Docket: 2007-2303(IT)G

BETWEEN:

SHAW-ALMEX INDUSTRIES LIMITED,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on September 17 and 18, 2009, at Toronto, Ontario.

Before: The Honourable Justice Lucie Lamarre

Appearances:

Counsel for the Appellant:	Michael Morgan
Counsel for the Respondent:	Suzanne Bruce

JUDGMENT

The appeal from the reassessment dated October 26, 2005 made under the *Income Tax Act* (**Act**) for the 1999 taxation year is dismissed with costs to the respondent in accordance with Tariff B of the *Tax Court of Canada Rules (General Procedure)*. However, the appellant is entitled, pursuant to paragraphs 39(1)(*b*) and 50(1)(*a*) of the Act, to claim a capital loss of $518,000 CDN that was incurred in its 1999 taxation year and that may be applied against capital gains, if any, in other years, in accordance with the relevant provisions of the Act.

Signed at Ottawa, Canada, this 4th day of November 2009.

"Lucie Lamarre"

Lamarre J.

Citation: 2009 TCC 538
Date: 20091104
Docket: 2007-2303(IT)G

BETWEEN:

SHAW-ALMEX INDUSTRIES LIMITED,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Lamarre J.

[1] This is an appeal against a reassessment made by the Minister of National Revenue (**Minister**) under the Income Tax Act (**Act**) for the 1999 taxation year. The appellant was first assessed for that year on May 18, 2000, and subsequently reassessed on October 26, 2005, which is after the three-year normal reassessment period defined in subsection 152(3.1) of the Act.

[2] In reassessing the appellant, the Minister disallowed the deduction of $518,000 CDN ($350,000 US) claimed by the appellant in computing its income for its 1999 taxation year. The deduction was claimed on account of the appellant's liability under the guarantee given to Wachovia Bank, a bank based in Atlanta, Georgia, in the United States (**US**), in respect of the indebtedness of its non-resident sister corporation, Shaw-Almex Fusion Corporation (**Fusion Co**).

[3] The Minister reassessed the appellant within three years of the end of the normal reassessment period, pursuant to subparagraph 152(4)(*b*)(iii) of the Act, on the basis that the reassessment was made as a consequence of a transaction involving the appellant and a non-resident person with whom the appellant was not dealing at arm's length.

[4] Subsection 152(3.1) and subparagraph 152(4)(*b*)(iii) of the Act read as follows:

152. Assessment

<u>Definition of "normal reassessment period</u>

(3.1) For the purposes of subsections (4), (4.01), (4.2), (4.3), (5) and (9), the normal reassessment period for a taxpayer in respect of a taxation year is

> (*a*) where at the end of the year the taxpayer is a mutual fund trust or a corporation other than a Canadian-controlled private corporation, the period that ends 4 years after the earlier of the day of mailing of a notice of an original assessment under this Part in respect of the taxpayer for the year and the day of mailing of an original notification that no tax is payable by the taxpayer for the year; and
>
> (*b*) in any other case, the period that ends 3 years after the earlier of the day of mailing of a notice of an original assessment under this Part in respect of the taxpayer for the year and the day of mailing of an original notification that no tax is payable by the taxpayer for the year.

<u>Assessment and reassessment</u>

(4) The Minister may at any time make an assessment, reassessment or additional assessment of tax for a taxation year, interest or penalties, if any, payable under this Part by a taxpayer or notify in writing any person by whom a return of income for a taxation year has been filed that no tax is payable for the year, except that an assessment, reassessment or additional assessment may be made after the taxpayer's normal reassessment period in respect of the year only if

> . . .
>
> (*b*) the assessment, reassessment or additional assessment is made before the day that is 3 years after the end of the normal reassessment period for the taxpayer in respect of the year and
>
> > . . .
> > (iii) is made as a consequence of a transaction involving the taxpayer and a non-resident person with whom the taxpayer was not dealing at arm's length.

