid or payable by the debtor in respect of it pursuant to a legal obligation.

[20] Reference to such an obligation is obviously a reference to a legal obligation to pay interest under paragraph (*a*) of the definition of "commercial debt obligation."

[21] It should be noted here that, in the French version of the definition of "commercial debt obligation," the assumption concerning interest follows immediately the introductory words of the definition, which means that the legislator's assumption applies to both paragraph (*a*) and paragraph (*b*) of the definition. Accordingly, the reference in paragraph (*b*) to such an obligation mentioned in paragraph (*a*) is nonetheless subject to the legislator's general assumption concerning interest, and no particular inference can be drawn from the reference to a legal obligation to pay interest mentioned in paragraph (*a*) of the definition of "commercial debt obligation."

[22] The English definition of "commercial debt obligation" differs somewhat from the French version and is, by and large, clearer and more precise. The expression "commercial debt obligation" is defined as follows:

> **"commercial debt obligation"** issued by a debtor means a debt obligation issued by the debtor
>
> > (*a*) where interest was paid or payable by the debtor in respect of it pursuant to a legal obligation, or
> >
> > (*b*) if interest had been paid or payable by the debtor in respect of it pursuant to a legal obligation,
>
> an amount in respect of the interest was or would have been deductible in computing the debtor's income, taxable income or taxable income earned in Canada, as the case may be, if this Act were read without reference to subsections 15.1(2) and 15.2(2), paragraph 18(1)(*g*), subsections 18(2), (3.1) and (4) and section 21.

[23] This wording is clearer and more precise because the assumption concerning interest only applies with respect to paragraph (*b*), which is complete in itself. Paragraph (*a*) deals with cases where interest was actually paid or payable under a legal obligation, whereas paragraph (*b*) deals with the assumption that interest was paid or payable under a legal obligation.

[24] Given the ambiguity of the wording of the Act in the French version, it is quite appropriate to consider the English version of the same text to seek Parliament's intent. It should certainly be noted that the Act is a bilingual document and that both the English and French versions thereof are equally authoritative: see *Canada Act 1982*, 1982, c. 11 (U.K.), R.S.C. 1985, Appendix II, No. 44, as amended, and *An Act respecting the status and use of the official languages of Canada*, R.S.C. 1985, c. 31 (4th Supp.). The effect of this principle is that one version of the Act is not a translation of the other and that, in order to interpret the Act, it is necessary to look at both versions of it. Each version is regarded as an original and is supposed to convey the same meaning as the other. To conclude on that point, it is appropriate to refer to the principles of interpretation of bilingual statutes set out by the Supreme Court of Canada in *Medovarski v. Canada (M.C.I.)*, [2005] 2 S.C.R. 539, at pages 550 and 551:

> In interpreting bilingual statutes, the statutory interpretation should begin with a search for the shared meaning between the two versions: P.-A. Côté, *The Interpretation of Legislation in Canada* (3rd ed. 2000), at p. 327. In *Daoust*, Bastarache J. held for the Court that the interpretation of bilingual statutes is subject to a two-part procedure.
>
> First, one must apply the rules of statutory interpretation to determine whether or not there is an apparent discordance, and if so, whether there is a common meaning between the French and English versions. "[W]here one of the two versions is broader than the other, the common meaning would favour the more restricted or limited meaning": *Schreiber*, at para. 56, *per* LeBel J. *Schreiber* concerned a discrepancy between the French version of s. 6(*a*) of the *State Immunity Act*, R.S.C. 1985, c. S-18, which stated that the exception to state immunity is narrowly "*décès*" or "*dommages corporels*", compared to the broader English "death" or "personal injury". Given the conflict between the two provisions the Court adopted the clearer and more restrictive French version. The common meaning is the version that is plain and not ambiguous. If neither version is ambiguous, or if they both are, the common meaning is normally the narrower version: *Daoust*, at paras. 28-29.
>
> Second, one must determine if the common meaning is consistent with Parliament's intent: *Daoust*, at para. 30.

[25] In order to avoid the ambiguity of paragraph (*b*) in the French version, Parliament should have used the verb "auraient" rather than "avaient" to indicate that the paragraph made an assumption. Furthermore, Parliament could have added the following words to the introductory portion of the definition of "créance

commerciale" ("commercial debt obligation") after the word "déductible": "ou auraient été déductibles, le cas échéant," to take into account the situation covered by paragraph (*b*), namely that in which interest had not been paid or payable under a legal obligation.

