

BETWEEN:

TAPIO PAAJANEN,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on common evidence with *Monique Paajanen*
(2010-1639(IT)I) on June 8, 2011 at Sudbury, Ontario
By: The Honourable Justice Judith Woods

Appearances:

Agent for the Appellant: Robert D. Topp
Counsel for the Respondent: Ashleigh Akalehiywot

JUDGMENT

The appeal with respect to assessments made under the *Income Tax Act* for the 2004 and 2005 taxation years is allowed, and the assessments are referred back to the Minister of National Revenue for reconsideration and reassessment on basis that the income of Monique Paajanen from a partnership was \$754 for the 2004 taxation year and \$2,888 for the 2005 taxation year.

The appellant is entitled to his costs, if any.

Signed at Toronto, Ontario this 21st day of June 2011.

“J. M. Woods”

Woods J.

BETWEEN:

MONIQUE PAAJANEN,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on common evidence with *Tapio Paajanen*
(2010-1638(IT)I) on June 8, 2011 at Sudbury, Ontario
By: The Honourable Justice Judith Woods

Appearances:

Agent for the Appellant: Robert D. Topp
Counsel for the Respondent: Ashleigh Akalehiywot

JUDGMENT

The appeal with respect to an assessment made under the *Income Tax Act* for the 2004 taxation year is dismissed.

The appeal with respect to an assessment made under the *Act* for the 2005 taxation year is allowed, and the assessment is referred back to the Minister of National Revenue for reconsideration and reassessment on basis that the income of the appellant from a partnership was \$2,888.

The appellant is entitled to her costs, if any.

Signed at Toronto, Ontario this 21st day of June 2011.

“J. M. Woods”

Woods J.

Citation: 2011 TCC 310
Date: 20110621
Dockets: 2010-1638(IT)I
2010-1639(IT)I

BETWEEN:

TAPIO PAAJANEN,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent;

AND BETWEEN:

MONIQUE PAAJANEN,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Woods J.

[1] These are appeals by Monique Paajanen and her husband, Tapio Paajanen, in respect of assessments made under the *Income Tax Act* for the 2004 and 2005 taxation years.

[2] There is only one issue to be determined and that is the amount of Mrs. Paajanen's income from a business that she operated in partnership with her sister, Danielle Audet.

[3] The respondent submits that the sisters did not share income on a reasonable basis in the relevant taxation years, and that Mrs. Paajanen's share of the income should be increased pursuant to subsection 103(1.1) of the *Act*. For the 2004 taxation year, it is submitted that Mrs. Paajanen's share should be increased from \$754 (6.5 percent) to \$5,803 (50 percent). For the 2005 taxation year, it is submitted that her share should be increased from \$2,888 (15 percent) to \$9,627 (50 percent).

[4] The issue is relevant not only for Mrs. Paajanen but also for her husband because his entitlement to a personal credit under paragraph 118(1)(a) of the *Act* is affected by the amount of his wife's income.

[5] The respondent raised a preliminary objection regarding the appeal for Mrs. Paajanen's 2004 taxation year. It was submitted that this appeal should be quashed because it dealt with a nil assessment. Mrs. Paajanen's counsel did not object to this as long as it did not affect Mr. Paajanen's appeal for the 2004 taxation year. After some discussion, counsel for the respondent agreed with this position.

[6] The factual findings below are based on the evidence presented at the hearing and the pleadings. In this regard, many of the facts set out in the notice of appeal were not challenged at the hearing and I have accepted them.

Factual background

[7] In 1996, Mrs. Paajanen and her sister, Mrs. Audet, decided to commence a retail business in partnership. The nature of the business is evident from its name, the Barnyard Birder Nature Shop.

[8] The circumstances which led to the formation of the partnership are sympathetic. Mrs. Audet's husband had died in 1995 and she was left with very few financial resources and two young children to raise. Mrs. Paajanen wished to help her sister with a potential source of income by building a business in partnership.

[9] It appears that the business did not earn a significant profit in its early years.

[10] The following chart summarizes the income allocated to each of the partners as well as I can determine from the notice of appeal. I would also note that most of the income shown as being allocated to Mrs. Audet (Partner 2) prior to the taxation years at issue was accounted for as wages but I do not think that this is material.

Year	Total	Allocation	Allocation
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	Income	Partner 1	Partner 2
1999	\$11,178	\$4,339	\$6,839
2000	5,574	459	5,114
2001	4,855	427	4,427
2002	4,090	45	4,045
2003	2,722	361	2,361
2004	11,606	754	10,852
2005	19,253	2,888	16,365

[11] The notice of appeal also indicated that partner drawings always exceeded income until 2005 and that the allocations to partners generally reflected cash distributions.

