Docket: 2021-1049(GST)G

BETWEEN:

WILFREDO CASTRO,

Appellant,

and

HIS MAJESTY THE KING,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

Appeal heard on March 22, 2023, at Montreal, Quebec

Before: The Honourable Justice Guy R. Smith

Appearances:

Counsel for the Appellant:	Richard Seers
Counsel for the Respondent:	Stéphanie Douville Pierre G. Zemaitis

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JUDGMENT

In accordance with the attached reasons for judgment, the appeal from the assessment made under Part IX of the *Excise Tax Act* for the period from January 1, 2018, to March 31, 2018, is dismissed. Costs are awarded to the respondent.

Signed at Ottawa, Canada, this 17th day of January 2024.

"Guy Smith"

Smith J.

Translation certified true
on this 10th day of March 2025.

Vera Roy, Senior Jurilinguist

Citation: 2024 TCC 3
Date: 20240117
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REASONS FOR JUDGMENT

Smith J.

I. INTRODUCTION

[1] Wilfredo Castro, the appellant in this case, has appealed from an assessment made by the Agence du revenu du Québec ("the Minister") on behalf of the respondent on November 30, 2018, under Part IX of the *Excise Tax Act*, R.S.C. 1985, c. E-15 (the "ETA"), for the period from January 1, 2018, to March 31, 2018 (the "period in issue").

[2] In calculating his net tax, the appellant claimed an adjustment for a debt relating to the assignment of a property considered to be a bad debt.

[3] The Minister denied the request for an adjustment on the basis that the appellant was not dealing with the recipient of the property at arm's length and that the tax payable at that time had not been included in determining the amount of the net tax for the period in issue and had not been paid, contrary to the requirements of section 231 and subsection 231(1.1) of the ETA.

[4] For the reasons that follow, the appeal must be dismissed.

II. **ISSUES**

[5] The issues are as follows:

1. Was the Minister correct to deny the adjustment on the basis that the appellant was not dealing with the recipient of the property, 9221-2240 Québec Inc. (the "corporation"), at arm's length?

2. Was the Minister correct to deny the adjustment on the basis that the tax payable for the period in issue had not been included in determining the amount of the net tax and had not been paid?

III. **RELEVANT STATUTORY PROVISIONS**

[6] The relevant statutory provisions are as follows:

Part IX of the *Excise Tax Act*, R.S.C. 1985, c. E-15

Relationships, Associations, Separate Persons and Residence

Arm's length

126 (1) For the purposes of this Part, related persons shall be deemed not to deal with each other at arm's length and it is a question of fact whether persons not related to each other were, at any particular time, dealing with each other at arm's length.

Related persons

(2) Persons are related to each other for the purposes of this Part if, by reason of subsections 251(2) to (6) of the *Income Tax Act*, they are related to each other for the purposes of that Act.

…

SUBDIVISION A

Collection

221 (1) Every person who makes a taxable supply shall, as agent of Her Majesty in right of Canada, collect the tax under Division II payable by the recipient in respect of the supply.

…

SUBDIVISION B

Remittance of Tax

…

Calculation of net tax

228 (1) Every person who is required to file a return under this Division shall, in the return, calculate the net tax of the person for the reporting period for which the return is required to be filed, except where subsection (2.1) or (2.3) applies in respect of the reporting period.

…

Bad debt — deduction from net tax

231 (1) If a supplier has made a taxable supply (other than a zero-rated supply) for consideration to a recipient with whom the supplier was dealing at arm's length, it is established that all or a part of the total of the consideration and tax payable in respect of the supply has become a bad debt and the supplier at any time writes off the bad debt in the supplier's books of account, the reporting entity for the supply may, in determining the reporting entity's net tax for the reporting period that includes that time or for a subsequent reporting period, deduct the amount determined by the formula

$$\mathbf{A \times B/C}$$

where

A is the tax in respect of the supply;

B is the total of the consideration, tax and applicable provincial tax remaining unpaid in respect of the supply that was written off at that time as a bad debt; and

C is the total of the consideration, tax and applicable provincial tax in respect of the supply.

