Date: 20090417

Docket: A-293-08

Citation: 2009 FCA 117

CORAM: **LÉTOURNEAU J.A.**
NADON J.A.
PELLETIER J.A.

BETWEEN:

ADP CANADA CO.
(SUCCESSOR TO CANADIAN
AUTOMATIC DATA PROCESSING SERVICES LTD.)

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Heard at Montréal, Quebec, on April 1, 2009.

Judgment delivered at Ottawa, Ontario, on April 17, 2009.

REASONS FOR JUDGMENT BY: LÉTOURNEAU J.A.

CONCURRED IN BY: NADON J.A.
PELLETIER J.A.

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REASONS FOR JUDGMENT

LÉTOURNEAU J.A.

Issue

[1] Did Archambault J. of the Tax Court of Canada (judge) err in finding that the $1.1 billion in funds received by the appellant (ADP) should be included in its "taxable capital" and "taxable capital employed in Canada" as an advance under paragraph 181.2(3)(*c*) of the *Income Tax Act* (Act)? The taxation year in issue is 2001.

[2] For the reasons that follow, I believe that the judge erred and therefore his decision cannot stand and should be reversed.

[3] Before I address the issue raised in this appeal, I need to provide the relevant legislation and some background information.

The relevant legislation and the nature of the tax at issue

[4] Paragraph 181.2(3)(*c*) reads:

181.2 (3) Capital – The capital of a corporation (other than a financial institution) for a taxation year is the amount, if any, by which the total of	**181.2**(3) Capital – Le capital d'une société, sauf une institution financière, pour une année d'imposition correspond à l'excédent éventuel du total des éléments suivants :
(*a*) the amount of its capital stock (or, in the case of a corporation incorporated without share capital, the amount of its members' contributions), retained earnings, contributed surplus and any other surpluses at the end of the year,	*a*) le capital-actions de la société (ou, si elle est constituée sans capital-actions, l'apport de ses membres), ses bénéfices non répartis, son surplus d'apport et tout autre surplus à la fin de l'année;
(*b*) the amount of its reserves for the year, except to the extent that they were deducted in computing its income for the year under Part I,	*b*) ses réserves pour l'année, sauf dans la mesure où elles sont déduites dans le calcul de son revenu pour l'année en vertu de la partie I;
(*b*.1) the amount of its deferred unrealized foreign exchange gains at the end of the year,	*b*.1) ses gains sur change non réalisés reportés à la fin de l'année;
(*c*) the amount of all loans and advances to the corporation at the end of the year,	*c*) les prêts et les avances qui lui ont été consentis à la fin de l'année;

[Emphasis added]

[5] The tax levied pursuant to the above paragraph was a temporary tax imposed on the corporate sector to help reduce the federal deficit: see *Budget Papers*, tabled in the House of Commons, April 27, 1989, by the Department of Finance Canada, at page 40. It applied to large corporations that had financial resources in excess of $10,000,000 to carry on their activities. The tax was abolished in 2005.

Facts and Procedural History

[6] ADP is a corporation whose business is to provide its clients with integrated payroll and payroll tax services for a fee. ADP pays, on behalf of its clients, the latter's employees as well as the statutory remittances with respect to those employees. In other words, instead of setting up their own payroll department, ADP's clients contract out this service to ADP. For the taxation year ending June 30, 2001, ADP's earned payroll-processing fees totaled $130,520,848.

[7] ADP's clients are required to provide the sums due in advance to ADP so that ADP can process and transfer them to the clients' employees and the tax authorities on the due date specified in the contract for services. Up to 48 hours prior to the initiation by ADP of any correlating payroll distribution to its clients' employees, clients must provide ADP with all amounts associated with their payroll, including the relevant service fees, plus any withholding taxes to be remitted on the clients' behalf to the relevant taxing authorities.

[8] The amount of salaries and withholding taxes (the Funds) sent to ADP by its clients are kept in a separate account reported as Funds held for clients until transferred to the employees or the tax authorities. ADP's transfer obligations are referred to as the Client Funds Obligations Account.

