Docket: 2003-1209(IT)G

BETWEEN:

MANCHESTER CHIVERS & ASSOCIATES
INSURANCE BROKERS INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

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Appeals heard on May 19, 2005 at Edmonton, Alberta

Before: The Honourable Justice J.E. Hershfield

Appearances:

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| Counsel for the Appellant: | Neil W. Nichols |
| Counsel for the Respondent: | Margaret M. McCabe |

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**JUDGMENT**

The appeals from the assessments made under the *Income Tax Act* for the 1997, 1998 and 1999 taxation years are allowed, without costs, and the appeals are referred back to the Minister of National Revenue for reconsideration and reassessment in accordance with and for the reasons set out in the attached Reasons for Judgment.

Signed at Ottawa, this 27th day of September 2005.

"J.E. Hershfield"

Hershfield J.

Citation: 2005TCC402
Date: 20050927
Docket: 2003-1209(IT)G

BETWEEN:

MANCHESTER CHIVERS & ASSOCIATES
INSURANCE BROKERS INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

## REASONS FOR JUDGMENT

**Hershfield J.**

[1] This is an appeal with respect to the Appellant's 1997, 1998 and 1999 taxation years. In each such year the Appellant deducted directors' fees paid for directors who were the adult children of the shareholders of the Appellant company (the "subject directors" or the "children"). The directors' fees were disallowed as an expense on the basis that they were not incurred to earn income from a business or, in the alternative, on the basis that the expenses claimed were not reasonable. The Respondent relies on paragraph 18(1)(*a*) and section 67 of the *Income Tax Act* (Canada) (the "*Act*") respectively.

[2] The Appellant is in the insurance business. It has an October 30 year-end.

[3] One of the principal shareholders of the Appellant, Mr. Manchester, gave evidence at the hearing. He, his wife and the third shareholder, Mr. Chivers, were the sole shareholders of the Appellant company. Three of the four subject directors were children of Mr. and Mrs. Manchester and the fourth was the child of Mr. Chivers. The three shareholders were also directors of the company throughout the years in question as they had been prior to the appointment of the subject directors sometime prior to the years under appeal.

[4] Mr. Manchester admitted that the appointment of the children as directors was largely tax driven. The Appellant's earnings were in excess of the amount eligible for the small business deduction. Expensing corporate earnings to the adult children would result in tax savings and help ease the financial burden associated with the education and maintenance of the children. As things have turned out, the denial of the deduction for fees paid to the children will result in a double tax penalty. The denial of the expense will result in the Appellant paying tax on the amount denied notwithstanding that the children have included the fees in their income.[1]

[5] Aside from the tax savings motive for appointing the children as directors, Mr. Manchester testified that the appointment of the subject directors to the Board of the Appellant was also to expose them to the Appellant's business in the hope that one or more of them would take an interest in it, become active in it and, one day, take it over so as to ensure its continuity and value. This was forward looking as when the children were first appointed (prior to the years under appeal), they were all in school although only one of the children remained in school throughout the entire period under appeal. Two of the other three children began working in 1998 and the fourth, Jody Manchester, had left school prior to the years under appeal and was employed during much of the period under appeal in the insurance business but with a different firm in a different city.[2] None of the children were employed during the subject period with the Appellant other than in their capacity as directors.

[6] Mr. Manchester acknowledged that the children did little as directors of the company other than sign necessary corporate documents as required of directors. There were no directors' meetings and few discussions, although the children were

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[1] Evidence at the hearing demonstrated that in several instances the fees paid to the children gave rise to tax consequences. This is not surprising given the quantum of the fees which will be set out in more detail later in these Reasons. In cases like this it is possible to consider that the parents were the constructive recipients of the fees paid. If such an approach had been taken, the deduction might have been allowed as bonuses paid to the parents whose services would typically warrant the expense. There was no indication at the hearing that such approach was ever considered or that it might still be a possibility. Such an approach would frustrate the tax planning aspect of this case but avoid the double tax. This is not to suggest one way or the other as to which approach the Respondent should take in cases such as this. It simply recognizes an approach often taken by the Respondent.