[5] There is no issue with regard to the fact that the appellant and Fusion Co were related corporations and therefore not dealing at arm's length, and that Fusion Co was at all material times a non-resident person. The appellant takes issue however with the assertion that the reassessment was made as a consequence of a transaction involving the appellant and Fusion Co. Rather, the appellant submits, the providing

to Wachovia Bank of a guarantee of repayment of a loan by that bank to Fusion Co and the subsequent requirement that the appellant honour the guarantee and repay the loan from Wachovia Bank did not constitute transactions with Fusion Co within the meaning of subparagraph 152(4)(*b*)(iii) of the Act. According to the appellant, its providing of a guarantee to Wachovia Bank constituted a transaction with that bank, a non-resident person with whom the appellant at all material times dealt at arm's length (subparagraph 36(a) of the Notice of Appeal).

[6] The appellant also submits that the requirement that it honour the guarantee and provide repayment to Wachovia Bank of the loan constituted an event, not a transaction. The same argument is made regarding the subsequent repayment by the appellant to Wachovia Bank of the loan (subparagraphs 36(b) and (c) of the Notice of Appeal).

[7] Arguing on the merits of the appeal, the appellant submits that the deduction claimed was related to an actual liability in the amount of $518,000 CDN that it had at the end of the 1999 taxation year (the appellant's year end being September 30, 1999), and not to a contingent liability in that year as contended by the Minister. As a result, the appellant argues, it was an expense incurred for the purpose of gaining or producing income from a business and therefore fully deductible against income pursuant to paragraph 18(1)(*a*) of the Act. The Minister, on the other hand, is of the view, first of all, that the deduction is prohibited for the 1999 taxation year, pursuant to paragraph 18(1)(*e*) of the Act, on the basis that it was a contingent liability in that year. The Minister also submits that a repayment made under a guarantee is a capital expenditure the deduction of which is prohibited by paragraph 18(1)(*b*), and that it is not deductible under paragraph 18(1)(*a*) of the Act.

[8] In the alternative, the appellant submits in paragraph 46(b) of its Notice of Appeal, that the loss should be treated as an allowable capital loss in the 1999 taxation year under paragraph 38(*b*) of the Act, the deduction of which would be allowed under section 3 of the Act. This is denied by the respondent on the basis that the conditions required under paragraphs 39(1)(*b*) and 50(1)(*a*) of the Act have not been met. Counsel for the appellant did not argue in court that the loss should be treated as an allowable capital loss incurred in the 1999 taxation year in the event that it is held not to be a loss on account of revenue. It is my understanding, however, that he considered the debt owed to the appellant by Fusion Co at the end of the 1999 taxation year to be a bad debt. Therefore, the capital loss should be deemed to have been incurred in that year pursuant to paragraphs 39(1)(*b*) and 50(1)(*a*) of the Act. The relevant provisions of the Act read as follows:

18(1) General limitations -- In computing the income of a taxpayer from a business or property no deduction shall be made in respect of

> (*a*) General limitation - an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property;
>
> (*b*) Capital outlay or loss - an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part;
>
> . . .
>
> (*e*) Reserves, etc. - an amount as, or on account of, a reserve, a contingent liability or amount or a sinking fund except as expressly permitted by this Part.

SECTION 38: Taxable capital gain and allowable capital loss

For the purposes of this Act,

> . . .
>
> (*b*) a taxpayer's allowable capital loss for a taxation year from the disposition of any property is ¾ of the taxpayer's capital loss for the year from the disposition of that property; and

39(1) Meaning of capital gain and capital loss [and business investment loss] -- For the purposes of this Act,

> . . .
>
> (*b*) a taxpayer's capital loss for a taxation year from the disposition of any property is the taxpayer's loss for the year determined under this subdivision (to the extent of the amount thereof that would not, if section 3 were read in the manner described in paragraph (*a*) of this subsection and without reference to the expression "or the taxpayer's allowable business investment loss for the year" in paragraph 3(*d*), be deductible in computing the taxpayer's income for the year or any other taxation year) from the disposition of any property of the taxpayer other than
>
> . . .

> 50(1) Debts established to be bad debts and shares of bankrupt corporation - For the purposes of this subdivision, where
>
> > (*a*) a debt owing to a taxpayer at the end of a taxation year (other than a debt owing to the taxpayer in respect of the disposition of personal-use property) is established by the taxpayer to have become a bad debt in the year, . . .
> >
> > and the taxpayer elects in the taxpayer's return of income for the year to have this subsection apply in respect of the debt or the share, as the case may be, the taxpayer shall be deemed to have disposed of the debt or the share, as the case may be, at the end of the year for proceeds equal to nil and to have reacquired it immediately after the end of the year at a cost equal to nil.

