[OFFICIAL ENGLISH TRANSLATION]

2001-910(IT)I

BETWEEN:

SAINT-RAYMOND PLYMOUTH CHRYSLER INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on January 16, 2002, in Québec, Quebec,
hearing reopened on May 7, 2002,
and conference call held on July 23, 2002, at Ottawa, Ontario, by

the Honourable Chief Judge Alban Garon

Appearances

Agent for the Appellant:	Benoît Noreau
Counsel for the Respondent:	Stéphanie Côté

JUDGMENT

The appeal from the assessment made under the *Income Tax Act* with respect to the 1997 taxation year is dismissed.

Signed at Ottawa, Canada, this 30th day of July 2002.

"Alban Garon"

C.J.T.C.C.

Translation certified true
on this 12th day of November 2003.

Sophie Debbané, Revisor

[OFFICIAL ENGLISH TRANSLATION]

Date: 20020730
Docket: 2001-910(IT)I

BETWEEN:
SAINT-RAYMOND PLYMOUTH CHRYSLER INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Garon, C.J.T.C.C.

[1] This is an appeal from an income tax assessment by the Minister of National Revenue for the appellant's 1997 taxation year. By that assessment, the Minister disallowed a deduction of $23,254. That amount was part of the $26,166 claimed by the appellant as a bad debt following its sale of a vehicle to a related person, Location Raybec inc.

[2] In making the assessment under appeal, the Minister of National Revenue relied on the allegations set out in paragraph 5 of the Reply to the Notice of Appeal, which reads as follows:

> [TRANSLATION]
>
> (a) The appellant is a vehicle retailing business;

(b) On January 23, 1997, the appellant sold an automobile to Location Raybec inc. for $22,962 plus taxes, for a total price of $26,166;

(c) Location Raybec inc. and the appellant are related businesses for tax purposes. More specifically, the shareholders of Location Raybec inc. are:

- the appellant:	60%
- Benoît Noreau's wife:	10%
- Benoît Noreau's son:	30%

(d) Because of financial difficulties, Location Raybec inc. did not pay the appellant the amount owed ($26,166, including taxes);

(e) At September 30, 1997, which was the end of the appellant's fiscal year, the appellant claimed a bad debt of $26,166;

(f) The appellant repurchased the same vehicle for $22,847 (including taxes) on July 21, 1997, and subsequently resold it to a third party;

(g) On July 5, 2000, following an audit, the Minister issued a notice of reassessment adding $23,254 to the appellant's income;

(h) That $23,254 corresponds to the difference between the bad debt amount claimed by the appellant ($26,166) and the bad debt amount considered allowable by the Minister ($2,912);

(i) The bad debt amount considered allowable by the Minister ($2,912) corresponds to the difference between the amount of the sale by the appellant to Location Raybec inc. (excluding taxes), that is, $22,962, and the amount of the subsequent purchase (excluding taxes), that is, $20,050;

(j) At this point in the proceedings, the Minister is of the view that no capital loss was incurred by the appellant on the “sale-purchase” transactions described above.

[3] The appellant's president, Benoît Noreau, testified for the appellant. Jean-Claude Girard gave evidence for the respondent.

[4] The essential facts for the purposes of this case can be summarized briefly. The appellant, which operates a vehicle retailing business, sold an automobile to Location Raybec inc. on January 23, 1997, for $22,962, excluding taxes. Location Raybec inc. did not pay any of the purchase price in cash because of the financial difficulties it had to deal with. It did not provide any security to guarantee payment of the sale price. The appellant's purchase of the automobile had been financed by Chrysler Credit Ltd. The appellant repurchased the same vehicle from Location Raybec inc. on July 21, 1997, by paying $20,050 in cash, excluding taxes.

[5] Mr. Noreau testified that Location Raybec inc. operated a car rental business. During the period of nearly six months before the appellant repurchased the vehicle in question on July 21, 1997, Location Raybec inc. did not pay any of the sale price to the appellant because of its financial situation. The appellant did not try to take back the automobile as a result of Location Raybec inc.'s failure to pay the sale price. It preferred to pay Location Raybec inc. $22,847 in cash, including taxes, when it repurchased the automobile.

[6] Mr. Noreau also testified that Location Raybec inc. began operating its business in November 1996 and stopped in January 1998.

[7] Jean-Claude Girard, an auditor with the Canada Customs and Revenue Agency, explained how the bad debt was calculated. That calculation served as the basis for the assessment.