[2] She is currently a realistic candidate to take over the affairs of the corporation.

cautioned as to directors' liabilities, particularly statutory liabilities, that they were exposed to as directors. Jody Manchester testified at the hearing and confirmed that she was cautioned about liability risks. She also made reference to occasional conversations with her father about the corporation's business during the subject years. The other children never took an interest in the business and did not, in any event, testify at the hearing. Aside from Jody's evidence as to occasional conversations with her father, Mr. Manchester's evidence was that discussions, to the extent that they occurred in respect of the affairs of the corporation, were largely, if not solely, limited to discussions "around the table" when the children were at home (which would not have been often since they were for the most part not living at home during much of the period under consideration).

[7] It is clear that the children did not participate in the day-to-day operations of the corporation and did not partake in the management of the affairs of the corporation. They were not relied upon by the corporation in the performance of any directors' duties except to sign documents required to be signed by directors. Subject to making some allowances for Jody Manchester, I find that their presence added little if anything to the corporation's current well being. Little was expected of them.

[8] However, once appointed, the corporation has no choice but to recognize the presence of each and every member of its board. Shareholders are allowed to vote their shares in the election of directors in their self-interests for whatever reasons they may have. The tax saving motivation for their election cannot impugn the appointment. That they hold office is a legal reality. They have duties at law and to suggest that the question of the appropriate compensation is other than one of reasonableness, determined by any number of factors including the extent to which they attend to duties prescribed by their office, is misguided. The corporation is imposed upon as a matter of corporate law to deal with the issue of compensating its directors. That process is part of its income earning process. The Respondent cannot rely on paragraph 18(1)(*a*) to deny the expensing of directors' fees fixed as prescribed by corporate law. That is, in my view, paragraph 18(1)(*a*) cannot apply as the reason to deny directors' fees paid in the course of operating as a corporate entity regardless how little a director may contribute to the income stream or income potential of the corporation.[3] However, that a legal requirement to pay directors'

[3] Appellant's counsel referred to a number of authorities ranging from cases on accepted business practises, the requirement to examine the purpose of an expenditure as opposed to identifying a link between the expenditure and a particular income and, of course, cases that confirm that a tax motive does not impugn legally effective transactions. I need not refer to these cases. The principles they stand for are well established.

fees arises from a required process is not sufficient in terms of allowing the deduction under the *Act* given the limitation set out in section 67 of the *Act.*

[9] Section 67 reads as follows:

> 67. 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.

[10] The remaining issues then are whether the directors' fees in the years in question were reasonable in the circumstances and, if not, what amounts would be reasonable.

[11] While reasonableness in the context of this appeal should not, as ably argued by Appellant's counsel, be determined by the methodology employed in the setting of directors' fees, that methodology needs to be mentioned. Mr. Manchester's wife, a shareholder, determined each child's director's fee on the basis of that child's requirements for the year. Indeed the fees were fixed after the draws were made. The company was paying the personal living expenses of the children as and when required and as approved by Mrs. Manchester on the withdrawal from the corporation's account. Hence you have directors' fees that are all over the map in numerical terms. There is no relationship between the amount declared and paid as directors' fees and the performance of duties on behalf of the company, nor does any such relationship exist in terms of any expectations of what these members of the board might add by their mere presence. Further, there is nothing in their remuneration declared and paid on a current basis that can properly relate in a reasonable way to some future goal of succession.