[9] In the taxation year 2001, ADP processed $83 billion on behalf of its clients. At the end of June 2001, ADP reported a balance of $1,104,129,044 as Client Funds Obligations in its financial statements.

[10] Under its contract for services, ADP was authorized to invest the Funds received from and held for clients until they were transferred to the clients' employees or the tax authorities. Because there was a continuous flow of Funds transferred in and out of ADP's clients' accounts, ADP enjoyed the benefit of approximately $500 million as a permanent source of sums to invest. The return in the nature of interest on the investment of these sums for the year 2001 amounted to $57,089,700.

[11] In the reassessment dated January 7, 2005, the Minister of National Revenue (Minister) added to ADP's taxable capital the $1.1 billion reported by ADP as Client Funds Obligations in its June 30, 2001 financial statements. The addition was made pursuant to and for the purposes of Part I.3 of the Act.

[12] As a result of the increase that he made to ADP's taxable capital, the Minister disallowed to ADP a carry back of unused surtax credit of $140,759 in the computation of its tax payable under Part I.3 of the Act for its taxation year ending June 30, 1999.

[13] Because of and as a corollary to the conclusion that I have reached on this appeal, ADP is entitled to that surtax credit. The judgment will reflect such entitlement.

[14] I have summarized in a nutshell the key facts necessary to dispose of this appeal. Before the Tax Court, the hearing proceeded on an agreed statement of facts. For the sake of completeness, I reproduce a more elaborate portion of the relevant facts as they are found in paragraph 2 of the judge's reasons for judgment:

> …
>
> 6. The Appellant carries on a business under which it provides its clients with an integrated payroll and payroll taxes services for a fee (the "payroll-processing fees").
>
> 7. The duties and obligations of the Appellant and its clients are setout [*sic*] in an agreement signed by each party.
>
> 8. The Appellant pays, on behalf of its clients, to their employees, their salaries and pays, to the tax authorities, the withholding taxes relating to those salaries.
>
> 9. The obligation to pay the salaries and to make the applicable withholding tax remittances to the tax authorities is an obligation of the clients of the Appellant, not the Appellant's own legal obligation.
>
> 10. The contractual obligation of the Appellant toward its clients is limited to the payroll services, including the payment of the salaries to its Clients' employees and the payment of the applicable withholding tax remittances to the tax authorities made on behalf of its clients.
>
> 11. The only remuneration paid to the Appellant by its clients is the payroll-processing fees.

12. For the taxation year ended June 30th, 2001, the Appellant earned payroll-processing fees for a total amount of $130,520,848.

13. In addition to processing its clients' payroll data (*i.e.* calculating the amount of wages owed by its clients to their employees as well as the amount of withholding taxes its clients are obligated to remit to the relevant taxing authorities), the Appellant's payroll and tax filing services also include the making of actual payments, on behalf of its clients, to its clients' employees and to the tax authorities.

14. Such payments are initiated or drawn from the Appellant's bank accounts, not from its clients' bank accounts.

15. In the course of its payroll services business, the Appellant collects funds from its clients to pay their employees on their respective paydays and to pay, to the relevant tax authorities, the withholding taxes relating to those salaries.

16. The Appellant's clients are required to pay in advance to the Appellant, up to 48 hours prior to the initiation by the Appellant of any correlating payroll payments to its clients' employees, all amounts associated with their payroll, including the relevant payroll-processing fees, plus any withholding taxes that are to be remitted on their behalf to the respective tax authorities.

17. Those amounts are held by the Appellant for a period of 3 to 45 days before payment of the salaries and the appropriate withholding taxes to the tax authorities, depending on the remittance deadline provided for each client.

18. Those amounts provide partial protection to the Appellant regarding potential funding breaches by clients in respect of subsequent payrolls.