[26] Paragraphs (*a*) and (*b*) of the French version of the definition of "commercial debt obligation" are drafted in practically the same way. Considering that Parliament does not speak for nothing, it is quite reasonable to believe that in paragraph (*b*) it intended to cover a situation different from that dealt with in paragraph (*a*). It is therefore plausible to think that paragraph (*a*) contemplates loans with interest, whereas paragraph (*b*) contemplates interest-free loans. Parliament appears to have wanted to include in the definition of commercial debt obligation advances on which no interest is paid or payable under a legal obligation.

[27] According to the authors[1] who have spoken on the issue, the definition of commercial debt obligation includes interest-free loans as, in their view, what is

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[1] PARENT, Robert, "Application de l'article 80 L.I.R., Règlement de dettes", *Revue de Planification Fiscale et Successorale*, Vol. 23, No. 3, page 464 :

> [TRANSLATION] Moreover, an interest-free debt of a taxpayer would be subject to the provisions of section 80 I.T.A.; where interest had been paid or payable, it would have been deductible.

ROYAL, Normand, *Utilisation des pertes fiscales et opérations de restructuration de dettes*, Congrès de l'APFF 2008, October 9, 2008 :

> [TRANSLATION] A commercial debt obligation is defined as a debt obligation issued by the debtor with respect to which interest is deductible (but only as regards certain provision of the Act) or would have been deductible if the interest had been paid or payable on the debt t pursuant to a legal obligation. Thus, under appropriate circumstances, a commercial debt obligation would include an interest-free loan. [Emphasis added.]

PICKFORD, Barry, *The Tax Treatment of Forgiveness of Debt and Foreclosures : The proposed New Rules*, Report of Proceedings of Forty-Sixth Tax Conference (Toronto: Canadian Tax Foundation, 1995), 3:1-62:

> Interest-free debts will be commercial debt obligations if interest would have been deductible if it had been payable. [Emphasis added.]

BERNSTEIN, Jack, *Update on Debt Forgiveness and Mortgage Foreclosure Proposals in Real Estate Transactions: Tax Planning for the Second Half of the 1990s*, 1995 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1996), 21:1-43:

> A preliminary step in determining whether the provisions of section 80 will apply is to ascertain whether the debt is a commercial debt obligation and whether it has been settled. A commercial debt obligation is one on which the interest is

important to determine is whether, in cases where interest would have been payable, that interest would have been deductible in computing the debtors' income.

[28] Contrary to the appellant's position, I do not believe that there must necessarily be a legal obligation to pay interest in order for a debt obligation to qualify as a commercial debt obligation. The fact that the advances to Showbizznet were not subject to any repayment agreement does not therefore in any way change the situation, contrary to the appellant's submissions.

[29] That is also the case with the shareholder's intention to convert their advances into shares in Showbizznet's capital stock. Regardless of the parties' intention, the tax consequences must apply to the facts as they actually were. This principle arises out of numerous decisions by our courts. See in this regard the following excerpt from Linden J.'s decision in *Friedberg v. Canada (F.C.A.)*, [1991] F.C.J. No. 1255 (QL):

> In tax law, form matters. A mere subjective intention, here as elsewhere in the tax field, is not by itself sufficient to alter the characterization of a transaction for tax purposes. If a taxpayer arranges his affairs in certain formal ways, enormous tax advantages can be obtained, even though the main reason for these arrangements may be to save tax (see The Queen v. Irving Oil 91 D.T.C. 5106, per Mahoney J.A.). If a taxpayer fails to take the correct formal steps, however, tax may have to be paid. If this were not so, Revenue Canada and the courts would be engaged in endless exercises to determine the true intentions behind certain transactions. Taxpayers and the Crown would seek to restructure dealings after the fact so as to take advantage of the tax law or to make taxpayers pay tax that they might otherwise not have to pay. While evidence of intention may be used by the Courts on occasion to clarify dealings, it is rarely determinative. In sum, evidence of subjective intention cannot be used to 'correct' documents which clearly point in a particular direction.

[30] The following extracts from the decisions rendered by the Supreme Court of Canada in *Bronfman Trust v. The Queen*, [1987] 1 S.C.R. 32, at pages 54 and 55, and in *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622, at paragraphs 39 and 40, are also very pertinent:

> *Bronfman Trust*, Dickson C.J.

> deductible or would have been deductible if it had been charged. An interest-free debt will not be a commercial debt obligation if, assuming that interest had been paid or payable, the interest would not be deductible. A debt will not be a commercial debt obligation if the interest paid or that would be paid (if it is charged) is non-deductible. [Emphasis added.]