[12] In 1996 one child received as much as $37,589.00 and another received as little as $9,500.00. In 1997 one child received as much as $40,000.00 and another received as little as $1,500.00. In 1998 only two children received fees even though all remained directors: one received fees of $16,700.00 and the other received $35,000.00. All such amounts were determined on the basis of, and paid to cover, personal expenses, unrelated to corporate affairs, based on personal needs as dependants or partial dependants of the shareholders of the company. The child in school throughout the appeal period received $9,500.00, $40,000.00 and $35,000.00 in each of the subject years and Jody Manchester, the child that was in the same business as the Appellant, received $28,900.00 (due to being unemployed

at the time) and $11,600.00 in respect of the 1997 and 1998 years respectively and nil in respect of the 1998 year being self-sufficient by that time.[4]

[13] In these circumstances, the challenge of deciding the reasonableness of the directors' fees for the purposes of section 67 is perplexing. On being invited to make a suggestion on the question, counsel for the Appellant offered for my consideration the disallowance of 30% of the expenditures as being unreasonable based in part at least on their having a personal element.[5] The Respondent offered no suggestions. While I believe that the Respondent had a responsibility to assist the Court and present views on reasonableness (and not simply fall back on the position taken which was to let the Appellant prove its own case), I did not press the point at the hearing given the Respondent's principal position was to deny all the subject expenditures pursuant to paragraph 18(1)(*a*).[6]

[14] It is of course impossible to delineate principles that might act as a firm guide, in cases like this, in the identification of a reasonable expense. What is clear is that if directors' fees are arbitrarily set, without reference to *anything* meaningful in the corporate context, then they are going to be subject to scrutiny. The more arbitrary and disproportionate to any possible relevant factor, the more vigilant the scrutiny will be particularly in closely held corporations where non-arm's length, passive directors are appointed. In such circumstances, corporations, such as the Appellant, are put in a difficult position given that the burden of proof is on them to establish what is reasonable.

[15] The Appellant's counsel did cite authorities, however, that should be mentioned. In *Safety Boss Limited v. The Queen*[7] the view is expressed that an

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[4] No evidence was provided as to what if any fees were paid to the shareholder directors in their capacity as directors.

[5] The Reply to the Notice of Appeal makes no mention of paragraph 18(1)(*h*) of the *Act* which denies expenses to the extent they are personal. The basis for the allowance suggested by the Appellant was not explained although one might speculate that alleviation of double tax might have been a factor. The suggestion might have been of assistance if the Respondent blinked, but that did not happen.

[6] In a valuation case, the Respondent would rarely if ever fail to produce evidence even if valuations were only relevant in the context of an alternative assessing position. In any event, the considered views of the Respondent as to reasonable fees for passive directors of closely held companies might have been helpful.

[7] 2000 DTC 1767 (T.C.C.).

expense should not be denied unless no reasonable business person would pay such amount having only the business consideration of the corporation in mind. What is that amount in the case at bar?

[16] In *Otto Roofing Ltd. v. M.N.R.* [8] an earned bonus paid as an additional director's fee was disallowed based on it being disproportionate to the corporation's earnings. It was unreasonable to pay directors 80% of the corporation's earnings. If that were the general rule, many high tech companies in recent years would be disallowed directors' fees altogether. Regardless, in the case at bar, earnings were sufficient to reward directors but that only begs the question as to determining a reasonable amount in the circumstance of this case.

[17] The Appellant also puts reliance on the liability aspect of the office of directors. Directors are indeed subject to risks under a number of statutory liability provisions not the least of which we see in this Court under the *Act* and the *Excise Tax Act* (GST) for unremitted taxes collected by the corporation. Fiduciary duties are a breeding ground for liability as well. While the children relied on their parents to protect them (as testified to by Jody Manchester) and while they would not likely be called on, compared to the other directors with resources, there is always a risk of liability that could financially ruin any director, active or passive, at any time.

[18] On the other hand, compensating directors for the liability risks for their own breaches is questionable where all concerned are of a common mind that the directors will effectively ignore their fiduciary duties. Still, persons in trust positions are exposed and insuring directors against liability is a practical reality. Compensation in lieu of insurance at a comparable cost to the corporation might be a reasonable approach in many instances.

