Docket: 2010-776(IT)G

BETWEEN:

MOTECH MOLDING INC. / MOTECH TECHNOLOGIE DE MOULAGE INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on March 13, 2012, at Montreal, Quebec.

Before: The Honourable Justice Johanne D'Auray

Appearances:

Counsel for the Appellant:	Marc-Antoine Deschamps
Counsel for the Respondent:	Philippe Dupuis

JUDGMENT

The appeals from the reassessments made under the *Income Tax Act* for the 2005 and 2006 taxation years are dismissed with costs.

Signed at Toronto, Ontario, this 10th day of October 2012.

"Johanne D'Auray"

D'Auray J.

Citation: 2012 TCC 351
Date: 20121010
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BETWEEN:

MOTECH MOLDING INC. / MOTECH TECHNOLOGIE DE MOULAGE INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

D'Auray J.

[1] The issue in this appeal is whether the appellant Motech Molding Inc./Motech Technologie de Moulage Inc. (**Motech**) is entitled to deduct, as property expenses for its 2005 and 2006 taxation years, sponsorship fees and race car maintenance and repairs expenses that it paid for its affiliated corporations Phoenix Innotech Inc. (**Phoenix Innotech**) and Orion Racing Inc. (**Orion Racing**).

[2] Motech argued that the sponsorship fees are deductible, since it paid the expenses directly to Orion Racing for the purpose of increasing the value of Phoenix Innotech, an affiliate of Tesla Packaging Ltd. **(Tesla),** in order to earn dividend income or to improve the dividend income stream of the affiliated corporations.

[3] The respondent submitted that the sponsorship fees related to the business income stream of Phoenix Innotech and that Motech's purpose in paying them was to improve the profitability of Phoenix Innotech. The relationship between the sponsorship fees and the alleged source of income, the potential dividends from Tesla, was too remote.

[4] After an analysis of the facts, I have decided that Motech's purpose in paying the sponsorship fees to Orion Racing for sponsoring Phoenix Innotech was related to the income business stream of Phoenix Innotech. In my view, the relationship between the sponsorship fees and the potential dividend income stream was too remote; hence, they do not qualify as expenses from property.

Facts

[5] At the hearing, the parties filed a Partial Statement of Agreed Facts. It states:

Motech Molding Technology Inc.

1. The Appellant, *Motech Molding Technology Inc*. ("**Motech**"), is a management and investment corporation, whose fiscal period ends on March 31 of each calendar year.

2. At every relevant time throughout its 2004, 2005 and 2006 fiscal periods, Motech's only shareholder, administrator and corporate director was Jacek Mucha.

3. Throughout Motech's 2004, 2005 and 2006 fiscal periods, Motech did not have any manufacturing activities, did not do consulting work and did not offer any services to any other person.

4. Throughout Motech's 2004, 2005 and 2006 fiscal periods, Motech's only sources of income were rental, dividend and interest income.

Orion Racing Inc.

5. At every relevant time throughout Motech's 2004, 2005 and 2006 fiscal periods, Motech was the only shareholder of, and Jacek Mucha was the only administrator and corporate director of, *Orion Racing Inc*. ("**Orion**").

6. At every relevant time throughout Motech's 2004, 2005 and 2006 fiscal periods, the main business of Orion was car racing.

7. Jacek Mucha participates in the design and building of Orion's race cars, and also drives Orion's race cars.

8. Jacek Mucha is the only person who drove Orion's race cars throughout Motech's 2004, 2005 and 2006 fiscal periods.

9. Orion's fiscal period ends on October 31 of each calendar year.

Tesla Packaging Inc.

10. At every relevant time since July 8, 2004 for Motech's 2005 fiscal period and throughout its 2006 fiscal period, Motech was the only shareholder of, and Jacek Mucha the only administrator and corporate director of, *Tesla Packaging Inc*. ("**Tesla**").

11. At every relevant time since July 8, 2004 for Motech's 2005 fiscal period and throughout its 2006 fiscal period, Tesla was a management corporation.

12. Tesla's fiscal period ends on June 30 of each calendar year.

13. Tesla started its operations on July 8, 2004.

14. Tesla has never paid any dividends to Motech.

Phoenix Innotech Inc.

15. On July 8, 2004, Tesla acquired 55 % of all the issued shares of *Phoenix* Innotech *Inc*. ("**Phoenix**") from Manfred Forestier, Phoenix's founder, namely 1,782 of the 3,240 issued Class A shares of Phoenix.

16. At every relevant time since July 8, 2004 for Motech's 2005 fiscal period and throughout its 2006 fiscal period, Tesla was the 55 % shareholder of Phoenix, and Manfred Forestier was the 45 % shareholder of Phoenix.

17. At every relevant time since July 8, 2004 for Motech's 2005 fiscal period and throughout its 2006 fiscal period, Jacek Mucha and Manfred Forestier were the administrators and corporate directors of Phoenix.

18. At every relevant time since July 8, 2004 for Motech's 2005 fiscal period and throughout its 2006 fiscal period, the main business of Phoenix was manufacturing and marketing stretch wrap packaging equipment, principally for its market located in the United-States (approximately two-thirds of Phoenix's clients are located in the United-States and one-third are located in Canada).