Facts

[9] The appellant is a Canadian private family corporation that has been in existence since 1958. Resident in Canada, it carried on, in the relevant period, the business of manufacturing and distributing conveyor belt vulcanizing equipment. Fusion Co was a corporation incorporated in 1995 under the laws of the state of Georgia, having an office in Clarkston, Georgia, and resident in the US. During the relevant period, it carried on in the US the business of distributing conveyor belt splicing and repair equipment and supplies. At all relevant times, the two corporations were controlled by different members of the same family (the Shaw family).

[10] On November 30, 1995, Fusion Co, as borrower, entered into a line of credit/loan agreement with Wachovia Bank (**the US bank**), as lender, pursuant to which agreement Fusion Co subsequently borrowed $350,000 US (Exhibit A-1, Tab 3). The line of credit was to expire on August 27, 1996, or on demand, whichever was earlier. At the request of Wachovia Bank, the appellant agreed to guarantee the loan and obtained from the Bank of Nova Scotia a $350,000 US letter of guarantee dated November 27, 1995. It was issued to Wachovia Bank and was to expire on November 30, 1996 (Exhibit A-1, Tab 4). That letter of guarantee was renewed from time to time (see Exhibit A-1, Tabs 5 and 6) and was still in existence on September 30, 1999, the date on which the appellant's 1999 taxation year ended. As a matter of fact, in the appellant's financial statements for the year ended September 30, 1999, the amount of $518,000 CDN ($350,000 US), with respect to which the letter of guarantee from the Bank of Nova Scotia was issued to Wachovia Bank, appears as a contingent liability (see note 9, page 9 of the appellant's 1999

Annual Report, Exhibit A-1, Tab 7). In that same note, however, there is the following statement:

> At the demand of the Wachovia Bank the corporation entered into an agreement to pay Shaw Almex Fusion Corp.'s loan which was guaranteed by the letter of guarantee issued by Scotiabank. This loan has been recorded on the financial statements as of September 30, 1999.

[11] Mr. Dan Ball, the chartered accountant who prepared the Annual Report, explained that he considered that the amount of $518,000 CDN owed to Wachovia Bank became an actual liability for the appellant before September 30, 1999, as he was told by the owners and directors of the appellant that Wachovia Bank had made a formal verbal demand for payment. As Fusion Co appeared to be insolvent, the directors of the appellant did not want the Bank of Nova Scotia to receive a formal written request for payment since that could have impaired their future borrowing capacity with that bank. Mr. Timothy Shaw, a member of the Shaw family, who was a shareholder and director of Fusion Co at the time, explained in court that a consultant-advisor was sent to the state of Georgia, in August 1999 to negotiate with Wachovia Bank on behalf of the appellant to try to find a solution whereby the loan could be repaid without alerting the Bank of Nova Scotia. These negotiations culminated on December 29, 1999 in the signature of a Forbearance Agreement (Exhibit A-1, Tab 9).

[12] By that agreement, Wachovia Bank accepted repayment in monthly payments of $35,000 US that were to start in January 2000. In fact, it is my understanding that the whole amount was repaid by the appellant in its 2000 taxation year (Exhibit R-1, Tab 5). During all that period, however, the letter of guarantee issued by the Bank of Nova Scotia was still in force (see first paragraph on page 1 and paragraph 3(d) on page 3 of the Forbearance Agreement, Exhibit A-1, Tab 9).

[13] This is why, explained Mr. Ball, from an accounting point of view a contingent liability still existed. But, added Mr. Ball, because the appellant had been aware since April 1999 that Wachovia Bank did not want to renew the line of credit to Fusion Co on the grounds that that company had neither the funds nor the assets to cover its liability, and since the appellant knew that it was bound by its letter of guarantee, Mr. Ball considered that the $350,000 US ($518,000 CDN) liability became an actual liability in the 1999 taxation year. Under generally accepted accounting principles (**GAAP**), this liability had to be shown as such in the 1999 financial statements. He would have been negligent had he done otherwise.