Reporting and remittance conditions

231 (1.1) A reporting entity is not entitled to deduct an amount under subsection (1) in respect of a supply unless

> **(a)** the tax collectible in respect of the supply is included in determining the amount of net tax reported in the reporting entity's return under this Division for the reporting period in which the tax became collectible; and
>
> **(b)** all net tax remittable, if any, as reported in that return is remitted.

…

***Income Tax Act*, R.S.C. 1985, c. E-15**

Arm's length

251 (1) For the purposes of this Act,

> **(a)** related persons shall be deemed not to deal with each other at arm's length;
>
> **(b)** a taxpayer and a personal trust (other than a trust described in any of paragraphs (a) to (e.1) of the definition *trust* in subsection 108(1)) are deemed not to deal with each other at arm's length if the taxpayer, or any person not dealing at arm's length with the taxpayer, would be beneficially interested in the trust if subsection 248(25) were read without reference to subclauses 248(25)(b)(iii)(A)(II) to (IV); and
>
> **(c)** in any other case, it is a question of fact whether persons not related to each other are, at a particular time, dealing with each other at arm's length.

Definition of *related persons*

(2) For the purpose of this Act, *related persons*, or persons related to each other, are

> **(a)** individuals connected by blood relationship, marriage or common-law partnership or adoption;
>
> **(b)** a corporation and
>
> > **(i)** a person who controls the corporation, if it is controlled by one person,
> >
> > **(ii)** a person who is a member of a related group that controls the corporation, or
> >
> > **(iii)** any person related to a person described in subparagraph 251(2)(b)(i) or 251(2)(b)(ii); and

…

Associated corporations

256 (1) For the purposes of this Act, one corporation is associated with another in a taxation year if, at any time in the year,

> **(a)** one of the corporations controlled, directly or indirectly in any manner whatever, the other;

> **(b)** both of the corporations were controlled, directly or indirectly in any manner whatever, by the same person or group of persons;

…

Factual control — interpretation

(5.11) For the purposes of the Act, the determination of whether a taxpayer has, in respect of a corporation, any direct or indirect influence that, if exercised, would result in control in fact of the corporation, shall

> **(a)** take into consideration all factors that are relevant in the circumstances; and
>
> **(b)** not be limited to, and the relevant factors need not include, whether the taxpayer has a legally enforceable right or ability to effect a change in the board of directors of the corporation, or its powers, or to exercise influence over the shareholder or shareholders who have that right or ability.

…

IV. **RELEVANT FACTS**

A. **Background**

[7] The appellant and his spouse, Andréa Castro ("the Castros"), are registrants under Part IX of the ETA.

[8] On April 27, 2010, they purchased a property located at 1463 Bishop Street, Montreal, Quebec ("the property"), from Concordia University for $3,250,000. The property was being used as an administrative centre, but the Castros wanted to carry out major renovations to create 32 rental housing units.

[9] At the time, the Castros were directors and each held 50% of the voting shares of the corporation, which was incorporated on April 12, 2010. It had engaged in no commercial activity and was not registered under the ETA.

[10] When the Castros began the property renovation project, they needed additional financing to be able to continue the work. These were the circumstances in which they accepted a financing offer made in a letter dated December 15, 2011 (the "letter of offer"), from Capital Corporation ("Capital"), a private lender, for a $3,400,000 loan.

[11] Under the terms of the letter of offer, the loan had to be secured by a first-ranking hypothec on the property, by a number of collateral hypothecs and by a personal guarantee given by the appellant and his spouse of $1,000,000 each. It provided that the property was to be transferred to the corporation and that the voting shares of the corporation held by the Castros at the time were to be pledged to Capital.

[12] The letter of offer provided that the guarantee had to be given, the property assigned, and the funds disbursed before the notary designated by Capital and that the work had to be performed by the general contractor also designated by Capital or its affiliated corporations.

[13] By notarized deed of assignment dated February 16, 2012, the Castros assigned the property to the corporation in return for payment of $1 (the "assignment").

[14] In the assignment contract prepared by the designated notary, the appellant and his spouse declared that the property was used for residential purposes, that there had been no major renovations to it, that no input tax credit had been claimed in connection with the acquisition of the property, and that the sale was consequently tax exempt. The guarantee documents were also executed on that date, including the movable hypothec with delivery of the voting shares of the corporation to Capital.

