Docket: 2006-1949(GST)I

BETWEEN:

LOGICIELS UPPERCUT INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

Appeal heard on April 14, 2008, at Rouyn-Noranda, Quebec

Before: The Honourable Justice François Angers

Appearances:

Agent of the Appellant:	Francis Langlois
Counsel for the Respondent:	Brigitte Landry

JUDGMENT

The appeal from the assessment made under the *Excise Tax Act* for the period from September 1, 2000, to February 28, 2005, is allowed, and the assessment is vacated, in accordance with the attached Reasons for Judgment.

Signed at Fredericton, New Brunswick, this 13th day of June 2008.

"François Angers"

Angers J.

Translation certified true
on this 15th day of October 2008.

Brian McCordick, Translator

Citation: 2008TCC312
Date: 20080613
Docket: 2006-1949(GST)I

BETWEEN:

LOGICIELS UPPERCUT INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

REASONS FOR JUDGMENT

Angers J.

[1] Logiciels Uppercut Inc (hereinafter "Uppercut Software" or "Uppercut") is appealing from an assessment made by the Minister of National Revenue ("the Minister") under the *Excise Tax Act* (ETA) for the period from September 1, 2000, to February 28, 2005. On November 16, 2004, Uppercut Software, though its agent, signed a waiver of limitation for the period from September 1, 2000, to May 31 2001.

[2] By the assessment, the Minister added $44,311.40 as taxable supplies on which the Appellant did not remit tax amounting to $3,101.80. The Minister also disallowed a $2,016 input tax credit (ITC) in relation to a $33,127.20 debt that the Minister did not consider a bad debt because it was to be set off against a financial obligation of Uppercut Software to its debtor Fun Key Studio Inc. ("Fun Key"), in the sense that each was a debtor and creditor of the other.

[3] The Minister also imposed $1,948.26 in penalties under sections 280 and 285 of the ETA.

[4] During the period in issue, Uppercut Software operated a business that created software and provided computer and related services. In the course of an audit, the Respondent's auditor noticed cash deposits into Uppercut Software's bank account, with corresponding general ledger entries under "advances and liabilities" as advances from directors.

[5] Consequently, the auditor prepared a list of all these deposits, some of which were identified as injections of cash by directors Francis Langlois and Jean-Louis Bertrand. The auditor agreed that these deposits were advances by a director, and they were not taxed. The auditor was satisfied about the source of the funds, because the directors were able to provide evidence of withdrawals from their personal accounts for each of the advances that they made into Uppercut Software's account.

[6] However, the auditor did not receive similar evidence concerning nine cash deposits made on dates ranging from July 22, 2002, to September 20, 2004. The deposits were the subject of the first part of the assessment, and were taxed as income. Each deposit, with the exception of a $311.40 cheque, consists of a cash amount ranging from $1,000 to $10,000. According to the evidence, most of the deposit slips were signed by one Alain Roy. Mr. Roy is also a director of Uppercut Software, and, according to Francis Langlois, its agent, the amount of $44,311.40 is from Mr. Roy and consists of advances to Uppercut just like those made by him and by Jean-Louis Bertrand. Despite a few attempts, Francis Langlois was unable to obtain proof from Alain Roy of the source of the money that he advanced to Uppercut, since Mr. Roy was not cooperating. It should be noted that Mr. Roy was not called upon to testify at the hearing of the instant case.

[7] According to Mr. Langlois, the directors' advances, including the ones from Mr. Roy, were made in order to enable Uppercut Software to [TRANSLATION] "stay afloat" after incurring expenses on purchasing software. He noted that, according to the profit and loss statement as at February 28, 2005, Uppercut was not a profitable company, and had enough losses that it did not have any taxes to pay. Being an accountant by profession, Mr. Langlois looked after Uppercut's accounting personally. He says that, as of 2000, Uppercut was practically not in business any longer, and that, even though it had operated since 1996, it never had many customers. Mr. Langlois' role was to look after accounting and financing, and the role of Jean-Louis Bertrand, whom he described as being [TRANSLATION] "in charge", was to look after software programming and development, whereas Alain Roy was a mere shareholder who worked in the construction business, not in software. Mr. Langlois sent a letter to the auditor identifying the shareholders who had injected money, and he included the requisite evidence, except with respect to Mr. Roy, who had provided no such evidence.

[8] On January 14, 1999, Uppercut Software borrowed $50,000 from Fun Key on an interest-free basis. The loan was repayable upon demand. Uppercut held shares in Fun Key and did business with the company. The loan was for Uppercut's day-to-day operations. To guarantee the repayment of the loan, Uppercut assigned 150,000 of its Fun Key Class A shares to Fun Key.