Appellant's arguments

[8] It is worth reproducing some of the comments made by the appellant's agent. Referring to June 1997, he stated the following:

> [TRANSLATION]
>
> Certainly I became disillusioned in June because things weren't improving too much, and I always come back to the fact that I definitely owed that money to Chrysler Credit.
>
> . . .

> That I owed it was clear. Even though I repurchased the vehicle, there was no connection . . . for me, it was to get back as much of my money as possible that I . . . I told you earlier that I paid for the vehicle once again. Because I paid for all the others and for that one too.
>
> [Transcript, page 67, lines 4-8 and 11-16]

[9] To the following question asked by the Court:

> [TRANSLATION]
>
> But in that case, why didn't St-Raymond decide to say to Location Raybec: I'm buying back the car, you're having financial difficulties. I'm buying back the car but I'm not paying you since you didn't pay me in the first place?
>
> [Transcript, page 69, lines 8-13]

[10] Mr. Noreau answered as follows:

> [TRANSLATION]
>
> Okay, that could have been done. I don't pay Raybec and then, on the other hand, I pay it an advance of $20,000, so it would have come to the same thing.
>
> [Transcript, page 69, lines 14-17]

[11] Referring to his accountant, Mr. Noreau testified as follows:

> [TRANSLATION]
>
> And he also relied on the fact that a decision had been put in the books: bad debt, well, not bad debt, account receivable. And on

> September 30, we knew there was nothing that could be collected any more.

[Transcript, page 70, lines 13-17]

[12] Dealing with paragraph 8 of the Reply to the Notice of Appeal, Mr. Noreau made the following comments:

> [TRANSLATION]
>
> Paragraph 8 is the key issue for me, which I can't accept otherwise.
>
> > He argues that, in the context of a sale to an unrelated person, the appellant would never have agreed to lay out money to buy back a vehicle from a person to whom it had sold the vehicle without being paid.
>
> That's the big issue for them, for the Department. Except that, as I touched on it a little earlier, if I hadn't repurchased the vehicle or . . . I would still have had a loss with respect to Chrysler Credit. I owed the money for that vehicle, which was not . . . Raybec didn't pay me, whether . . .

[Transcript, page 77, line 21, to page 78, line 4]

[13] Mr. Noreau referred to the fact that, as he sees it, he acted reasonably and honestly, as shown by the following comments:

> [TRANSLATION]
>
> Well, we purchased the vehicle for $20,050 and resold it for $21,600, for a profit of $1,550 minus the reconditioning expenses. And, kind of like I was saying earlier, as long as it was in inventory, there was still a debt to Chrysler Credit, regardless of whether it was in inventory at St-Raymond Plymouth Chrysler or Location Raybec. There was still a connection to the vehicle. So I

> think I acted reasonably and honestly in the situation. That is more or less the conclusion I want to make. Thank you.
>
> [Transcript, page 80, lines 14-24]

Respondent's arguments

[14] In the Reply to the Notice of Appeal, the respondent had relied not only on paragraph 20(1)(*p*) but also on section 69 of the *Income Tax Act* ("the *Act*") in support of her assessment. At the hearing, counsel for the respondent did not rely on section 69 of the *Act* since the respondent did not adduce any evidence to show that the appellant had disposed of the vehicle in question for a consideration less than the fair market value thereof.

[15] Counsel for the respondent relied particularly on the introductory portion of subsection 20(1) of the *Act*, which states that, in computing income from a business or property, a taxpayer is entitled to deduct "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". She emphasized the word "reasonably" used in that portion of subsection 20(1) that was quoted. The respondent challenged in particular the unreasonableness of the loss incurred by the appellant.

[16] The respondent also referred to section 67 of the *Act*, which provides as follows:

> In computing income, no deduction shall be made in respect of an outlay or expense in respect of which any amount is otherwise deductible under this Act, except to the extent that the outlay or expense was reasonable in the circumstances.