[15] However, the renovation project encountered numerous problems. Capital instituted a proceeding for the judicial sale of the property, while the Castros brought an action in damages. A settlement was eventually reached, and the matter was resolved by an agreement signed on December 10, 2013, by which the Castros assigned their voting shares of the corporation to a new corporation controlled by Capital and its affiliated corporations for the amount of $1. In exchange, they were released from the guarantees given under the letter of offer, including the $1,000,000 personal guarantees. Some time later, they signed a release in favour of the corporation, which was homologated by the Court of Québec on May 5, 2016.

B. **Assessment for unreported tax**

[16] In the interim, the Minister initiated an audit and concluded that the assignment was a taxable supply since the property was not used for residential purposes and the renovations were not sufficiently advanced to allow for such use. The Minister therefore concluded that the Castros, as registrants, had to collect tax calculated on the fair market value of the property at the time of the assignment, under subsection 221(1) of the ETA.

[17] On November 10, 2016, an assessment was made for the period in issue of the tax the Castros were required to declare in their quarterly report. The assessment determined tax of $85,050 each, excluding the amount of the provincial sales tax (QST). That assessment was appealed to this Court in file No. 2017-4748(GST)G. However, a notice of discontinuance was filed on March 2, 2020, thus putting an end to the matter, and to the matter of the QST assessment.

C. **Steps taken to recover the unreported tax**

[18] After receiving the assessment made on November 10, 2016, the Castros took steps, as agents of the Minister, to recover the GST and QST relating to the assignment of the property on February 16, 2012.

[19] Those steps were unsuccessful, however. Counsel for the new corporation argued that the request for reimbursement was frivolous since [TRANSLATION] “the notarized contract was an authentic act and is evidence that ... the transfer of the property to the Corporation is an exempt supply”. The Castros received a final letter on February 28, 2018, denying their request, and that was when they concluded that it was a bad debt.

[20] In the appellant’s GST return for the period in issue, the appellant deducted $81,250, the amount considered to be the bad debt, from his net tax.

[21] In making the assessment dated November 20, 2018, that is in issue here, the Minister refused to grant the request for an adjustment for that debt.

D. **Capital loss arising from the share sale**

[22] Having concluded that they had suffered a capital loss equivalent to the fair market value of the voting shares of the corporation as a result of the transaction that took place on December 10, 2013, and the release given on April 19, 2016, the appellant and his spouse took steps with the Agence de revenu du Québec asking that it recognize the capital loss relating to the assignment of the shares of the corporation. In March 2018, Revenu Québec recognized that the appellant and his spouse had suffered a capital loss in the amount of $1,780,777.

V. **ANALYSIS**

[23] Before a taxpayer may claim a deduction for a bad debt under section 231 of the ETA, certain conditions must be met. In the case before us, the following conditions, as provided in subsections 231(1) and 231(1.1) of the ETA, are disputed by the parties:

a. The two parties to the transaction are dealing at arm's length;

b. All or a part of the consideration and the tax has become a bad debt;

c. The tax collectible in respect of the supply is included in determining the net tax in the return for the reporting period in which the tax became collectible; and

d. All net tax remittable, if any, as reported in that return is remitted.

[24] Those conditions are all mandatory and cumulative; consequently, failure to satisfy any of them constitutes a bar to the deduction in issue: *Equinox Realty Ltd. v. The Queen*, 1997 CanLII 105 (TCC) at para. 7 ("*Equinox*"), and *9267-9075 Québec inc. v. The Queen*, 2020 TCC 53 at para. 42 ("*9267-9075*").

A. **Arm's length**

[25] The appellant submits that the assignment of the property to the corporation was an essential condition of the offer of financing letter leading to a loan agreement.

[26] Since they were obliged to make the assignment and [TRANSLATION] "grant a movable hypothec with delivery of the shares", the Castros submit that they lost *de jure* and *de facto* control of the corporation because they were deprived [TRANSLATION] "of their real decision-making powers and thus of their effective control within the Corporation".

