Federal Court of Appeal | Cour d'appel fédérale

Date: 20210419

Docket: A-50-20

Citation: 2021 FCA 78

CORAM: **BOIVIN J.A.**
RENNIE J.A.
WOODS J.A.

BETWEEN:

JAMES KRUMM

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Heard by online video conference hosted by the registry on April 15, 2021.

Judgment delivered at Ottawa, Ontario, on April 19, 2021.

REASONS FOR JUDGMENT BY: WOODS J.A.

CONCURRED IN BY: BOIVIN J.A.
RENNIE J.A.

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REASONS FOR JUDGMENT

WOODS J.A.

[1] This appeal concerns the tax shelter provisions in the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (the Act). The appellant, James Krumm, was reassessed for his 1997 and 1998 taxation years to disallow deductions in respect of an acquisition of an interest in computer software on the basis that the software was a tax shelter. The Tax Court dismissed Mr. Krumm's appeal (2020 TCC 7, *per* Visser J.) and Mr. Krumm has appealed to this Court.

[2] The question is whether the Tax Court erred in finding that the software was a “tax shelter” within the meaning ascribed to that term (subsection 237.1(1) of the Act). If the software was a tax shelter, Mr. Krumm may not claim deductions with respect to the property since he did not provide a prescribed form containing, among other things, an identification number for the tax shelter (subsection 237.1(6) of the Act).

Background facts

[3] A brief summary of the facts is provided since the facts are described in detail in the reasons of the Tax Court.

[4] In 1997, Mr. Krumm acquired a 50 percent interest in application software from Intersports Acceleration Corp. (IAC). Mr. Krumm was introduced to IAC by an insurance salesman, Vladimir Morgun, who was also a shareholder of IAC.

[5] The negotiations for the purchase were conducted by Mr. Krumm’s lawyer, Dennis Nerland.

[6] The acquisition agreement provided for a purchase price of $2.8 million. The price was to be paid by a cash payment of $700,000 and the delivery of an interest-bearing promissory note with a principal amount of $2.1 million. Under the terms of the agreement, Mr. Krumm was not in essence at risk with respect to his obligation to pay interest or the principal on the note and no such payments were made.

[7] In the 1997 and 1998 taxation years, Mr. Krumm claimed capital cost allowance deductions equal to the purchase price of $2.8 million. He also claimed deductions for interest accruing on the promissory note, but only the capital cost allowance deductions are at issue in this appeal.

[8] Prior to the closing of the acquisition, IAC provided Mr. Krumm with a valuation report for the software that IAC had requested from a valuation firm, emc partners. The report provided an opinion that the fair market value of the software was not less than $11.2 million.

[9] It is striking that very little evidence was provided at the Tax Court regarding the initial marketing of the software except with respect to the sale to Mr. Krumm.

Standard of review

[10] The appellate standard of review applies to this appeal. Questions of law are to be determined on the correctness standard, and questions of fact and questions of mixed fact and law (excluding extricable questions of law) are to be determined on the basis of palpable and overriding error: *Housen v. Nikolaisen*, 2002 SCC 33, [2002] 2 S.C.R. 235.

Analysis

[11] It is evident from the background facts that it was contemplated that Mr. Krumm would lay out cash in the amount of $700,000 and receive tax benefits that exceeded this amount. It was a no-risk investment, as long as the tax deductions withstood scrutiny.

[12] The sole question in this appeal is whether the Tax Court erred in concluding that tax deductions were not available on the basis that the software was a tax shelter, as defined. The Crown raised an alternative argument before the Tax Court that the tax deductions were unreasonable within the meaning of section 67 of the Act. The Tax Court rejected this submission, and the Crown has not appealed with respect to this conclusion.

[13] Mr. Krumm submits that the Tax Court made two reviewable errors in applying the tax shelter provisions in this case.

- The Court failed to find that the tax shelter provisions were limited to publicly marketed and promoted transactions.

- The Court erred by concluding that tax shelter status can be inferred from "equivocal and qualified statements" as to the tax deductions available.

[14] A tax shelter as defined in subsection 237.1(1) of the Act generally describes a property that is marketed on the basis that prospective purchasers could expect a specified after-tax result

if they acquire an interest in the property. The relevant part of the definition applicable to the taxation years at issue reads: "… it can reasonably be considered, having regard to statements or representations made or proposed to be made in connection with the property, that [within a four year period] … the total of all amounts each of which is … represented to be deductible … would equal or exceed [the cost of the property, as adjusted]."

Application limited to publicly marketed transactions

[15] Mr. Krumm submits that his arrangement with IAC was a private transaction and not the type of arrangement contemplated by the tax shelter provisions which were intended to be applicable only to publicly marketed transactions. He submits that the Tax Court erred by not taking into account this legislative purpose.

[16] The Tax Court found (at para. 32 of the reasons) that the valuation report satisfied the requirements of the applicable legislation because it "made statements which were intended to recruit any potential investor, including Mr. Krumm, to purchase the Software on the basis of its tax characteristics."