19. Phoenix's fiscal period ends on July 8 of each calendar year.

20. Phoenix has never paid any dividends to Tesla.

Sponsorship Fees

21. For its 2005 and 2006 fiscal periods, Motech paid to Orion sponsorship fees for Orion's race car team and paid amounts for Orion's race car maintenance and repair expenses (collectively the "**sponsorship fees**").

22. For its 2005 and 2006 fiscal periods, Motech paid the following amounts for the sponsorship fees:

	2005	2006
Sponsorship fees	$225,000	$225,000
Race car maintenance and repair expenses	$106,277	$139,786
Total	$331,277	$346,786

23. The race car maintenance and repair expenses paid by Motech were racing and maintenance expenses of Orion which constitute running or operating expenses of Orion.

24. The sponsorship fees were paid by Motech in small amounts throughout Motech's 2005 and 2006 fiscal periods.

25. Motech's name or logo did not appear on Orion's race cars for Motech's 2005 and 2006 fiscal periods.

26. Phoenix's name and logo appeared on Orion's race cars since July 8, 2004 for Motech's 2005 fiscal period and throughout its 2006 fiscal period, together with the mention "*The stretch wrapping experts*".

27. At every relevant time since July 8, 2004 for Motech's 2005 fiscal period and throughout its 2006 fiscal period, Phoenix was the principal sponsor of Orion's race car team, and Motech only paid for Phoenix's sponsorship.

28. Phoenix's sponsorship was for advertising for Phoenix's business of manufacturing and marketing stretch wrap packaging equipment.

29. Motech's responsibilities with respect to Phoenix's sponsorship of Orion's race car team were limited to paying the sponsorship fees.

30. Motech paid the sponsorship fees independently of the ranking of Orion's race car team in any given race.

31. No invoices or other documents were issued by Orion to either Motech or Phoenix for the sponsorship fees.

32. No written sponsorship agreement existed between Orion and either Motech or Phoenix.

33. The decision to sponsor Orion's race car team was taken by Jacek Mucha.

34. In addition to Phoenix's principal sponsorship since July 8, 2004 for Motech's 2005 fiscal period and throughout its 2006 fiscal period, Orion also entered into other sponsorship agreements with other sponsors with which it dealt at arm's length, namely Mazda, Hoosier Tires and Red Line Oil.

35. Those other sponsorships were paid either in products or in money in the form of rewards for the performances in the races in return for the team posting the names of the sponsors in the cars.

36. The monetary value of the rewards for those other sponsorships was not very significant, the value of which the Appellant estimates at a total for approximately $5,000. per year

[6] At the hearing, Mr. Mucha testified on behalf of the appellant and Mr. Jean-François Otis, an appeal officer for the Canada Revenue Agency, on behalf of the respondent.

[7] Mr. Mucha testified that he adopted with Phoenix Innotech the same business model that he had earlier used with Orion Packaging Ltd. (**Orion Packaging**). Orion Packaging is a corporation that Mr. Mucha owned in the 1980's and 1990's. To fully appreciate the appellant's position, it is therefore necessary to examine the business model that Mr. Mucha used with Orion Packaging.

[8] During the 1980's and the 1990's, Mr. Mucha owned 100% of the shares of Motech, which in turn owned 100% of the shares of Orion Packaging.

[9] During that time, Orion Packaging was one of the leading companies involved in the manufacture and marketing of stretch wrap packaging equipment in North America. It sold the equipment throughout North America and overseas. It was a highly profitable corporation. Mr. Mucha testified that Motech received dividends amounting approximately to $2.5 million a year from Orion Packaging.

[10] Motech also owned 100% of the shares of Orion Racing Inc. whose business was car racing.

[11] Mr. Mucha explained that he used race cars as a marketing strategy for promoting Orion Packaging. He wished to portray Orion Packaging as a leading edge

engineering-based corporation in the same way that race cars are seen to be based on leading edge engineering technology.

[12] In return for the payment of sponsorship fees to Orion Racing, Orion Packaging's name and logo were displayed on the race car. Orion Packaging also gave its distributors and customers, pamphlets, posters and calendars with the picture of the race car. The racing team, called the Mucha team, raced in the Atlantic Formula series. The Atlantic Formula is well known in the United States, Australia and New Zealand. Most of the distributors and clients of Orion Packaging were in the United States. In Mr. Mucha view's, the sponsorship gave Orion Packaging considerable exposure and had a positive impact on its business.

[13] In calculating its income for its fiscal periods, Orion Packaging deducted the sponsorship fees that it paid to Orion Racing.

[14] On June 11, 1999, Mr. Mucha sold the assets of Orion Packaging to Pro Mach Inc. (**Pro Mach**). The sale followed upon an agreement entered into on June 11, between Orion Racing, Orion Packaging, and Pro Mach, whereby Pro Mach agreed to pay Orion Racing, sponsorship fees of one million US per year. See Joint Book of Documents, Tab 19.

[15] Following a change in ownership in the Pro Mach group, the new owners stopped sponsoring Orion Racing in 2003. The Pro Mach group also decided to put in place a new management team. As a result, Mr. Mucha, who had been employed as a consultant for the Pro Mach group, decided to stop working for the group.