[9] In the same year, Uppercut did some development work on "Viewer" software for Fun Key. Fun Key got six invoices from Uppercut, once invoice per week, from August 16, 1999, to September 20, 1999. The invoices totalled $28,800, plus $2,016 in GST and $2,113.20 in QST. In a letter dated October 13, 1999, Mr. Langlois, of Uppercut, notified Fun Key's representatives that the work that was to be performed had been ready since September 25, 1999, and that they could pick up and verify the work at Uppercut's office so that the problem could be laid to rest and Uppercut could be paid in full for the work. Fun Key never took possession of the "Viewer" software and never paid the invoices that it received from Uppercut for the work. However, Uppercut made GST and QST remittances on the invoices.

[10] During the same period, that is to say, in August and September 1999, Uppercut's and Fun Key's lawyers exchanged letters following an August 26 meeting between their clients' representatives. The conflict at that time was primarily about the new business structures, but the outcome was that Fun Key asked for its $50,000 loan to be repaid in full, with interest, no later than September 17, 1999. Uppercut never repaid the $50,000, and Fun Key never sued for non-payment. In Uppercut's profit and loss statement for the fiscal year ended February 28, 2002, the $50,000 debt to Fun Key is still entered as a long-term liability.

[11] However, in Fun Key's profit and loss statements for the fiscal years ended April 30, 1998, 1999, 2000 and 2001, the amount of the demand loan to Uppercut Software is stated as a $50,000 receivable for the years 1999 and 2000. In the 2001 statement, that receivable is reduced to $15,000, and in the 2002 statement, it is down to zero. On October 18, 2002, Fun Key made an assignment of its assets for the benefit of its creditors under the *Bankruptcy and Insolvency Act*. According to the auditor's report, Uppercut was not listed as one of the creditors in Fun Key's bankruptcy.

[12] As for Uppercut, it wrote off Fun Key's debt as a bad debt on February 28, 2001, on the basis that it did not have the means to sue and that its relationship with Fun Key had deteriorated. Uppercut's liability on the $50,000 loan was removed from its financial statements following Fun Key's bankruptcy.

[13] In view of the above, the first issue to be determined is whether the cash deposits into Uppercut Software's bank account constitute taxable supplies on which the Appellant did not collect GST. One must also determine whether the Respondent was entitled to assess penalties by reason of Uppercut's failure to remit the GST to the Receiver General within the time allotted by the ETA. The second issue for determination is whether Uppercut was entitled to deduct $2,016 as a bad debt in computing its net tax on the invoices issued to Fun Key.

[14] It is worth noting that, under subsection 299(1) of the ETA, the Minister is not bound by any return, application or information provided by or on behalf of any person and may make an assessment, notwithstanding any return, application or information so provided or that no return, application or information has been provided. Moreover, under subsection 299(3) of the ETA, an assessment is deemed valid unless it has been vacated on an objection or appeal. The onus is therefore on Uppercut to show, on a balance of probabilities, that the assessment is wrong.

[15] The auditor, using the bank deposits method, identified a large number of deposits on which no GST was paid. In Uppercut's accounting, the corresponding entry in the general ledger stated that the deposits were directors' "advances and liabilities". Consequently, the auditor asked for supporting documents showing that they were indeed advances made by the directors. Two of the directors, whose advances were minimal, showed to the auditor's satisfaction that the money used for the advances had been withdrawn from their personal bank accounts. However, he did not receive such evidence from Alain Roy, the third director, and therefore considered the deposits, which totalled $44,311.40, to be taxable supplies on which Uppercut did not collect GST.

[16] The fact that these deposits were made in cash undoubtedly contributed to the auditor's doubts as to the source of the funds. However, I must acknowledge that Uppercut's accounting books identified these funds as advances from directors, and that the advances are, in fact, entered on the two financial statements that Uppercut tendered in evidence. The statement as at February 28, 2002, says that Uppercut has a short-term liability of $1,000 to Alain Roy. This advance is not actually one of the deposits covered by the assessment. As far as the deposits covered by the assessment are concerned, the financial statement as at February 28, 2002, lists a short-term liability to Alain Roy in the amount of $32,311.40, and another such liability in the amount of $3,350 to Francis Langlois.

[17] Francis Langlois is the only person who testified for Uppercut Software. All of Alain Roy's deposits were identified; he is the person who made the most deposits. Mr. Langlois apparently made one of the deposits after receiving the money from Mr. Roy, and two deposits were apparently made by the third director's wife.

[18] Mr. Langlois is an accountant, and he looks after the Appellant's books. In my opinion, he testified forthrightly and honestly, and his credibility was never put in question. He is unaware of the source of Mr. Roy's funds, but is certain that the funds are not income earned by Uppercut for services rendered, and that they are advances from Mr. Roy to Uppercut. He claims that Uppercut carried on very little business as of the year 2000; the company was hardly even in business, and had very few clients, hence the need to inject funds.