[14] Mr. Ball also relied on a letter sent on April 6, 1999 by Wachovia Bank for the attention of Mr. Timothy Shaw at Fusion Co (Exhibit A-2) in stating that the US Bank had called for payment. This letter, however, is drafted in quite similar terms to those found in other letters granting the loan to Fusion Co, or extending its terms that had been sent over the years.

[15] I reproduce hereunder some relevant parts of that letter:

> April 6, 1999
>
> Shaw-Almex Fusion Corp.
> Mr. Timothy Shaw, President
> . . .
>
> Dear Tim,
>
> Wachovia Bank, N.A. ("Lender") is pleased to offer SHAW-ALMEX FUSION CORP. ("Borrower") the following described credit facility (the "Commitment".) This Commitment will become effective upon your acceptance of the terms and conditions outlined in this letter, and your return of an executed copy and a closing in a manner satisfactory to Lender. "Closing", "close" or "closed" as used herein, shall mean the execution, recordation where necessary, delivery to Lender of all documentation required by this commitment letter, and satisfaction of all terms and conditions specified herein in a timely manner. After closing, this Commitment will expire on 10/31/99 or on demand, whichever is earlier.
>
> Commitment type: Revolving Line of Credit.
>
> Amount: Up to Three Hundred Fifty Thousand Dollars ($350,000)
>
> Purpose: Borrowing under this Revolving Line of Credit will be utilized for short-term working capital purposes.
>
> . . .
>
> Repayment Terms: Interest payable monthly in arrears. Outstanding principal balance payable at expiration or on demand, whichever is earlier.
>
> Collateral: Letter of Guarantee in favor of Lender, issued by the Bank of Nova Scotia, in an amount not less than $350,000.00 in form and substance acceptable to Lender, to expire on or after 1/31/00.
>
> . . .

Christian M. Mande
Assistant Vice President
Business Banker
Wachovia Bank, N.A.

[16] Mr. Timothy Shaw was the one who dealt with Mr. Christian Mande, who was the assistant vice-president of Wachovia Bank at the time. Mr. Shaw testified that in April 1999 he received a phone call from Mr. Mande, who made it clear that Wachovia Bank did not want to renew the revolving line of credit, as Fusion Co kept the balance owing on the line of credit at the maximum, even exceeding the limit, and never being able to bring the balance down. Mr. Shaw said that the first call was a courtesy call, but it was clear that he had been given a heads-up to make arrangements to get other credit facilities in place prior to Wachovia Bank calling the loan. Mr. Shaw did not see how Fusion Co could obtain other credit facilities, given what was happening in the marketplace at the time and the lack of profitability shown in Fusion Co's financial statements. Mr. Shaw said that Wachovia Bank was very serious in April 1999, and although doing so in a very polite way, indicated that it would not hesitate to avail itself of the letter of guarantee provided by the Bank of Nova Scotia in order to obtain repayment of the loan. Mr. Shaw stated that "it was very clear that that was where we were headed" (Transcript, p. 51). He remembered having spoken to his parents, the controlling shareholders of the appellant, and to his brother, another shareholder of the appellant, in Canada. Everyone was nervous about Wachovia Bank exercising its rights under the letter of guarantee from the Bank of Nova Scotia. He said that this would have been detrimental to the whole business for two reasons. First, the appellant's reputation and its relationship with the Bank of Nova Scotia had to be preserved at all costs. There was a definite fear that if the $518,000 CND were taken in a single transaction, that would seriously harm the appellant's long-term relationship with that bank. Secondly, there was a fear that, if Fusion Co were perceived in the marketplace as not being able to survive, all their marketing and plans would "go by the wayside" (Transcript, p. 94). Mr. Shaw said that the appellant's and Fusion Co's businesses were highly integrated: they did business together, and there was a synergy between them in the market. So the collapse of Fusion Co would greatly affect the appellant's business, which clearly was not desirable. It was not a matter of choice (Transcript, p. 143). That is why a consultant was sent to Georgia in August 1999 to negotiate with the US Bank; that ultimately resulted in the signature of the Forbearance Agreement in December 1999 and the repayment of the loan in full by the appellant over the course of the year 2000.