[16] Under the Asset Purchase Agreement, Mr. Mucha undertook not to compete for a period of five years. See Joint Book of Documents, Tab 20.

[17] Near the end of the five year period, Mr. Mucha started looking for another business to buy. He found Phoenix Innotech Inc. which, like Orion Packaging, was in the business of manufacturing and marketing stretch wrap packaging equipment.

[18] As I stated before, Mr. Mucha testified that he wanted to follow with Phoenix Innotech the same business model that he had with his previous corporation Orion Packaging. However, there are two distinctions between the previous business model and the new one.

[19] The first distinction relates to the corporate structure. Motech owned all the shares of Orion Packaging. Motech did not own any shares in Phoenix Innotech. Tesla, a wholly owned affiliate of Motech, bought 55% of the shares of Phoenix Innotech, the remaining 45% of the shares were owned by its founder, Mr. Manfred Forestier.

[20] Mr. Mucha testified that Tesla was only a "paper corporation" and "in between company". Phoenix Innotech was in poor financial shape with many creditors. Tesla was incorporated to prevent the creditors from going after Motech. In addition, although the non-competition clause was not really an issue, the purchase by Tesla, instead of Motech, of the shares of Phoenix Innotech was a way of ensuring that it did not become an issue.

[21] The other distinction was that Motech paid the sponsorship fees to Orion Racing for Phoenix Innotech's sponsorship. Under the previous business model, Motech did not pay the sponsorship fees of Orion Packaging. Instead, Orion Packaging paid the fees directly to Orion Racing and took a deduction from its income for such fees.

[22] With respect to the race car maintenance and repair expenses, Motech paid them directly to Orion Racing and deducted them as part of the sponsorship fees. It was admitted that these expenses constituted running, or operating expenses, of Orion Racing. See Partial Agreed Statement of Facts, paragraph 23.

[23] Both the sponsorship fees and the car maintenance and repairs were listed in the accounting records of Motech under the heading "sponsorship fees". Accordingly, in these reasons, unless otherwise specifically indicated, I will use the term "sponsorship fees" to refer to both the sponsorship fees and the car maintenance and repairs.

[24] Mr. Mucha testified that Phoenix Innotech did not have the financial capacity to pay the sponsorship fees. He also stated that he did not want to inject funds into Phoenix Innotech via Tesla because the creditors of Phoenix Innotech might seize the

funds. In addition, he did not want the transaction to be visible to the other shareholder Manfred Forestier, since his relationship with him was not good.

[25] Mr. Mucha also testified that the Mucha racing team was one of the most prominent teams and was featured on the cover of the Sports Car Club of America (**SCCA**) magazine. As a driver, Mr. Mucha had won many races. Since some of the races were televised on Sports Vision, he was of the view that the sponsorship gave good exposure and had a positive impact on the business of Phoenix Innotech.

Position of Motech

[26] Counsel for Motech submitted that it was not disputed that Motech, Orion Racing, Tesla and Phoenix Innotech are affiliated corporations within the meaning of section 251.1 of the *Income Tax Act* (**Act**).

[27] Counsel for Motech referred to the Supreme Court of Canada's decision in *Symes v. Canada*, [1993] 4 S.C.R. 695, in support of the principle that an income receipt is not needed for an expense to be deductible. He referred the Court to the reasons for judgment of Justice Iacobucci where he stated for the majority of the Court at paragraph 57, that for an expense to be deductible it need not directly lead to the production of income:

> 57 In order to be deductible as business expenses, the appellant's child care expenses must have been incurred "for the purpose of gaining or producing income from the business" within the meaning of paragraph 18(1)(*a*) of the Act. This is not to say that the expenses must directly lead to the production of income. Even with respect to the more restrictively worded ancestor of paragraph 18(1)(*a*), it was recognized in *Imperial Oil Ltd. v. Minister of National Revenue*, [1947] C.T.C. 353, 3 D.T.C. 1090 (Ex. Ct.), at page 371 (D.T.C. 1098), that it is not necessary to prove a causative relationship between a particular expense and a particular receipt. Indeed, provided that an expense otherwise satisfies paragraph 18(1)(*a*), an expense may be deductible even if it results in a loss.

[28] According to counsel for Motech, the fact that no dividends have been paid to Motech by Phoenix Innotech, via Tesla, was therefore irrelevant to determining the deductibility of the sponsorship fees.

[29] With respect to the relationship between the expenses and the income stream, counsel for Motech referred to the decision of the Federal Court of Appeal in *HMQ v. Byram*, 1999 D.T.C. 5117.