19. A portion of each payment made to the Appellant by its clients represents an amount to be paid to certain tax authorities that do [*sic*] not become due until some time after the pay date in question. However, for matters of simplicity, clients pay the Appellant all amounts applicable to a particular payroll at one time.

20. The amounts of salaries, withholding taxes and payroll-processing fees paid to the Appellant by its clients are kept in separate account of the Appellant until paid to the employees, paid to the tax authorities or earned by the Appellant, as the case may be.

21. Those pre-funded amounts are referred to in this Amended Partial Agreed Statement of Facts as the "Funds Held for Clients" and the Appellant's respective obligations toward its clients are referred to as the "Client Funds Obligations".

22. Whenever the Appellant receives an amount from its clients for the payment of its payroll and appropriate withholding taxes, the Client Funds Obligations account is credited by the amount received and the Funds Held for Clients account is debited by the same amount.

23. Whenever the Appellant pays salaries and thereafter makes withholding tax remittances to tax authorities on behalf of its clients, the Client Funds Obligations account is debited by the amount paid by the Appellant and the Funds Held for Clients account is credited by the same amount.

24. Whenever the payroll-processing fees paid to the Appellant by its clients are earned by the Appellant, the Client Funds Obligations account and the Bank account are debited by the amount earned and the Funds Held for Clients account and the Revenue account are credited by the same amount.

25. In its trial balance for the fiscal period ended June 30th, 2001, the Appellant reported a debit balance of $1,104,129,044 in the Funds Held For Clients account and a credit balance of the same amount in the Client Funds Obligations account.

26. Of the amount shown as Client Funds Obligations in the Appellant's June 30th, 2001, trial balance, only the portion relating to the payroll-processing fees payable to the Appellant was eventually recognized as income for accounting and tax purposes.

27. It is the amount of $1,104,129,044 reported as Client Funds Obligations in the Appellant's June 30th, 2001, trial balance that the Minister added, by reassessment dated January 7th, 2005, to the Appellant's "capital", "taxable capital" and "taxable capital employed in Canada" for the purposes of the application of subsection 181.1(1) of the ITA to the Appellant's taxation year ended June 30th, 2001.

28. As of June 30, 2001, the Appellant held in the Funds Held for Clients account the following amounts on account of the fees payable by its clients that were earned and recognised as income for income tax purposes but not yet transferred to its bank account:

Fees	$4,583,744.78
GST and HST	335,247.97
QST	89,414.33
Total	5,008,407.08

29. As a result of the increase mentioned in paragraph 27 of this Amended Partial Agreed Statement of Facts, made by the Minister, to the Appellant's "capital", "taxable capital" and "taxable capital employed in Canada", the Minister disallowed, by reassessment dated January 7th, 2005, to the Appellant a carry back of unused surtax credit of $140,759 in the computation of its tax payable under Part I.3 of the ITA, for its taxation year ended June 30th, 1999.

30. The amounts included by the Appellant in the Funds Held for Clients account as of June 30, 2001, were in respect of salaries and withholding tax remittances to the tax authorities that were payable after June 30th, 2001, and payroll-processing fees earned by the Appellant but not yet transferred to its bank account.

31. The amounts of the Funds Held For Clients and the Client Funds Obligations accounts were not reported in the Appellant's balance sheet for its fiscal period ended June 30th, 2001, filed with its 2001 tax return.

32. The financial statements filed by the Appellant with its 2001 tax return were not audited but included a "Notice to Reader". No notes to the financial statements were attached.

33. According to the generally accepted accounting principles, the Appellant's Funds Held For Clients and Client Funds Obligations accounts should have been disclosed as an asset and a liability, respectively, in its financial statements or in a note attached to those financial statements.

34. The Appellant's payroll services business is similar to the payroll services businesses of its sister companies.

35. The consolidated balance sheet of the Appellant's US parent company, namely Automatic Data Processing, Inc., filed with its 2001 Annual Report, reported as an asset and as a liability the "Funds Held For Clients" and "Client Funds Obligations" accounts, respectively, of the Appellant's sister companies.