[17] What stands out in my mind from Mr. Shaw's testimony is that it was very clear to him that the payments were made by the appellant in lieu of enforcement of the guarantee through the Bank of Nova Scotia.

[18] The appellant also called two of its employees to testify. The first, Mr. Ross James Currie, was hired in 1995 from one of the appellant's competitors, to seek and find new products relating to the "press side" of the business. It is my understanding that the appellant had only two competitors internationally, with one of which Mr. Currie had been employed before going to the appellant. In 1995, the appellant was only operating vulcanizing equipment for conveyor belts. Its competitors also had the material to splice belts (the "rubber side" of the business). That is why Fusion Co was incorporated, and Mr. Currie worked, from Canada, on this aspect of the business (the rubber side of the business, p. 149 of the Transcript). He played a role in launching Fusion Co in the US. He said that the appellant had no choice but to offer a complete package, meaning that it had to have the vulcanizing equipment for conveyor belts and the material to splice the belts. He was responsible for purchasing and testing all the materials for the international market. He said that the overall operation was run by the Almex group, that is, the Shaw Family. He stated that, in 1999, Fusion Co's employees started to get disgruntled and the company faced significant challenges. However, he could not testify regarding the financial aspects of the business.

[19] The other employee to testify, Mr. Alan Russell Goodwin has been working for the appellant since 1996. He had previously been working for the same competitor of the appellant's as that for which Mr. Currie had worked. Mr. Goodwin is the director of sales and marketing for the appellant and is based in the state of Texas in the US. He testified that the fusion aspect of the business was integral to the overall operations of the appellant. He explained that the expansion in the US was market-driven, aimed at maintaining the appellant's existing customer base and meeting the increasing competition faced by the Canadian operation. He also said that things started to decline in 1998 and 1999 as they were not achieving the sales and other goals that they had set. He also mentioned that the press side and the vulcanizing side of the business were very much integrated and very necessary to maintaining the growth of the company.

[20] Mr. Timothy Shaw said that Fusion Co was ultimately sold off in 2001 to a former employee. It was a sale of assets for an amount between $300,000 and $400,000. However, the purchaser completely defaulted on payment and the purchase price was never paid. The appellant now has a division called Fusion Systems, and it is by Fusion Systems that Mr. Currie is currently employed.

Analysis

I) Procedural Issue

[21] The first issue to be determined is whether the respondent could rely on subparagraph 152(4)(*b*)(iii) of the Act to reassess the appellant after the normal reassessment period and could benefit from the extended reassessment period provided for in that provision of the Act.

[22] It is the respondent's position that the appellant was reassessed as a result of a transaction involving the appellant, Fusion Co (a non-arm's length non-resident person) and Wachovia Bank (an arm's length non-resident person). In the respondent's view, there was a transaction, namely the successive execution and renewal of lines of credit and guarantee agreements whereby the appellant guaranteed Fusion Co's debt to Wachovia Bank, all of which culminated in the signature of the Forbearance Agreement.

[23] In the respondent's opinion, Wachovia Bank did not issue a formal demand for repayment of the revolving line of credit balance. The appellant made the payments scheduled in the Forbearance Agreement to Wachovia Bank on behalf of Fusion Co, and as a result of its non-arm's length relationship with its sister corporation (Fusion Co). The appellant acted as Fusion Co's guarantor. Accordingly, the respondent argues, the Minister properly reassessed the appellant pursuant to subparagraph 152(4)(*b*)(iii) of the Act.

[24] The appellant, on the other hand, submits that the reassessment was not made as a consequence of a transaction involving it and a non-resident person with whom it was not dealing at arm's length. It is the appellant's position that the providing of a guarantee by it to Wachovia Bank constituted a transaction with Wachovia Bank and not with Fusion Co.

[25] Further, it is submitted that the appellant's honouring the guarantee constituted an event, not a transaction.