[30] In *Byram*, the issue before the Court was whether Mr. Byram could claim a capital loss on interest-free loans that he had made to USCO, as USCO was unable to borrow further funds. Some of the funds were lent when Mr. Byram was a shareholder of USCO and other funds when Elkhound Resources Ltd was the shareholder of USCO. Elkhound's shares were owned by Mr. Byram and members of his family. None of the loans were reduced to writing. Mr. Byram subsequently sold the loans for one dollar to another person and claimed a capital loss. In calculating his income for the 1984 taxation year, Mr. Byram reduced his capital gains by claiming a capital loss on the loans to USCO pursuant to subparagraph 40(2)(*g*)(ii). The Crown took the position that while the loans were made for the purpose of gaining or producing income from property, the potential dividend income from a subsidiary was too remote to support the deduction under paragraph 40(2)(*g*)(ii). Justice MacDonald, writing for the Court of Appeal, allowed Mr. Byram to claim the capital loss as, in his view, there was a sufficient connection between Mr. Byram as shareholder and the potential dividend from USCO. He stated at paragraph 22 of his reasons:

> 22 The shareholders of a company are directly linked to that corporation's future earnings and its payment of dividends. Where a shareholder provides a guarantee or an interest free loan to that company in order to provide capital to that company, a clear nexus exists between the taxpayer and the potential future income. Where a loan is made for the purpose of earning income through the payment of dividends, this connection is sufficient to satisfy the purpose requirement of subparagraph 40(2)(*g*)(ii).

[31] Counsel for Motech argued that the reasoning in *Byram* applied to this appeal since the wording of paragraph 40(2)(*g*)(ii) is the same as of paragraph 18(1)(*a*) of the Act:

> **40.** (1) Except as otherwise expressly provided in this Part
>
> [**…**]
>
> (2) Notwithstanding subsection 40(1),
>
> […]
>
> (*g*) a taxpayer's loss, if any, from the disposition of a property, to the extent that it is
>
> […]
>
> (ii) a loss from the disposition of a debt or other right to receive an amount, unless the debt or right, as the case may be, was acquired by the taxpayer for the purpose of gaining or producing income from a business or property (other than exempt income) or as consideration for the disposition of capital property to a person with whom the taxpayer was dealing at arm's

length.

[Underlining added.]

[32] He also reminded the Court that, as was the case in *Byram*, the corporations in this appeal were affiliated corporations with the parent corporation having direct control of the downstream affiliates. He argued that, as Motech was the shareholder of Tesla and Tesla of Phoenix Innotech, Motech was linked to Phoenix Innotech's future earnings and payment of dividends.

[33] Counsel submitted that I should interpret paragraph 18(1)(*a*) of the Act with a view to commercial reality and Motech should benefit from the expansion of paragraph 18(1)(*a*) given by the Supreme Court of Canada in *Symes*.

[34] Counsel also submitted that the decision of Federal Court of Appeal in *Lyncorp International Ltd. v. R.*, 2011 FCA 352, did not apply to this appeal.

[35] *Lyncorp* dealt with the deductibility of flight expenses of a plane fractionally owned by Lyncorp which was wholly owned by a Mr. Mullen. In order to check on Lyncorp's subsidiaries, Mr. Mullen used a private airplane. At issue was whether the flight expenses paid by Lyncorp for the benefit of its subsidiaries were deductible in calculating its income. The Court of Appeal decided that the nexus between the flight expenses and the potential dividend income from the subsidiaries was too remote. Accordingly, the flight expenses were not deductible by Lyncorp.

[36] In counsel's view, the decision in *Lyncorp* is distinguishable as it did not involve corporations which were all affiliated as was the case in this appeal. In addition, it was submitted that the Court in *Lyncorp* found that the evidence as to the precise nature of the services rendered by Mr. Mullen was sketchy. There was no agreement between Lyncorp and Mr. Mullen setting out the services he was to render. Mr. Mullen did not receive any fees for the services he rendered and the Court found a personal element in Mr. Mullen's use of the plane. In counsel's view, the deduction in *Lyncorp* was denied on evidentiary grounds.

[37] In contradistinction with *Lyncorp*, it was submitted that a deduction of the sponsorship fees by Motech is warranted.

[38] Motech was a management and investment corporation. Motech's only sources of income were rental, dividend and interest income. Mr. Mucha's testimony was to the effect that Motech had a history of receiving dividends from his previous corporation, Orion Packaging. Counsel submitted that the Court cannot second guess

the business model chosen by Mr. Mucha and enlarge the concept of remoteness between the expense and the income stream found in *Lyncorp*.

[39] Counsel for Motech stated that it made business sense that Motech did not funnel money directly into Phoenix Innotech. Phoenix Innotech was in poor financial shape. In light of the many creditors of Phoenix Innotech, it would have been too risky for Motech.

[40] He submitted that Motech paid the sponsorship fees directly to Orion Packaging in order to increase the value of Phoenix Innotech an affiliate of Tesla in order to earn dividend income or to improve the dividend income stream of the affiliated corporate group. The sponsorship was visible on the racetrack and there was previous business experience justifying that business model and the anticipation of dividends.