[17] Relying on subsection 20(1) and section 67 of the *Act*, counsel for the respondent stated the following:

> [TRANSLATION]
>
> So the question that can be asked is whether, on September 30, 1997, there was a debt that hadn't been collected. The facts tell us there was. But is it reasonable to think that the amount of the debt or expense that the per . . . that the taxpayer can take is what it is claiming, $26,000? The answer would be no,

> because the taxpayer's chances of collecting actually amounted to $20,000 plus taxes, $22,000, which is the amount for which it repurchased the vehicle.
>
> [Transcript, page 58, lines 4-13]

[18] Further on, counsel for the respondent added:

> [TRANSLATION]
>
> So what is unreasonable in this is that the taxpayer, through transactions that were specific to its circumstances, to its situation because the businesses were related, that explain how this was dealt with. I agree with you, and I'll agree with anyone who says to me: "yes, but 20(1)(*p*) doesn't impose any restriction because of the non-arm's length relationship." The only restriction in 20(1)(*p*) is the reasonableness of the transactions. This may be coloured by a non-arm's length relationship, whether factual or legal, it doesn't matter . . . by any other circumstance, which means that not only is a $25,000 bad debt being claimed, but a $20,000 expense is also being claimed given that a $20,000 expense was obviously recorded when the vehicle was purchased. Which means that, in the end, for a $25,000 vehicle, for $25,000 in income, a total expense of $45,000 is being claimed.
>
> [Transcript, page 59, lines 5-23]

[19] Finally, in her rebuttal, counsel for the respondent stated that [TRANSLATION] "in light of the transactions between the appellant and its subsidiary, the possible recharacterization should be compensation, legal compensation." She added that the decision of the Supreme Court of Canada in *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622, [TRANSLATION] "would make it possible for the Department to apply compensation because the appellant's transactions with its subsidiary did not properly reflect the actual legal effect, which was compensation."

Analysis

[20] The issue is whether, in computing its business income for its 1997 taxation year, the appellant is entitled to deduct a bad debt of $26,166 for the amount not

paid by Location Raybec inc. on the sale price (including taxes) of the automobile purchased on January 23, 1997.

[21] The right to deduct an amount as a bad debt is governed by paragraph 20(1)(*p*) of the *Act*, which reads as follows:

> 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:
>
> ...
>
> (*p*) the total of:
>
> (i) all debts owing to the taxpayer that are established by the taxpayer to have become bad debts in the year and that have been included in computing the taxpayer's income for the year or a preceding taxation year, and
>
> (ii) all amounts each of which is that part of the amortized cost to the taxpayer at the end of the year of a loan or lending asset made or acquired in the ordinary course of business by a taxpayer who was an insurer or whose ordinary business included the lending of money established by the taxpayer to have become uncollectable in the year;

[22] It is not in dispute that the appellant's debt had become a bad debt at the time it repurchased the automobile in question on July 21, 1997.

[23] First of all, I do not agree with counsel for the respondent regarding the interpretation of the introductory portion of subsection 20(1) of the *Act*. The criterion of reasonableness relates not to the transaction referred to in any of the paragraphs of subsection 20(1) but rather to such part of the deduction of an amount as is applicable to a particular source of income. This is clear from a careful reading of the introductory portion of the subsection. I refer to the following passage: “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”. This wording simply takes account of the fact that in some

situations the deduction of amounts is wholly applicable to a single source of income, whereas in other cases the deduction of an amount may be applicable to several sources of income and only partly to one source of income. When applicable to several sources of income, only such part of the amount as may reasonably be regarded as applicable to that source of income is deductible.

[24] Nor do I think that section 67 of the *Act* can apply in this case. The restriction imposed by that section applies only where the outlay or expense is not reasonable in the circumstances, as specified by the wording of the section:

> In computing income, no deduction shall be made in respect of an outlay or expense in respect of which any amount is otherwise deductible under this Act, except to the extent that the outlay or expense was reasonable in the circumstances.

[25] The amount that the appellant would like to deduct is equal to the price of the vehicle, including taxes, specified in the contract of sale entered into by the appellant and Location Raybec inc. The appellant did not receive any of that sale price. It therefore claimed the full amount of the sale price, including taxes, as a bad debt. It has not been put in evidence that the sale price was excessive. From the standpoint of section 67, the amount of the deduction seems reasonable to me. In reaching this conclusion, I have assumed that a bad debt is an expense, which is doubtful. An expense is normally an outlay made to obtain goods or services.

[26] It follows that the main arguments made by the respondent during the hearing of this case do not seem to me to support the validity of the assessment.

[27] Given the facts of this appeal, I consider it necessary to begin by determining the amount of the debt owed to the appellant by Location Raybec inc. at the end of the appellant's 1997 taxation year.

[28] To answer this question, one of the causes of extinction of obligations, that is, compensation, must be considered.

[29] Articles 1672 and 1673 of the *Civil Code of Québec* indicate the situations in which compensation applies and the consequences of compensation. They read as follows:

> Art. 1672. Where two persons are reciprocally debtor and creditor of each other, the debts for which they are liable are extinguished by compensation, up to the amount of the lesser debt.