[26] In *SMX Shopping Centre Ltd. v. The Queen*, 2003 FCA 479, Sharlow J. A. analyzes the meaning of the word "transaction" as used in subparagraph 152(4)(*b*)(iii) of the Act. She states at paragraph 24:

> [24] There is no merit in the second argument [that there was no transaction]. In the context of subparagraph 152(4)(*b*)(iii) of the *Income Tax Act*, the word "transaction" must be interpreted to include a transaction that the taxpayer alleges forms the factual foundation for a deduction claimed in an income tax return. Thus, for example, if a taxpayer claims to be entitled to a deduction for a particular expense it has paid, and the payment of the expense (assuming it occurred), would have involved the taxpayer and a non-resident person with whom the taxpayer was not dealing at arm's length, the Minister has the legal authority to reassess within the extended reassessment period to disallow the deduction. That legal authority does not disappear if the taxpayer later denies that the expense was paid, or fails to prove that it was paid.

[27] In *Blackburn Radio Inc. v. The Queen,* 2009 TCC 155, V. Miller J. of this Court states that the word "transaction" as it is used in subparagraph 152(4)(*b*)(iii) of the Act does not include an arrangement. V. Miller J., in paragraph 35 of her reasons for judgment, relied on the definition found in the *Canadian Oxford Dictionary*:

> 35. There is no general definition of the word "transaction" in section 248 of the Act but it is defined in the Canadian Oxford Dictionary as follows:
>
> 1 a. a piece of esp. commercial business done; a deal (*a profitable transaction*).
> b. *N Amer*. = TRADE 4b.
> c. the management of business etc.
> 2. (in *pl*.) published reports of discussions, papers read, etc., at the meetings of learned society.

[28] I am not exactly sure what the appellant means when it asserts that honouring the guarantee was an event rather than a transaction. In the present case, the payments were made by the appellant to Wachovia Bank pursuant to the Forbearance Agreement, of which Fusion Co was the signatory. It is true that the appellant's liability would not have been incurred without the existence of the guarantee that it gave to Wachovia Bank. However, the evidence focused in part on the fact that the appellant did not want the Bank of Nova Scotia to be involved in the repayment of the loan to Wachovia Bank because this could have impaired its future borrowing capacity at that bank. The evidence also disclosed that the appellant and Fusion Co's operations and businesses were closely interrelated.

[29] As a consequence, I conclude that the repayment of the loan to Wachovia Bank was the result of "a piece of . . . commercial business" or "the management of [a] business" in which both the appellant and Fusion Co were involved. Therefore, the repayment of the loan was a transaction involving the appellant, Fusion Co and Wachovia Bank. The reassessment denying the loss arguably incurred on the repayment of the loan was therefore made as a consequence of the transaction

described above. Thus, the Minister was not out of time for the purpose of reassessing pursuant to subparagraph 152(4)(*b*)(iii) of the Act.

II) Disallowance by the Minister of the non-capital loss in 1999

[30] With respect to the deductibility of the amount of $518,000 CND on income account in the 1999 taxation year, the appellant claims that its liability to the Wachovia Bank was no longer contingent, as the bank had called for payment under the guarantee. Mr. Ball's testimony was that he treated that liability as an actual liability in 1999. The decision to do so was based on discussions he had had with the owners and directors of the appellant and on the letter sent to Fusion Co by Wachovia Bank on April 6, 1999 (Exhibit A-2). I tend to agree with counsel for the respondent that the above-mentioned letter is not a demand for payment. Indeed, that letter is no different from the other extensions that had been granted by Wachovia Bank to Fusion Co since that company was first given its line of credit in 1995. The letter does not say that the US Bank is making a formal demand for payment. On the contrary, it says that the US Bank is pleased to offer Fusion Co a revolving line of credit for an amount up to $350,000 US. One difference is that the purpose of the borrowing is stated to be the utilization of the funds as short-term working capital, while the original letter in 1995 said that the funds were to be used for general working capital purposes. The collateral requirement in both the April 6, 1999 letter and the 1995 letter is drafted in almost the same terms, the difference being that the former states that the letter of guarantee issued by the Bank of Nova Scotia must be for an amount not less than $350,000 US in form and substance acceptable to the US Bank and that it is to expire on or after January 31, 2000.