[41] In counsel's view, Motech's situation was governed by *Potash Corporation of Saskatchewan v. Her Majesty the Queen*, 2011 TCC 213. He argued that the *Potash* decision established that an expense incurred by a parent corporation in improving the return of downward investments was a business expense deductible by the parent corporation. He quoted the following statement from Justice Hershfield's reasons for judgment:

> 108 From a pragmatic business point of view the subject expenses did satisfy a cashflow need integral to the conduct of PCS's business. Practically speaking tax planning costs are incurred in the ordinary course of business and expenses so incurred should not so readily be divorced from its income earning activities. Once the expenditure is divorced from the specific investment that gave rise to the income, in this case the shares in the Luxemburg entity, it must attach to the business that benefited from it. PCS's business was enhanced by being part of a global market in fertilizers. While mining and marketing potash is its business, potash does not exist in a vacuum. It is a component of fertilizer—its value and marketability as a nutrient is interdependent with phosphate and nitrogen. Investing in other entities with a view to being a leading player in this aspect of its *own* business cannot be divorced from its own income earning activity. While that may not make the direct investment in shares a business expense, expenditures incurred to improve the efficiency of the investment to enable better exploitation of its own business by increasing its debt service capability and increasing its funding of Canadian operations are expenditures incurred for the purpose of earning income from its business. That the expenditure was capital in nature by virtue of paragraph 18(1)(*b*) does not change that finding.

[42] He submitted that the amounts paid for the sponsorship fees were reasonable in the circumstances, in accordance with section 67 of the Act. He argued that section

67 does not import a business judgment rule. The amounts spent on the sponsorship fees were within the valuation standards and industry practices. Accordingly, he submitted that the sponsorship fees were reasonable and that the appeal should be allowed.

Position of the respondent

[43] In the respondent's view, Motech was attempting to deduct expenses which properly related to another corporate taxpayer's business. In other words, Motech was attempting to apply against the source of income, namely the dividend income from Tesla, Phoenix Innotech's sponsorship fees.

[44] The respondent pointed out that during the 2004,[1] 2005 and 2006 taxation years, Motech did not engage in any manufacturing activities, did not perform any consulting work and did not offer any services to any other person. Motech's only sources of income in these years were from rental, interest income, and dividends. Motech's responsibility with respect to Phoenix Innotech's sponsorship fees of Orion's race car team was limited to paying the sponsorship fees. See Partial Agreed Statement of Facts, paragraphs 3 and 27.

[45] The respondent submitted that pursuant to the decision of the Supreme Court of Canada in *Stewart v. Canada*, 2002 SCC 46, when dealing with a question of the deductibility of an expense, what is in question is the relationship between that expense and the source of income to which it relates. The respondent also argued that the Federal Court of Appeal held in *Byram* and *Lyncorp* that where the relationship between the expenses and the source of income is too remote, the expenses will not be deductible.

[46] The respondent submitted that pursuant to the wording of paragraph 18(1)(*a*) of the Act, the Court has to determine objectively the purpose for which the sponsorship fees were incurred. Was it to earn income from property, namely dividends or was it to enhance the income stream of Phoenix Innotech?

[47] The respondent argued that in light of the facts of this appeal, the relationship between the sponsorship expenses and the business income stream of Phoenix Innotech was very direct whereas the relationship between the sponsorship expenses

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[1] The 2004 taxation year of Motech was not reassessed since the time limit for reassessing had expired.

and the alleged dividend income from Phoenix Innotech via Tesla was too remote and tenuous.

[48] In the respondent's view, the documentary evidence and the oral evidence at the hearing showed that the payments of the sponsorship fees by Motech to Orion Racing on behalf of Phoenix Innotech were made for the purpose of promoting Phoenix Innotech so that it would become a profitable corporation.

[49] The respondent referred to paragraph 28 of the Partial Agreed Statement of Facts, where it is stated that: *Phoenix's sponsorship was for advertising for Phoenix's business of manufacturing and marketing stretch wrap packaging equipment.*

[50] The respondent also referred to paragraphs 34, 35 and 37 of the Answer to the Reply to the Notice of Appeal, where the appellant states:

> 34. The appellant paid the sponsorship fees in order for Phoenix to expand and gain income from its stretch wrapping business including, among other things to build a brand in association with Orion, to propose a brand to the engineers as important clients to Phoenix and to increase the notoriety of Phoenix's name to such clients.
>
> 35. The payment of the sponsorship fees to Orion has a connection with Phoenix's stretch wrapping and packaging activities, an industry highly specialized.
>
> 37. The appellant paid the sponsorship fees to help the business of Orion and Phoenix and the net operating losses generated from the activities were never questioned by the Canada Revenue Agency.

[51] In addition, the respondent has drawn the attention of this Court to the testimony of Mr. Mucha to the effect that the payment of the sponsorship fees was aimed at attracting clients for Phoenix Innotech. In the respondent's view, only Phoenix Innotech would benefit of any increased in sales from the advertising and the promotion.

[52] The respondent agreed with Motech that the previous business model utilized by Mr. Mucha was relevant to determining the purpose of the payments of the sponsorship fees by Motech. Under the previous business model, the sponsorship expenses were directly related to the stretch wrapping business income stream. Mr. Mucha testified that it was Orion Packaging that paid the sponsorship fees to Orion Racing. If the expenses were directly related to improve the profitability of the stretch wrapping business of Orion Packaging, the only difference between the previous business model and the model during the years under appeal was that Motech paid for the sponsorship fees. The purpose of the sponsorship fees remained

the same, namely the payments were made to improve the profitability of Phoenix Innotech.