[19] As to other factors that might play into determining reasonable fees, commercial realities must be recognized. Generally it might be reasonable to pay more where the responsibility is greater or where the very presence of the person adds credibility and influence. A variety of intangible contributions might be considered. Comparables for closely held corporations might have been helpful. The Respondent might well have offered evidence on this latter aspect of directors' compensation instead of simply leaving the burden of proof with the Appellant. In

[8] 63 DTC 174 (T.A.B.).

any event, I have considered the following factors in the limited circumstances of this case:

(1) Jody Manchester was the child that an outsider, considering the possible best interests of the business, might have considered as the most worthy among the children in terms of compensating her as a director. She had experience in the Appellant's business, some interest and, along with the others, signed documents and had liability risks. Even though expectations and actual participation were limited she might have been a helpful addition to the board. Until she stopped receiving compensation in 1999, she received $28,900.00 in the Appellant's fiscal 1997 year and $11,600.00 in its fiscal 1998 year;

(2) Each of the other children had liability risks and performed duties only as minimally imposed on them, namely, signing documents. They had no experience and no apparent interest. Expectations were minimal. There is no evidence to suggest that they could make a contribution or otherwise be a helpful addition to the board. Excluding years in which no compensation was paid, they received differing amounts of annual compensation for acting as directors: at the low end $1,500.00 and at the high end $40,000.00. The mean fell between $16,700.00 and $27,600.00. At $27,600.00, the amount is almost 250% of that paid to Jody Manchester in 1998. This strikes me as patently unreasonable having only the business considerations of the corporation in mind;

(3) That a director stops receiving compensation in any given year is not a factor in considering a reasonable compensation for that or any other director in that or in any other year;

(4) Subject to complying with rules governing the fixing of fees for directors, some differential in compensation is reasonable as among directors where any reasonable distinction can be drawn;

(5) Barring a business explanation (such as a deficiency in a prior years' compensation, years of service, a regulatory requirement, etc.) it is not reasonable that a corporation expense more for fees in respect of one director than for another where the other made, objectively and subjectively, the same or a greater contribution.

[20] With all these factors in mind I will allow as reasonable, the amount of $11,600.00 as a deduction in respect of Jody Manchester's services as a director for each of the Appellant's 1997 and 1998 taxation years. That she was, as a person in the business, capable of contributing, should be sufficient to allow more than a small allowance in respect of her appointment. On the other hand, if it was reasonable to pay her $11,600.00 in 1998, no more can be justified, on the evidence, as reasonable for 1997. In respect of each of the other directors, I will allow as reasonable, the amount of $1,500.00 in respect of their directors' services for each year in respect of which compensation was paid. If it was reasonable to pay Mr. Chivers' son that amount in 1997, no more can be justified, on the evidence, as reasonable for any of the other directors (aside from Jody Manchester) in any other of the subject years. All such amounts allowed are, in my view, somewhat generous but, in the circumstances, I have given the Appellant the benefit of any doubt as to the reasonableness of the fees in question.

[21] Accordingly, the appeals are allowed, without costs, on the basis set out above in paragraph 20 of these Reasons.

Signed at Ottawa, Canada, this 27th day of September 2005.

"J.E. Hershfield"

Hershfield J.

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| CITATION: | 2005TCC402 |
| COURT FILE NO.: | 2003-1209(IT)G |
| STYLE OF CAUSE: | Manchester Chivers & Associates Insurance Brokers Inc. and Her Majesty the Queen |
| PLACE OF HEARING: | Edmonton, Alberta |
| DATE OF HEARING: | May 19, 2005 |
| REASONS FOR JUDGMENT BY: | The Honourable Justice J.E. Hershfield |
| DATE OF JUDGMENT: | September 27, 2005 |

APPEARANCES:

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| Counsel for the Respondent: | Margaret M. McCabe |

COUNSEL OF RECORD:

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