[17] I agree with the Tax Court's conclusion on this issue. The valuation report states that IAC requested the valuation in anticipation of selling an interest in the software to investors. The report further states that the terms and conditions of the proposed acquisition agreement were taken into account for certain aspects of the valuation. These statements suggest that the report

was intended to influence potential investors and that the proposed terms and conditions of sale were established in advance for this purpose.

[18] The submission by Mr. Krumm is not supported by the facts or by a textual, contextual and purposive interpretation of the tax shelter definition. As for the facts, the valuation report makes it clear that the report was intended to influence prospective purchasers. As for the interpretation of the tax shelter definition, there is nothing in the text or context which suggests that the provisions are intended to be limited to publicly marketed transactions. As for its purpose, the Department of Finance has expressed concern about "abuses through aggressive tax shelter promotions" (Canada, Department of Finance, *Measures Limiting The Use Of Tax Shelters Announced*, News Release 94-112 (Ottawa: Department of Finance, 1 December 1994)). The concern expressed by the government would be frustrated if the legislation were applicable only to certain types of promotions.

Required contents of statements or representations

[19] Mr. Krumm submits that the tax shelter provisions do not apply because the valuation report does not explicitly state an amount that will be deductible for tax purposes. Two arguments are raised. First, Mr. Krumm submits that the statements in the report are not sufficient because they do not refer to an explicit amount that is deductible. Mr. Krumm also refers to a qualification in the report and suggests that the report does not state unequivocally that deductions will be available.

[20] The Tax Court rejected these submissions and concluded that the statements and representations in the report satisfied the requirements of the legislation. The Court stated (at para. 30 of the reasons):

> [30] … It is my view that the tax opinions and representations set out in the Valuation Report were intended to advise a prospective purchaser as to the tax treatment they could expect if a purchase of Software was made. It is also my view that the representations were of sufficient detail such that it could reasonably be considered that a prospective purchaser could deduct the full purchase price of the Software over a two year period.

[21] These issues raise questions of mixed fact and law to which the palpable and overriding error standard of review applies.

[22] The valuation report is central to these issues. The question is whether the report as a whole supports the requirement of the legislation that a prospective purchaser would reasonably conclude that it could deduct the full purchase price over a two-year period.

[23] I would observe that the valuation report is unusual in that it includes tax opinions as well as a valuation. This is illustrated by the concluding statements in the report:

> 51. It is our opinion that each of the modules of the Computer Program is application software and that each qualifies as a Class 12 asset for purposes of the *Income Tax Act* and the regulations thereto. Future investment in the Computer Program using provisions of this section of the Act may be compromised somewhat by the terms and conditions of this sale/acquisition.
>
> 52. It is our opinion that each of the modules of the Computer Program is commercially available for use for the purposes of the *Income Tax Act* and the regulations thereto.

> 53. It is our opinion, based upon the qualifications, restrictions and assumptions noted herein, that the fair market value of the revenue streams and of the Computer Program as at 25 June, 1997 is not less than $11.2 million.

[24] The report also includes an assumption that income tax laws will not change in the foreseeable future:

> 49. In finalising our opinion as to value, we have assumed, in addition to the assumptions noted elsewhere herein, that:
>
> […]
>
> (g) Federal and Provincial income tax laws prevailing at the valuation date will continue to prevail in the foreseeable future (including the proposed changes to the *Income Tax Act* announced by the Minister of Finance on December 1, 1994);

[25] The palpable and overriding error standard of review is a very high standard which is not met in this case. To be palpable, the error must be plainly seen. The Tax Court did not err when it concluded that prospective purchasers would reasonably consider that the report indicated that they could deduct the purchase price over the period allowed for Class 12 property that is available for use.

[26] Mr. Krumm further submits that the tax opinion in the report is qualified and therefore is not a sufficient representation for purposes of the relevant legislation. This submission relates to a qualification in the tax opinion at paragraph 51 of the report: "… Future investment in the Computer Program using provisions of this section of the Act may be compromised somewhat by the terms and conditions of this sale/acquisition."

[27] The argument is that paragraph 51 warns prospective purchasers that the tax consequences could be negatively impacted by the terms of the agreement. I note that this qualification applies only to a “future investment,” which is contrasted with “this sale/acquisition.” There is no error in concluding that this qualification has no application to prospective purchasers in “this sale/acquisition.”

Conclusion

[28] I have therefore concluded that there is no reviewable error in the Tax Court’s reasons which warrant the intervention of this Court. I would dismiss the appeal, with costs.

"Judith Woods"
J.A.

“I agree.
Richard Boivin J.A.”

“I agree.
Donald J. Rennie J.A.”

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

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PLACE OF HEARING:	BY ONLINE VIDEO CONFERENCE
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CONCURRED IN BY:	BOIVIN J.A. RENNIE J.A.
DATED:	APRIL 19, 2021

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