[53] With respect to Motech's argument, that it made business sense for it not to put any money downstream, namely into Phoenix Innotech via Tesla, due to Phoenix Innotech's financial difficulties and its many creditors. The respondent argued that the financial statements of Tesla, Phoenix Innotech and Motech showed otherwise. During the years in issue, there were substantial sums of money in advances or loans from Motech to Tesla and from Tesla to Phoenix Innotech. By 2006, Motech had loaned Phoenix Innotech, via Tesla, up to $1.2 million without interest. See Joint Books of Documents, Tab 1 to 11.

[54] The respondent pointed out that, except for that one specific expense, the sponsorship fees, money flowed from Motech to Tesla to Phoenix Innotech. The respondent submitted that the reason offered by Motech as to why the sponsorship fees were paid by Motech directly to Orion Racing does not hold in light of the accounting records of the corporations.

[55] The respondent also referred to accounting entries which showed that after Pro Mach stopped paying the sponsorship fees to Orion Racing in 2003, and the purchase by Tesla on July 4, 2004 of 55% of the shares of Phoenix Innotech, Motech continued to pay Orion Racing for the expenses related to the racing team and the race car maintenance and repairs.

[56] The respondent also referred to paragraph 22 of the Partial Agreed Statement of Facts, where it is stated that race car maintenance and repairs of $106,277 and $139,786 for 2005 and 2006 taxation years respectively were paid by Motech to Orion Racing allegedly in relation to the sponsorship fees. Yet it is admitted at paragraph 23 of the Partial Agreed Statement of Facts, that the race car maintenance of Orion constituted running expenses or operating expenses of Orion Racing.

[57] The respondent argued that, contrary to Motech's position, the race car maintenance and repairs expenses could not be linked to potential dividends from Phoenix Innotech.

[58] The respondent argued that there was another dimension in this appeal which was a personal element. Mr. Mucha, who controlled the corporations at relevant times, had a passion for car racing and was the only driver for the Mucha team throughout 2004, 2005 and 2006 taxation years.

[59] Accordingly, an objective analysis of the facts showed that Motech's purpose in paying the sponsorship fees was to improve the profitability of Phoenix Innotech. The sponsorship fees were related to the business income stream of Phoenix Innotech.

[60] The respondent cited this Court's decision in *Lyncorp*, which was subsequently confirmed by the Federal Court of Appeal.

[61] The respondent referred to paragraph 46 of Justice C. Miller's reasons for judgment where a parent corporation tried to deduct operating expenses on behalf of its subsidiaries':

> 46 This is a unique case in that a company, Lyncorp, incurs costs (ignoring any personal element for the time being) that I would describe as operational expenses for the operations of other companies (Shulin Mining, Shulin Lake Lodge, C.R. Boatland, Shear), in which it has a debt or equity interest, without passing those costs onto those operating companies. The Appellant can rightfully declare that its equity interest could yield income from property; that is, there is a source of income. Yet, equally clear is that Shulin Mining, Shulin Lake Lodge, C.R. Boatland and Shear, had they been charged for these operational expenses, could have and should have claimed them, as they would have gone to producing income from their operations; that is, they had a business source of income. The fact is, only one company incurred the costs, Lyncorp. I will return to this.

[62] The respondent cited paragraphs 73 and 75 of Justice Miller's reason for judgment in *Lyncorp*, where he discussed which source of income related to an expense paid by the parent corporation instead of by the operating corporation:

> 73 The dilemma before me is which relationship triggers a possible deductible expense: the relationship between the expense, being the disputed flight costs, and the *business income* of the particular business ventures, or the relationship between the expense and the *property income* (dividends) of the parent company incurring the expense? I attempted to address the dilemma in argument by asking the parties about a direct or indirect relationship. They did not appear enthusiastic to take the bait. Yet, that is where, I believe, the resolution lies. To which source of income does the expense purportedly relate? The fact the Appellant incurred the expense has little impact on the answer to that question. The Appellant argues the expense relates to the property source of income. Indirectly, perhaps. But clearly, the remaining disputed flight expenses relate directly to the business income of the business ventures. The expenses were incurred to make the business ventures profitable. Yes, that might yield at some future point dividend income, but the direct cause and effect link is between the expenses and the business income of the business ventures,

> 75 The Appellant was, in effect, giving its business ventures several hundred thousand dollars, neither by way of debt or equity but simply by providing free services toward the operation of the business ventures' businesses, with the hope that this generosity would help them get on their feet and maybe some day, in some manner, repay them. This generosity was neither a loan nor an equity investment by the Appellant. It might best be described as an agreement to pay someone else's expenses. Equity investments yield dividend income. Debt investments yield interest income. Free services, with no obligation to repay, yield only hope. This is not a deductible expense.

[63] Counsel for the respondent argued that *Lyncorp* applies to this appeal. In his view, the reasons for judgment of Justice C. Miller are in line with the testimony of Mr. Mucha. The evidence showed that Mr. Mucha, as was the case with Mr. Mullen in *Lyncorp*, wanted to make Phoenix Innotech profitable. Mr. Mucha stated that the sponsorship fees had worked for Orion Packaging so they could work for Phoenix Innotech.