[12] In most years, the vast majority of the income was received by Mrs. Audet. I accept the evidence of Mrs. Paajanen that she agreed to this because her sister was in difficult financial circumstances. Mrs. Paajanen agreed to limit her own cash withdrawals in order that the business would be viable in the long run.

[13] The income allocated to Mrs. Paajanen in the 2004 and 2005 taxation years represented 6.5 percent and 15 percent, respectively, of the total partnership income.

[14] As I understand it, the business has become quite successful and the partners now share income equally.

[15] There is no written partnership agreement. The income allocations represent an oral agreement between the partners.

Analysis

[16] Subsection 103(1.1) of the *Act* requires that a partner's share of income be adjusted if the partner has agreed to share income with a non-arm's length person on a basis that is not reasonable. The provision reads:

103(1.1) Where two or more members of a partnership who are not dealing with each other at arm's length agree to share any income or loss of the partnership or any other amount in respect of any activity of the partnership that is relevant to the computation of the income or taxable income of those members and the share of any such member of that income, loss or other amount is not reasonable in the circumstances having regard to the capital invested in or work performed for the partnership by the members thereof or such other factors as may be relevant, that share shall, notwithstanding any agreement, be deemed to be the amount that is reasonable in the circumstances.

[17] It is submitted by the respondent that the allocations agreed to by the partners, 6.5 and 15 percent, are not reasonable given that the sisters' contributions to the partnership were relatively equal. It is submitted that a 50-50 income allocation is more reasonable.

[18] As mentioned above, this would result in an increase in income from \$754 to \$5,803 in the 2004 taxation year and from \$2,888 to \$9,627 in the 2005 taxation year.

[19] Counsel for the respondent referred in support to decisions of this Court which have suggested that allocations between non-arm's length partners should be based only on business-related criteria such as work performed and capital invested: *Fillion v The Queen*, 2004 DTC 2667; *Zalesky v The Queen*, [2000] 4 CTC 2126; *Spencer v The Queen*, [2003] 4 CTC 2679; *Archbold v The Queen*, [1995] CTC 2872, para 9.

[20] A business approach to allocations makes sense in the cases above because they all involved close family members representing one economic unit, such as a spouse or children, and tax planning appeared to be a key factor in the allocations.

[21] However, it would be wrong in my view to state as a general principle that allocations between non-arm's length partners must always be based solely on business-related criteria.

[22] First, I would note that subsection 103(1.1) is not drafted in such a narrow manner. Although it specifically mentions business-related criteria, it goes on to include any "relevant" factor. This suggests that Parliament did not want to limit the types of factors that should be taken into account.

[23] Second, in considering whether an allocation agreed to by partners is reasonable, it should be borne in mind that subsection 103(1.1) is an anti-avoidance provision. Terms such as "reasonable" and "such other factors as may be relevant" should be interpreted with this purpose in mind. A few years ago, I took a similar approach in interpreting subsection 55(2), another anti-avoidance provision, in *729658 Alberta Ltd. v The Queen*, 2004 DTC 2909.

[24] In this case, the agreement between Mrs. Paajanen and Mrs. Audet to share income unequally was not at all motivated by tax considerations. There was a modest tax saving to Mr. Paajanen with respect to personal credits, about \$1,000 per year. It does not make sense that this factor influenced the partners' agreement to share

income unequally. I accept the evidence of Mrs. Paajanen and her accountant that the allocations had nothing to do with tax.

[25] In this particular case, it is reasonable in my view for the partners to agree to share income based on the actual cash distributions to each partner. The appeals will be allowed, except for Mrs. Paajanen's appeal for the 2004 taxation year.

[26] The appellants shall be entitled to their costs, if any.

Signed at Toronto, Ontario this 21st day of June 2011.

“J. M. Woods”

Woods J.

CITATION: 2011 TCC 310

COURT FILE NOS.: 2010-1638(IT)I
2010-1639(IT)I

STYLES OF CAUSE: TAPIO PAAJANEN v. HER MAJESTY
THE QUEEN and MONIQUE PAAJANEN
v. HER MAJESTY THE QUEEN

PLACE OF HEARING: Sudbury, Ontario

DATE OF HEARING: June 8, 2011

REASONS FOR JUDGMENT BY: Hon. J.M. Woods

DATE OF JUDGMENTS: June 21, 2011

APPEARANCES:

Agent for the Appellants: Robert D. Topp

Counsel for the Respondent: Ashleigh Akalehiywot

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