36. The US Securities and Exchange Commission specifically requested that the "Funds Held For Clients" and "Client Funds Obligations" accounts be treated by the Appellant's parent company as an asset and a liability, respectively, in its financial statements.

37. The Appellant's Funds Held For Clients and Client Funds Obligations accounts are now disclosed as an asset and a liability, respectively, in the Appellant's financial statements since 2002.

38. The Appellant invests, primarily in fixed-income instruments (mostly cash equivalents and marketable securities), the amounts included in the Funds Held For Clients account.

39. The interests [*sic*] on such investments are recognized by the Appellant in its revenues as earned.

40. Such interests [*sic*] amounted to $57,089,700 in the Appellant's fiscal period ended June 30th, 2001.

41. In its financial statements for its fiscal period ended June 30th, 2001, the Appellant's [*sic*] reported income before taxes of $30,280,238.

42. In its fiscal period ended June 30th, 2001, the Appellant paid, to a related US company, fees of $1,168,063 to manage the amount included in the Funds Held For Clients account.

43. The contracts entered [into] by the Appellant and its clients provide that when the Appellant is responsible for missing the withholding tax remittance statutory deadline,

> the Appellant shall be responsible for any penalty and interest payable related to late remittance to the tax authorities.
>
> 44. In the course of the payroll services provided by the Appellant, withholding tax remittances made on behalf of its clients were occasionally made by the Appellant past the statutory deadline.
>
> 45. In its fiscal period ended June 30th, 2001, the Appellant paid $397,929 of penalties and interest with respect to late withholding tax remittances made on behalf of its clients.
>
> 46. Such penalties and interest were paid by the Appellant in the normal course of doing business.
>
> 47. The Appellant claimed a deduction of this amount of $397,929 in computing its business income for its taxation year ended June 30th, 2001.
>
> 48. By reassessment dated January 7th, 2005, the Minister of National Revenue disallowed this deduction of $397,929.00.
>
> [Emphasis added by the judge]

The decision of the Tax Court of Canada

[15] In coming to his conclusion, the judge relied heavily on an earlier decision that he had rendered and which was affirmed by our Court: see *Oerlikon Aerospatiale Inc. v. Canada*, [1997] DTC 962, [1999] DTC 5318.

[16] With respect, the decision in *Oerlikon* is of no assistance in the present instance because it was not disputed in that case that the amounts included by the Minister in *Oerlikon*'s capital for Part I.3 tax purposes were "advances". The taxpayer argued that the advanced funds, which were on account of its future income, were not "advances" within the meaning of Part I.3 of the Act because it was of the view that the term "advance" in paragraph 181.2(3)(*c*) meant only "advance in the

sense of a loan". The taxpayer argued therefore that the paragraph contemplated a lender-borrower relationship. In the present instance, the crux of the matter bears on whether the Funds at issue are "advances" or not within the meaning of the paragraph. I will come back to the *Oerlikon* decision when reviewing a specific finding made by the Tax Court judge.

[17] The Act provides no definition of the term "advance". As he did in the *Oerlikon* case, the judge relied upon financial, accounting and ordinary dictionaries. He saw as the common thread in the ordinary definitions of "advance" the fact of paying an amount before it is due: see paragraph 17 of the judge's reasons for decision.

[18] Referring to an accounting dictionary, he accepted the following two definitions: "Amount paid to a person to enable him to make expenditures for which he will have to account at a later date" and "Amount to be applied against the price of a contract, services or goods, paid before the contract is performed, the services rendered or the goods delivered": *ibidem* at paragraphs 9 and 17.

[19] Finally, in coming to his conclusion, the judge took comfort in the fact that ADP had the right to invest the Funds and to retain the interests generated thereby. He also attached great significance to the fact that the interest became an integral and important part of ADP's business without which ADP would have suffered a loss: see paragraphs 19 to 21 of his reasons for judgment.