[64] The respondent submitted that the decision in *Byram* did not apply to this appeal. The issue in *Byram* was whether a tax payer who made an interest-free loan to a company in which he held shares, could claim a capital loss under subparagraph 40(2)(*g*)(ii) of the Act.

[65] The respondent submitted that Mr. Byram injected funds into his corporation by way of an interest-free loan. Injecting capital into a corporation by way of a loan was found in *Byram* to be consistent with commercial reality.

[66] Counsel for the respondent argued that it is not consistent with commercial reality for a parent corporation to claim a deduction for operating expenses of a subsidiary in which he does not hold shares, on the basis that the expenses were paid for the purpose of earning dividends. The respondent also submitted that the fact they were affiliated corporations is irrelevant.

[67] The respondent also argued that the amounts claimed as sponsorship fees were not reasonable pursuant to section 67 of the Act.

Analysis

[68] The test as to whether an expense will be deductible was set out by the Supreme Court of Canada in *Stewart*. Writing for the majority, Justices Iacobucci and Bastarache explained that a taxpayer must first demonstrate that he or she has a source of income under section 9 of the Act. Once a source of income has been

established, *the relationship between the expense and the source to which it is purported to relate* must be analyzed so that it can be determined whether an expense is deductible. At paragraph 57 of their reasons for judgment they explained as follows:

> 57. It is clear from these provisions that the deductibility of expenses presupposes the existence of a source of income, and thus should not be confused with the preliminary source inquiry. If the deductibility of a particular expense is in question, then it is not the existence of a source of income which ought to be questioned, but the relationship between that expense and the source to which it is purported to relate. The fact that an expense is found to be a personal or living expense does not affect the characterization of the source of income to which the taxpayer attempts to allocate the expense, it simply means that the expense cannot be attributed to the source of income in question. As well, if, in the circumstances, the expense is unreasonable in relation to the source of income, then s. 67 of the Act provides a mechanism to reduce or eliminate the amount of the expense. Again, however, excessive or unreasonable expenses have no bearing on the characterization of a particular activity as a source of income.
>
> [Underlining added.]

[69] Therefore, the question that I have to answer in this appeal is: to what source of income do the sponsorship fees relate? Do they relate to the property stream that is the dividends that would potentially be received by Motech from Phoenix Innotech via Tesla? Or do they relate to the business income stream of Phoenix Innotech?

[70] In answering this question, I need to determine Motech's purpose in paying the sponsorship fees. Paragraph 18(1)(*a*) of the Act provides: *that in order to be deductible an expense has to be made for the purpose of gaining or producing income from the business or property.*

[71] It is for the Court to determine the purpose for which an expense is made by a taxpayer on the basis of an objective assessment of the facts. In *Symes*, Justice Iacobucci writing for the Court, stated with respect to paragraph 18(1)(*a*):

> 74. As in other areas of law where purpose or intention behind actions is to be ascertained, it must not be supposed that in responding to this question, courts will be guided only by a taxpayer's statements, *ex post facto* or otherwise, as to the subjective purpose of a particular expenditure. Courts will, instead, look for objective manifestations of purpose, and purpose is ultimately a question of fact to be decided with due regard for all of the circumstances.

[72] I am also mindful that in *Symes* the Supreme Court of Canada held that in order for an expense to be deductible, an expense need not directly lead to the production of income. Therefore, in determining whether Motech is entitled to deduct the sponsorship fees, it is irrelevant that no dividends were paid by Phoenix Innotech via Tesla to Motech.

[73] In light of all the facts in this appeal, I am of the view that Motech paid the sponsorship fees to Orion Racing on behalf of Phoenix Innotech in order to benefit the income stream of Phoenix Innotech.

[74] The testimony of Mr. Mucha during the hearing supports this conclusion:

p. 39, line 105:

> **[105]** Q. What was the main reason the sponsorship was starting to be implemented in 2004?
>
> A. Well, to gain acceptance of the market, like we did with Orion Packaging, to be visible by the market of stretch wrap equipment the same way we were with Orion packaging.

pp. 48-49, line 141:

> **[141]** Q. What was the interest of Motech... what was the goal by Motech to pay those expenses?
>
> A. Well, Motech is... at that time wasn't the sole owner, but was the owned through Tesla of the Phoenix Innotech and wanted to promote the company so eventually we bring it to profitability and the company will pay dividends to Motech.

pp. 56-57, line 186-190:

> **[186]** Q. Yes, but I'm asking just for the first phrase:
> The appellant paid...
> The appellant, that's Motech.
> ... paid sponsorship fees...
> A. I don't think it's very well formulated.
>
> **[187]** Q. Well, you agree that it was promotional services for Phoenix's business of stretch wrapping?
>
> A. Yes.

[188] Q. That you agreed with that?

A. Yes.

[189] Q. So, it was aimed at potential clients of Phoenix Innotech, that's correct?

A. Yes.

[190] Q. So, it was aimed at increasing the sales of Phoenix Innotech through some form of advertising or promotion?

A. Yes.

[75] Moreover, paragraph 28 of the Partial Agreed Statement of Facts, and paragraphs 34, 35 and 37 of the Answer to Reply to the Notice of Appeal, confirm that the purpose of the sponsorship payments made by Motech was to benefit the income stream of Phoenix Innotech.