[27] The respondent denies that the Castros lost *de jure* or *de facto* control of the corporation, since they were majority shareholders at the time of the assignment and the loan agreement provided that they retained their voting rights and their right to dividends. The respondent submits that [TRANSLATION] "the recipient and the supplier were not dealing with each other at arm's length at the time of the sale on February 16, 2012" within the meaning of subsections 126(1) and 126(2) of the ETA and that the appellant [TRANSLATION] "failed to rebut the presumption set out in section 251(1) of the *Income Tax Act* that related persons are deemed not to deal with each other at arm's length".

[28] To determine whether persons are related, subsection 126(1) of the ETA provides that "related persons shall be deemed not to deal with each other at arm's length". Subsection 126(2) then provides that persons related to each other by reason of subsections 251(2) to (6) of the *Income Tax Act*, R.S.C. 1985, c. E-15 (the "ITA") "are related to each other for the purposes of this Part".

[29] Subsection 251(2)(b) of the ITA provides that "related persons, or persons related to each other, are … a corporation and (i) a person who controls the corporation, if it is controlled by one person, (ii) a person who is a member of a related group that controls the corporation, or (iii) any person related to a person described in subparagraph 251(2)(b)(i) or 251(2)(b)(ii)".

[30] Subsection 251(4) of the ITA defines the expression "related group" as "a group of persons each member of which is related to every other member of the group". Because the appellant and his spouse are married, they are related persons under paragraph 251(2)(a) of the ITA. They therefore constitute a related group within the meaning of subsection 251(4) of the ITA.

[31] According to the case law, if the Court were to conclude that persons are related, that provision creates an "irrebuttable" or "not rebuttable" presumption that they are not dealing with each other at arm's length: *Simard v. Canada (Minister of National Revenue – M.N.R.)*, [1994] T.C.J. No. 1202 (QL) at para. 6 ("*Simard*") and *Lash v. Canada (Minister of National Revenue – M.N.R.)*, [2004] T.C.J. No. 205 (QL) at para. 9 ("*Lash*").

[32] Accordingly, if the appellant and his spouse controlled the corporation, together or individually, they were both related to the corporation within the meaning of the Act.

[33] The concept of "control" was reviewed in *Besse Syndics Inc. v. Canada*, 2021 FCA 115, in which the Federal Court of Appeal stated:

> [22] **The *de jure* and *de facto* control tests both aim to determine who controls the composition of a corporation's board of directors** and therefore the corporation itself (*Buckerfield's Limited v. Minister of National Revenue*, 1964 CanLII 1187 (CA EXC), 64 DTC 5301 [*Buckerfield's Limited*]; *Silicon Graphics* at para. 67). ...
>
> [23] The difference between these two tests is limited to the range of factors that can be considered in determining who controls a given corporation (*McGillivray* at paras. 47-48). The law is well settled that ***de jure* control lies in the hands of those who have the power to appoint the board of directors. As a general rule, these are the majority shareholders. However, certain documents can modify or restrict their power. Thus, the *de jure* control analysis deals with any internal restriction—in the corporation's articles of incorporation or in a unanimous shareholder agreement—on these shareholders' power to elect the board of directors or to limit the ability of the board of directors to manage the affairs of the corporation** (*Duha Printers (Western) Ltd. v. Canada*, 1998 CanLII 827 (SCC), [1998] 1 S.C.R. 795 [*Duha Printers*] at paras. 36-37, …).
>
> (Emphasis added.)

[34] That decision confirms that *de jure* control lies in the hands of the persons who may appoint the board of directors, in this case the appellant and his spouse. In my opinion, the loan agreement and the pledge of the shares cannot constitute documents able to modify or restrict their power to appoint the board of directors.

[35] As Professors Aurore Benadiba and Jacques Deslauriers write in "Titre II – Les hypothèques conventionnelles" of *Les sûretés au Québec*, 2nd ed. (Montreal: Wilson Lafleur, 2018) 295 at 399:

> [TRANSLATION]
>
> 1120. **The debtor retains ownership of the property pledged** (art. 2733 C.C.Q.). For example, **even if a shareholder hypothecates their shares with delivery, they retain ownership of their shares. The restrictions that apply to the transfer of certain shares do not apply to pledges of the shares, since title is not being transferred**. This explains why the voting right of a debtor who pledged shares is maintained unless the debt is for the purchase price of the shares and the sale contract contains a clause so stating.