[19] Alain Roy could have been called as a witness in order to confirm Mr. Langlois' assertions, but he was not. However, based on the evidence as a whole, I do not believe that I can infer that his testimony would have been prejudicial to Uppercut in that it would have shown that the deposited funds were unreported income in Uppercut's hands on which GST was not remitted.

[20] The deposits are identified, the amounts are consistent with the accounting entries for advances by directors, and, based on Uppercut's situation and activities during the period and the testimony of Mr. Langlois in particular, I am satisfied, on a balance of probabilities, that the amount of $44,311.40 was not income that was received by Uppercut and on which GST was payable. Naturally, in light of this finding, the penalties cannot be imposed on these amounts.

[21] Uppercut also needs to show me, on balance of probabilities, that the Fun Key debt is a bad debt and that it is entitled to deduct it in computing its net tax under subsection 231(1) of the ETA.

[22] The Respondent claimed in her Reply to the Notice of Appeal that Uppercut was not on the list of the creditors in Fun Key's bankruptcy, and this has been admitted. Since Uppercut was not on the list, the Respondent determined that the $50,000 loan and $33,127.20 debt had been set off against each other, and that the Appellant was consequently not entitled to deduct the $2,016 as a bad debt in computing its net tax.

[23] However, the evidence adduced discloses that, in September 1999, Fun Key, through its lawyers, formally asked Uppercut's lawyers for the $50,000 loan to be repaid. In addition, according to Fun Key's financial statements as at April 30, 2001, Uppercut's debt was reduced to $15,000, and, in the following year, the debt was down to zero, which would explain why Uppercut was not one of the creditors in Fun Key's bankruptcy. According to Mr. Langlois, Uppercut did not repay the loan to Fun Key, so it is likely that Fun Key used its collateral, namely the shares, as repayment on the loan rather than setting it off against the amount that it owed Uppercut. In my opinion, this is not at all a situation in which it is suitable to apply the principles of compensation set out in articles 1672 and 1673 of the *Civil Code of Québec*, because the conditions that need to be met are not present, especially the condition that the debts be certain. The fact that Fun Key could exercise its rights under the guarantee makes it difficult to establish the amount of the debt at a precise moment in time, and this means that the debt is uncertain.

[24] In my opinion, the true question is whether the debt was truly a bad debt, thereby entitling Uppercut Software to deduct GST in the amount of $2,016 in computing its net tax. The ETA provides no definition of "bad debt". However, based on the case law and the provision itself, it is possible to draw up a list of criteria that must be present in order for a deduction to be permitted under subsection 231(1) of the ETA (see *Ciriello v. The Queen*, 98-2304(GST)I, November 30, 2000, and *Davies v. The Queen*, 97-1983(GST)I, May 29,1998):

1. The supplier and recipient of the taxable supply must be at arm's length from each other.
2. The supplier initially reported and paid the tax collectible.
3. The debt is unrecoverable, in whole or in part.
4. The supplier must have taken reasonable measures to collect on the debt.
5. The supplier wrote off the debt in its accounting records at some point.

[25] None of the evidence that has been heard enables me to conclude that the Appellant and Fun Key were not at arm's length from each other. The evidence discloses that the tax was reported and remitted, and that the Appellant wrote off the debt on February 28, 2001. It is also certain that the debt became uncollectible by reason of Fun Key's assignment in bankruptcy on October 18, 2002, a date that falls squarely within the period in issue. As for the reasonable measures taken to collect on the debt, I am of the opinion that, given the position that each party took in its correspondence, the circumstances of the instant case leave no room to suggest any likelihood that the amounts would be recovered. In fact, the Respondent never raised this last point. Consequently, the Appellant is entitled to this input. The appeal is allowed and the assessment is therefore vacated.

Signed at Fredericton, New Brunswick, this 13th day of June 2008.

"François Angers"

Angers J.

Translation certified true
on this 15th day of October 2008.

Brian McCordick, Translator

CITATION:	2008TCC312
COURT FILE NO.:	2006-1949(GST)I
STYLE OF CAUSE:	Logiciels Uppercut Inc. and Her Majesty the Queen
PLACE OF HEARING:	Rouyn-Noranda, Quebec
DATE OF HEARING:	April 14, 2008
REASONS FOR JUDGMENT BY:	The Honourable Justice François Angers
DATE OF JUDGMENT:	June 13, 2008

APPEARANCES:

Agent of the Appellant:	Francis Langlois
Counsel for the Respondent:	Brigitte Landry

COUNSEL OF RECORD:

For the Appellant:

Name:

Firm:

For the Respondent:	John H. Sims, Q.C. Deputy Attorney General of Canada Ottawa, Canada