[76] Furthermore, the parties addressed the following facts during their arguments:

- Counsel for Motech stated that it was too risky for Motech to funnel money directly into Phoenix Innotech via Tesla, due to Phoenix Innotech having too many creditors. According to the financial statements of the corporations, substantial sums were funneled by Motech by way of advances or loans to Phoenix Innotech via Tesla every year. Therefore, this explanation does not hold.

- The respondent also argued that according to the accounting records of Motech, Motech continued to pay Orion Racing the expenses for the Mucha team and the car maintenance and repairs even when there was no company to sponsor, namely for the period of December 2003 and July 2004. Therefore, it could not be said that it was the purpose of earning dividends.

In my view, these facts may be relevant with respect to the personal element in this appeal. However, they are not relevant to determine to what source of income the sponsorship fees related pursuant to the test set out in *Stewart*.

[77] As I have already mentioned, Mr. Mucha attempted to apply the same business model that he had previously used with Orion Packaging. In the first case, Orion Packaging paid Orion Racing for its sponsorship fees. The sponsorship fees were clearly for the benefit of Orion Packaging by enhancing its income stream. In this

appeal, applying the same business model, the sponsorship fees were clearly for the benefit of Phoenix Innotech, as they enhanced its income stream.

[78] In my view, although each case is fact-oriented, the decisions in *Lyncorp* have many similarities with this appeal:

- The question raised in *Lyncorp* is the same as in this appeal, namely can a parent corporation deduct an operating expense that it paid for its affiliate for the purpose of gaining income from dividends?

- As in *Lyncorp*, the fact that the parent corporation incurred the expenses was not determinative with respect to the relationship between the expenses and the income stream.

- In *Lyncorp* the expenses paid by the parent corporation related directly to the business income of the business ventures. The expenses were incurred to make the business ventures profitable. It was not denied that at some future point dividend income could be received by the parent corporation, but the direct link was between the expenses and the business income of the business ventures, not the relationship with any property source of income. The same is true in this appeal.

- As in *Lyncorp*, there was no agreement as to the sponsorship between Orion Racing and either Motech or Phoenix Innotech. No invoices or other documents were issued by Orion Racing to either Motech or Phoenix Innotech for the sponsorship fees.

[79] In *Byram*, Justice McDonald of the Federal Court of Appeal, made an interesting comment with respect to the concept of remoteness. He stated as follows:

> 23. In situations where the taxpayer does not hold shares in the debtor, but rather is a shareholder of a parent company or other shareholder of the debtor the taxpayer is not entitled to dividend income directly from the debtor. Generally speaking, the burden of demonstrating a sufficient nexus between the taxpayer and the dividend income, in such cases, will be much higher. The determination of whether there is sufficient connection between the taxpayer and the income earning potential of the debtor will be decided on a case by case basis depending on the particular circumstances involved.

[80] In my view, Motech has not established a sufficiently close connection between the sponsorship fees paid by it to its affiliate, Orion Racing, on behalf of

another affiliate, Phoenix Innotech, for anticipated dividends from yet another affiliate, Tesla. Simply stated, the potential receipt of dividends was too remote.

[81] It is also difficult to understand how the payments made by Motech to Orion Racing for the race car maintenance and repairs expenses were for the purpose of gaining dividends from Tesla. There is clearly no nexus between the operating expenses of Orion Racing and the alleged dividends income from Phoenix Innotech via Tesla.

[82] If Phoenix Innotech had incurred the sponsorship fees, they would have been deductible in computing its income.[2] The nature of the sponsorship fees without looking at "who" paid them is business and not property expenses. Can they be transformed into property expenses by the status of the payor? I am of the opinion that this question must be answered in the negative. This is, in my view, the remoteness issue addressed by the decision of the Court of Appeal in *Lyncorp* and in *Byram*. The fact that we are dealing with affiliated corporations is irrelevant.

[83] Justices Iacobucci and Bastarache of the Supreme Court in *Stewart* have addressed, in my view, the same issue in stating that what has to be put in question to determine the deductibility of an expense *is the relationship between that expense and the source to which it is purported to relate.*

[84] As for the decision in *Potash*, in that case the consulting fees payments were paid by Potash for its benefit. The consulting fees were incurred by Potash in order to obtain a tax plan that would make available cash flow to Potash in a most tax efficient manner. It was also noted in *Potash* that every entity paid for its own costs relating to the reorganization. The consulting fees were found to be eligible capital property under section 14 of the Act and deductible under 20(1)(*b*) of the Act. Therefore, it is not applicable to the case at bar.

[85] Justices Iacobucci and Bastarache in *Stewart* stated that after the relationship between the expenses and the income stream has been determined, the expenses may still not be deductible if the expenses are unreasonable under section 67 of the Act or if they are personal expenses under paragraph 18(1)(*h*) of the Act.

[86] In light of my conclusion, I do not have to decide if either section 67 or paragraph 18(1)(*h*) of the Act apply in this appeal.

[87] The appeals are dismissed with costs.

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[2] If the personal element question is not raised.

Signed at Toronto, Ontario, this 10th day of October 2012.

"Johanne D' Auray"

D'Auray J.

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