Analysis of the decision of the Tax Court and the submissions of the parties

[20] ADP was engaged in contracts for services with many clients. As previously mentioned, its obligations under these contracts were to ensure that the salaries due to the clients' employees and the taxes owed to the fiscal authorities would be paid and paid on time. The nature of the services to be rendered by ADP involved the transfer of Funds by the clients to ADP and the processing and conveying of these Funds by ADP to third parties. I think the nature of the services and the fact that the services involved sums of monies was the source of the confusion. If the goods to be transferred by ADP to third parties were cars, for example, no one would have said that the cars or the value of these cars were advances to ADP. There has been in my view some confusion between the services to be rendered by ADP and the payments due by ADP's clients for these services.

[21] With this in mind, the time has come to examine the definitions of "advance" upon which the judge founded his decision.

a) Whether the $1.1 billion was a payment made before it was due

[22] The short answer to this question is that the $1.1 billion is not what was due to ADP. What were due to ADP were the fees for the processing services rendered by ADP. The $1.1 billion is simply not an advance on the $130 million paid in fees for the processing services.

[23] Counsel for ADP addressed this definition of advance found and used by the Tax Appeal Board in *Crassweller v. Minister of National Revenue*, 49 DTCI, at page 18, referred to by the judge in paragraph 9 (footnote 9) of his reasons for judgment:

> …or something paid to a person before the time at which the payor becomes liable to make a payment to such person which later payment would be reduced by the amount of the advance and thus cancel any liability of the recipient to repay the advance.
>
> [Emphasis added]

He submits that this passage in the *Crassweller* decision was misconstrued and misapplied by the judge and by counsel for the respondent. I agree.

[24] If a transposition of the underlined words is made in the present instance, the excerpt then reads:

> …or something paid to ADP before the time at which the client becomes liable to make a payment to ADP which later payment would be reduced by the amount of the advance and thus cancel any liability of ADP to repay the advance.
>
> [Emphasis added]

[25] The only debts that the clients had towards ADP were the fees for the contract for services. The $83 billion, of which the $1.1 billion in issue was part, were debts that the clients had towards their employees and the fiscal authorities. The Funds were for the payments of these debts by the debtors, i.e. ADP's clients. ADP was merely facilitating the payments by the debtors of their debts.

It was not the creditor of the Funds due and, therefore, these Funds could not have been an advance paid to ADP.

b) Whether the $1.1 billion was an amount to be applied against the price of a contract or a service, paid before the contract is performed or the service is rendered

[26] Without further repetition, it is clear that the only payments due to ADP on account of the services to be rendered are the fees stipulated in the contract for services. It is also quite clear that the $1.1 billion bears no relationship with the price of the contract and consequently is not an advance on the contract.

c) Whether the $1.1 billion was an amount paid to ADP to make expenditures for which it will have to account at a later date

[27] I do not think there can be any doubt that the $1.1 billion is an expenditure of the clients of ADP, not an expenditure of ADP which acted as a mere conduit in ensuring that the amounts due to the clients' employees for salaries and the fiscal authorities for taxes are transferred on time to the intended recipients. Not surprisingly, no such expenditure is claimed by ADP in its financial statements of 2001 and 2002: see appeal book at pages 142 to 149.

[28] It cannot be said that the $1.1 billion is an expense incurred by ADP in rendering to its clients the services provided for in the contract for services. Indeed, the transfer of the $1.1 billion to third parties is the very service to be rendered by ADP under its contract. This, in my view, also

answers the respondent's contention that the $1.1 billion could be seen as a disbursement by ADP. If it is to be considered as a disbursement, it is undoubtedly one incurred by ADP's clients.

d) Whether the interests gained from an investment of the Funds and used as a financial resource by ADP changed the legal nature of these Funds

[29] In considering the fact that the Funds could be invested by ADP to its benefit, the judge referred at paragraph 11 of his reasons for judgment to the following excerpt from the decision of this Court in *Oerlikon*:

> [11] Justice Noël added at paragraph 32:
>
> > [32] The effect of an advance be it in the sense of a payment on account or a loan, is to make the amount of money it represents available to the person or corporation which receives it. In the instant case, the advances were an integral part of the financial resources available to the appellant at the end of its 1989 fiscal year according to the financial statements it filed, and nothing either in the legislation or the tax policy which led to its enactment indicates that Parliament intended to exclude advances from the tax under Part I.3.
>
> [Emphasis added by the judge]

[30] Later on, at paragraphs 21 and 22 of his reasons, the judge emphasized the significance of the financial resources obtained from the investment of the Funds to conclude "that the $1.1 billion constitutes advances referred to in the definition of "capital" in paragraph 181.2(3)(*c*) of the Act".

[31] I reproduce the two paragraphs:

> [21] Although strictly speaking, there is no requirement in that regard, it is comforting to realize that the $1.1 billion in advances existing at the end of the 2001 taxation year did indeed represent a significant financial resource available to ADP. The advances received during the entire course of the year allowed ADP to earn more than $57 million in interest, which represented 28% of its gross revenue. As pointed out by counsel for the Minister, without this interest earned from the advanced funds, ADP would have incurred a loss. This was indirectly acknowledged by Mr. Surminsky, who testified that had it not been allowed to invest the advances made available to it in contemplation of the payment of its clients' obligations with regard to salaries and government remittances, ADP would have been required to modify its business model and increase its fees.
>
> [22] Finally, it is worth noting that the balance sheet for ADP for the year ended June 30, 2001, shows a capital stock of $3.8 million and retained earnings of $18.6 million. So the advances from ADP's clients, which are described in its accounting records as Funds Held for Clients and Client Funds Obligations in its accounting records and which amounted at the end of its 2001 fiscal year to $1.1 billion, do constitute a significant asset and liability at the end of its taxation year. Mr. Surminsky also stated that a core amount of $500 million was a more or less permanent asset and liability of ADP. In his argument, counsel for ADP also contended that these funds allowed ADP to make long term investments, although this fact had not necessarily been put into evidence. Therefore, I do not have any doubt in concluding that the $1.1 billion constitutes advances referred to in the definition of "capital" in paragraph 181.2(3)(*c*) of the Act.
>
> [Emphasis added]

[32] To the extent that the judge concluded that the Funds were 'advances" because they turned out to represent a significant financial resource available to ADP, this conclusion is erroneous.

[33] In *Oerlikon*, in the above passage cited by the judge, this Court was considering the effects of an advance, one of which was to make the monies the advance represents available to the recipient. This Court had already found that it was an advance. This Court did not use the fact that the recipient was using the monies received as a financial resource as a basis for concluding that these monies were an advance. This Court neither confused nor conflated the cause and the effect.

Conclusion

[34] Under a contract for services, ADP acted as a facilitator and a conduit to ensure that the sums due by its clients to their employees and to the fiscal authorities were paid on time. The nature of the services provided by ADP implied the processing and transfer of the clients' Funds to those to whom they were due and who were the intended recipients. The Funds were the goods to be transferred. They were not "advances" to ADP because they were neither a payment made to ADP before it was due, nor an amount to be applied against the price of the service, paid before the service is rendered, nor an amount paid to ADP for an expenditure of ADP.

[35] For these reasons, I would allow the appeal with costs and set aside the decision of the Tax Court of Canada. Proceeding to render the judgment that should have been rendered, I would allow with costs the appeal of the appellant in the Tax Court of Canada and refer to the Minister:

a) the Notice of Assessment issued for the 2001 taxation year for reconsideration and reassessment on the basis that the amount of $1,104,129,044 must not be included in the capital of ADP under section 181.2 of the Act; and

b) the Notice of Assessment issued for the 1999 taxation year for reconsideration and reassessment on the basis that the amount of surtax credit of $140,759 must be allowed.

"Gilles Létourneau"
J.A.

"I agree
M. Nadon J.A."

"I agree
J.D. Denis Pelletier J.A."

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

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