> Compensation may not be claimed from the State, but the State may claim it.
>
> Art. 1673. Compensation is effected by operation of law upon the coexistence of debts that are certain, liquid and exigible and the object of both of which is a sum of money or a certain quantity of fungible property identical in kind.
>
> A person may apply for judicial liquidation of a debt in order to set it up for compensation.

[30] In this case, there is no doubt that, at the very time the repurchase contract of July 21, 1997, was entered into and as a direct consequence of that contract, the appellant immediately became a debtor of Location Raybec inc. for the price of repurchasing the automobile in question and that Location Raybec inc. became a debtor of the obligation to "deliver" the automobile in the technical sense of that term found in the *Civil Code of Québec* (arts. 1716 *et seq.*). Going back to the time the contract was entered into, it follows—to use the terminology of article 1673 of the *Civil Code of Québec*—that the appellant's debt to Location Raybec inc. was certain, liquid and exigible and that its object was a sum of money. It was certain because it could not be seriously contested. It was liquid because its amount was determined with certainty. It was also exigible since, in the contract of sale, payment of the price was not subject to any condition or term. Payment of the debt could be claimed right away. In my view, it is not important that the appellant paid the repurchase price at the time the repurchase contract was entered into. Whether that price was paid at the time of the contract or some time later changes nothing to the parties' legal situation.

[31] Location Raybec inc.'s debt to the appellant under the contract of sale of January 23, 1997, which provided for a price of $22,962, was also certain and liquid for the reasons given earlier as regards the appellant's debt. Was that debt exigible?

[32] During the hearing of this case, the front of the copy of the contract of sale of January 23, 1997, between the appellant and Location Raybec inc. was filed. The back of that contract was not filed, no doubt inadvertently.

[33] While judgment was reserved, I noticed this omission from the evidence and decided to reopen the hearing. The back of the contract was part of a key document given that the deduction for a bad debt claimed by the appellant results from that

contract and from the fact that Location Raybec inc. did not pay the sale price specified therein.

[34] The back of the contract states the following, *inter alia*:

> [TRANSLATION]
>
> If the purchaser fails to pay the sale price in full within three (3) days after delivery, the vendor can consider that the purchaser is clearly demonstrating its intention not to comply with its obligations hereunder, thereby putting itself in default by operation of law, which shall enable the vendor to take back the vehicles without legal proceedings, this sale rescinded by operation of law.

[35] The price in the contract of sale of January 23, 1997, was therefore exigible from Location Raybec inc. three days at the latest after delivery of the car in question. According to the contract of January 23, 1997, delivery took place the same day. As well, the object of Location Raybec inc.'s debt to the appellant was a sum of money.

[36] The debts of the appellant and of Location Raybec inc. thus met the four conditions set out in article 1673 of the *Civil Code of Québec*. It therefore follows that both debts were extinguished by operation of law up to the amount of the lesser debt. The debt of $22,962 owed by Location Raybec inc. to the appellant was reduced by the debt of $20,050 owed by the appellant to Location Raybec inc. The result is that, when the repurchase contract was entered into on July 21, 1997, the debt owed by Location Raybec inc. was only $2,912. The appellant's bad debt in relation to Location Raybec inc. was therefore only $2,912 as of July 21, 1997, and in particular at the end of the appellant's taxation year on September 30, 1997. That is precisely the amount of the deduction that the appellant was allowed by the Minister of National Revenue at the time of the assessment under appeal.

[37] Before concluding, some comments should be made on applying the Supreme Court of Canada's decision in *Shell Canada Ltd. v. Canada*, *supra,* to the facts of this case.

[38] In my opinion, that decision does not apply here. First of all, *Shell* dealt with the right to deduct certain interest payments. In this appeal, the issue relates to the deduction of an amount as a bad debt. Moreover, in *Shell* the Court held that “the economic realities of a situation cannot be used to recharacterize a taxpayer's *bona fide* legal relationships. . . . [A]bsent 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." The highest court specified that "recharacterization is only permissible if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect ...." Here, it is not a matter of recharacterizing the appellant's legal relationships. As I have already noted, compensation is a cause of extinction of obligations that is effected by operation of law, regardless of the intentions of the taxpayer and the Minister.

[39] For these reasons, the assessment of the Minister of National Revenue is confirmed and the appeal is dismissed.

Signed at Ottawa, Canada, this 30th day of July 2002.

"Alban Garon"

C.J.T.C.C.

Translation certified true
on this 12th day of November 2003.

Sophie Debbané, Revisor