(Emphasis added.)

[36] *De facto* control is not relevant to this analysis, and it is therefore not necessary to determine whether Capital had "any direct or indirect influence that, if exercised, would result in control in fact of the corporation", as set out in subsection 256(5.11) of the ITA.

[37] Despite the control exercised by Capital that the Castros describe in their testimony, the Court must conclude that the Castros constituted a related group since they owned 100% of the voting shares of the corporation. They were therefore both related to the corporation under subparagraph 251(2)(b)(ii) of the ITA.

[38] They are therefore deemed not to be dealing with the corporation at arm's length under section 126 of the ETA, and this conclusion alone is sufficient to dispose of the appeal. Nonetheless, I will review the remaining conditions.

B. **The bad debt**

[39] The appellant maintains that the net tax he should have collected at the time of the assignment, which he acknowledged in the notice of discontinuance filed in appeal file No. 2017-4748(GST)G, became a bad debt and he was entitled to write it off in his books of account for the period in issue.

[40] Although the respondent does not admit that the debt was bad, the Court is of the opinion that the appellant and his spouse were not required to exhaust all remedies against Capital in order to conclude that it was indeed a bad debt.

[41] In fact, the respondent has acknowledged that the Castros were entitled to a capital loss because of the assignment of their shares for consideration of $1. The Court is of the opinion that this is sufficient to conclude that the debt in question was a bad debt within the meaning of section 231 of the ETA.

C. **The conditions set out in subsection 231(1.1)**

[42] The other two conditions are set out in subsection 231(1.1) of the ETA, namely, the tax was included in determining the amount of net tax reported in the return for the period in issue, and the tax was remitted.

[43] As stated in *Equinox* and *9267-9075*, cited above, these are essential conditions. Since the net tax payable was not reported and was not remitted, the appellant is not entitled to the deduction claimed.

VI. **CONCLUSION**

[44] The aim of subsection 231(1) of the ETA is to prevent a situation in which there is a taxable supply and, as stated in that provision, “all or a part of the total of the consideration and tax payable” is not paid by the recipient of the supply.

[45] If the debt is considered to be a bad debt and is written off in the registrant’s books of account, the registrant may claim a deduction in determining their net tax. In other words, if the registrant has not been paid all or a part of the consideration and the debt is written off in their books of account, they may claim an adjustment.

[46] However, subsection 231(1.1) requires that “the tax collectible in respect of the supply … for the reporting period in which the tax became collectible” be included in determining the net tax and that “all net tax” be remitted. The bottom line is that these provisions allow a registrant to claim a refund of the net tax that was reported and paid but that could not be recovered.

[47] In this case, the Castros received bad advice regarding their obligation to collect the tax at the time of the assignment on February 16, 2012. They did not report the net tax and it was not remitted. It was only several years later, when the assessment for the tax payable became final, that they tried to recover the debt from Capital, the subsequent shareholder of the corporation.

[48] I do not believe that Parliament intended, in creating the deduction in section 231 of the ETA, to make it available to registrants in the situation in which the Castros found themselves. What is more, expanding the deduction to include situations like this one could have significant consequences. It would be too easy to evade the obligation to pay the tax if the only requirement was to not include it in a return then wait a few years for the tax authorities to make an assessment, solely in

order to claim a deduction at that point because the passage of years means that the tax has become a bad debt.

[49] The situation described by the Castros is certainly unfortunate, and it is obvious that they were manipulated by their business partner and given bad advice by the notary designated by the lender. Unfortunately, a mistake of law, whatever its source, cannot constitute a valid justification for granting the request for an adjustment under subsection 231(1) of the ETA.

[50] For these reasons, the appeal must be dismissed.

Signed at Ottawa, Canada, this 17th day of January 2024.

"Guy Smith"

Smith J.

Translation certified true
on this 10th day of March 2025.

Vera Roy, Senior Jurilinguist

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APPEARANCES:

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