[31] In my view, the April 6, 1999 letter does not constitute by itself a formal demand for repayment. However, Mr. Timothy Shaw, as president of Fusion Co, testified that he clearly understood from his discussion with Mr. Mande of Wachovia Bank that Wachovia Bank wanted to be repaid. He said that a consultant was sent at the end of the summer of 1999 by his parents to negotiate the repayment of the loan. They felt nervous and took seriously Mr. Mande's warning given in April 1999 over the phone. Finally, an agreement was reached in December 1999. Mr. Ball testified that he prepared the financial statements for the year ended September 30, 1999 at the beginning of the 2000 calendar year. At the time, the Forbearance Agreement was in place and the appellant had started to repay the loan. Although that agreement and the repayment of the loan occurred after the 1999 fiscal year end, I am prepared to accept that there was a serious concern before September 30, 1999 that Wachovia Bank was about to exercise its rights under the letter of guarantee from the Bank of Nova Scotia. In that sense, the liability toward Wachovia Bank was no longer contingent

but had become real for the appellant and had to be declared as an actual liability in 1999, not only under proper accounting principles but also from a legal point of view. It became a legally enforceable claim that could be executed at any time by the US Bank as the loan was payable "at expiration or on demand, whichever [was] earlier" (Exhibit A-2). Further, I am of the view that before the end of the 1999 fiscal year, the appellant no longer had any reason to believe that execution of the guarantee would not occur. The appellant had to face that fact, and by negotiating the Forbearance Agreement it only gained a little time. In *Canada v. McLarty*, 2008 SCC 26, at paragraphs 17 and 18, the Supreme Court of Canada referred to the well-accepted test for contingent liability as described in *Winter v. Inland Revenue Commissioners,* [1963] A.C. 235 (H.L.) at page 262. Among other things, the Supreme Court of Canada summarized as follows the test for determining whether a liability is contingent:

> The focus is therefore on two particular types of uncertainty: (1) whether an event may or may not occur; and (2) whether a liability depends for its existence upon whether that event may or may not happen.
>
> . . .
>
> The test is simply whether a legal obligation comes into existence at a point in time or whether it will not come into existence until the occurrence of an event which may never occur.

[32] In the present case, the appellant has satisfied me that by the end of the 1999 taxation year its liability under the guarantee became a real legal obligation enforceable at any time and therefore came into existence in that same 1999 taxation year.

[33] The issue now is whether it was capital in nature or whether it could be claimed as a current expense. The question to be asked is what exactly was the raison d'être of the payments.

[34] In *M.N.R. v. Steer*, [1967] S.C.R. 34, it was held that a guarantee with respect to a company's indebtedness given to a bank by a taxpayer in consideration of shares in the company was to be treated as a deferred loan to the company and that monies paid to discharge that indebtedness were to be treated as a capital loss. As a general rule, where, in substance, a loan is made for the purpose of providing working capital to a corporation, any loss which may result is a capital loss (see *Stewart & Morrison Ltd. v. M.N.R.,* [1972] C.T.C. 73, 72 DTC 6049 (S.C.C.), a case in which cash advances to an American subsidiary were treated as loans on the books and were

found to have provided working capital to enable the subsidiary to get started and to continue to operate).

[35] In the present case, the appellant gave a guarantee to the bank for the indebtedness of its sister corporation in consideration of loan guarantee fees (as per Exhibit A-4). The loan was given for working capital purposes and thus was on capital account. There are, however, exceptions to this principle. These were addressed by the Federal Court of Appeal in *Easton v. Canada*, [1998] 2 F.C. 44, [1997] F.C.J. No 1282 (QL), 1997 CarswellNat 2656.

[36] If payment under the guarantee is made for income producing purposes related to the taxpayer's own business and not that of the corporation for which it repays the loan, then the expense may be treated as being on income account. The example was given in *Easton* of the situation in *L. Berman & Co. Ltd. v. M.N.R.*, [1961] C.T.C. 237 (Ex. Court). In that case, the corporate taxpayer made voluntary payments to the suppliers of its subsidiary for the purpose of protecting its own goodwill. The subsidiary had defaulted on its obligations; the taxpayer had been doing business with those suppliers and wished to continue doing so in the future.