> Before concluding, I wish to address one final argument raised by counsel for the Trust. It was submitted -- and the Crown generously conceded -- that the Trust would have obtained an interest deduction if it had sold assets to make the capital allocation and borrowed to replace them. Accordingly, it is argued, the Trust ought not to be precluded from an interest deduction merely because it achieved the same effect without the formalities of a sale, and repurchase of assets. It would be a sufficient answer to this submission to point to the principle that the courts must deal with what the taxpayer actually did, and not what he might have done: *Matheson v. The Queen*, 74 D.T.C. 6176 (F.C.T.D.), *per* Mahoney J. at p. 6179.
>
> *Shell Canada Ltd.*, McLachlin J.
>
> [39] This Court has repeatedly held that courts must be sensitive to the economic realities of a particular transaction, rather than being bound to what first appears to be its legal form: *Bronfman Trust*, *supra*, at pp. 52-53, *per* Dickson C.J.; *Tennant*, *supra*, at para. 26, *per* Iacobucci J. But there are at least two caveats to this rule. First, this Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer's *bona fide* legal relationships. To the contrary, we have held that, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases. Recharacterization is only permissible if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect: *Continental Bank Leasing Corp. v. Canada*, [1998] 2 S.C.R. 298, at para. 21, *per* Bastarache J.
>
> [40] Second, it is well established in this Court's tax jurisprudence that a searching inquiry for either the "economic realities" of a particular transaction or the general object and spirit of the provision at issue can never supplant a court's duty to apply an unambiguous provision of the Act to a taxpayer's transaction. . . .

[31] On the basis of the principles set out above, I am of the view that the legal reality must be respected regardless of whether the intention of Showbizznet and its shareholders was to convert the advances into Showbizznet shares as they had previously done on several occasions.

[32] In order to determine whether the interest that would have been paid or payable on the advances under a legal obligation would have been deductible in computing Showbizznet's income under paragraph 20(1)(*c*) of the Act, it is necessary to look at the debtor's situation and consider whether such interest would have been paid on money borrowed for the purpose of earning income from a business or property.

[33] In paragraph 1.1 of Section C of the Notice of Appeal, it is clearly indicated that the shareholders of Showbizznet advanced funds to it on a regular basis so that it could continue its activities. Since the advances allowed Showbizznet to carry on operating its business, those advances were used for the purpose of earning income from a business; hence, the requirement concerning the deductibility of the interest found in the definition of "commercial debt obligation" is met.

[34] In light of the foregoing, the conditions for the application of section 80 of the Act have been fulfilled. Accordingly, it is appropriate to consider whether the debt represented by the advances has been either settled or extinguished. Subsection 80(3) of the Act provides that where a commercial obligation issued by a debtor is settled at any time, the forgiven amount at that time in respect of the obligation shall be applied to reduce at that time the enumerated losses. Paragraph 80(2)(*a*) of the Act provides that an obligation issued by a debtor is settled at any time where the obligation is settled or extinguished at that time.

[35] Under the agreement for the sale of the shares of Showbizznet signed on August 23, 2002, the shareholders of Showbizznet purely and simply waived the repayment of the advances they had made to the said company. Showbizznet was not a party to that agreement and the shareholders did nothing to give effect to the waiver. No release was issued to Showbizznet and no resolution of the board of directors or the shareholders of Showbizznet was adopted to give effect to the forgiveness of debt. However, Showbizznet's balance sheet and financial statements at August 23, 2002, which were attached to the said sale agreement as Appendix C, show that the shareholders' advances had been deleted.

[36] As the shareholders' advances had been stricken from Showbizznet's books, it is reasonable to conclude that the debt was extinguished by release within the meaning of article 1687 of the *Civil Code of Québec*. That provision reads as follows:

> 1687. Release takes place where the creditor releases his debtor from his obligation.
> Release is complete, unless it is stipulated to be partial.

[37] There is no doubt that the shareholders' unilateral waiver of repayment of the advances was for the exclusive benefit of Showbizznet. The consent to, or the acceptance of, this waiver by Showbizznet was implicitly given by its directors as the mandataries of the company under article 321 of the *Civil Code of Québec*. At the time of the sale of Showbizznet's shares, Showbizznet's directors were all members of the family of Réal Parent. The vendor shareholders were, with at most one

exception, members of Réal Parent's family and corporations related to those family members.

[38] For these reasons, the appeal from the assessment under the Act made on October 19, 2006, with respect to the appellant's taxation year ending August 31, 2003, is dismissed with costs.

Signed at Ottawa, Canada, this 16th day of November 2009.

"Réal Favreau"

Favreau J.

Translation certified true
on this 29th day of January 2010.

Erich Klein, Revisor

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APPEARANCES:

Counsel for the appellant:	René Dion
Counsel for the respondent:	Nathalie Labbé

COUNSEL OF RECORD:

For the appellant:

Name:	René Dion Quebec City, Quebec
For the respondent:	John H. Sims, Q.C. Deputy Attorney General of Canada Ottawa, Canada