[37] In a more recent case in this Court, *Valiant Cleaning Technology Inc. v. The Queen*, 2008 TCC 637, cash advances were made by Valiant to its non-resident subsidiary that was experiencing some financial difficulties. The Court came to the conclusion that Valiant had made a business decision to make these advances with a global view to the expansion of its services to a wider band of customers. Campbell J. concluded that the expenditures were made for the purpose of protecting the revenue stream of the Canadian operation.

[38] In my view, there is a distinction to be made with respect to the *Berman* and the *Valiant* cases. In both, there was a voluntary decision by the taxpayer corporation to make payments (either to suppliers or to a subsidiary) with a view to protecting the existing goodwill in the first case or expanding services to a wider band of customers in the second case.

[39] Here, on the other hand, the monthly payments were the result of negotiations with the US Bank, to which money was owed by Fusion Co, and the agreement of the bank (the lender) to spread the repayment of the loan over an extended period of time. Had Wachovia Bank not threatened to avail itself of the guarantee from the Bank of Nova Scotia, it is doubtful that the appellant would have paid off the loan, or at least it does not emerge from the evidence that it would have. The appellant has not satisfied me that the real purpose of the payments to Wachovia Bank, or their

raison d'être, was to secure its stream of income. The decision to make those payments was not a calculated business decision that was made from a business perspective and based on a common sense approach as was the case in *Valiant*. Although I recognize that the businesses of the appellant and Fusion Co can be seen as interrelated, the payments for which the loss is claimed are not the result of the decision-making process regarding the appellant's business operations. It was a forced payment for which the appellant was liable under the letter of guarantee, and it had no choice but to repay the loan. The guarantee was at the very outset given to the US Bank for the purpose of capitalizing Fusion Co's operations. It is a case in which the appellant agreed to finance its sister corporation by giving a guarantee and ended up losing its money. This is the equivalent of a loan and is capital in nature (as was stated in the *Steer* and *Stewart & Morrison* cases, *supra*).

[40] I therefore conclude that the loss was a capital loss and, by virtue of paragraph 18(1)(*b*) of the Act, could not be deducted from income for the 1999 taxation year.

[41] The appellant made no representations in court as to the treatment of the capital loss as regards the 1999 taxation year. It is my understanding, however, from the Notice of Appeal, that the appellant considered the loss to have occurred in that year. The respondent argued that the capital loss was not incurred in 1999 because the payments under the guarantee were not made before 2000. My conclusion is that there was an actual liability in 1999. I also conclude from the evidence that it was quite clear to the appellant in that same 1999 taxation year that Fusion Co had defaulted on its debt and would not repay the appellant. The capital loss should therefore, in my view, be considered as being an allowable capital loss in the 1999 taxation year pursuant to paragraphs 38(*b*), 39(1)(*b*) and 50(1)(*a*) of the Act. It is my understanding, however, from counsel for the appellant's brief comments in court on the issue of costs, that a capital loss in the 1999 taxation year has no impact on the reassessment for that year. That capital loss may be deducted against capital gains, if any, in other years, in accordance with the relevant provisions of the Act.

[42] The appeal against the reassessment dated October 26, 2005 is therefore dismissed.

Costs

[43] The respondent pointed out to the Court that three settlement offers had been made to the appellant. Two of these were exactly the same, but were made at different points in time before the hearing. They were offers to treat the loss as a

capital loss for the 2002 taxation year. The respondent's last offer, made on the eve of the trial, was to recognize the capital loss in the 2001 taxation year.

[44] Considering my conclusion herein, I hold that the respondent shall be awarded her costs in accordance with Tariff B of the *Tax Court of Canada Rules (General Procedure)*, and nothing more.

Signed at Ottawa, Canada, this 4th day of November 2009.

"Lucie Lamarre"

Lamarre J.

CITATION:	2009 TCC 538
COURT FILE NO.:	2007-2303(IT)G
STYLE OF CAUSE:	SHAW-ALMEX INDUSTRIES LIMITED v. HER MAJESTY THE QUEEN
PLACE OF HEARING:	Toronto, Ontario
DATE OF HEARING:	September 17 and 18, 2009
REASONS FOR JUDGMENT BY:	The Honourable Justice Lucie Lamarre
DATE OF JUDGMENT:	November 4, 2009

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