Docket: 2007-4218(IT)G

BETWEEN:

LES GESTIONS PIERRE ST-CYR INC.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

[OFFICIAL ENGLISH TRANSLATION]

Appeal heard on December 17, 2009, at Québec, Quebec.

Before: The Honourable Justice François Angers

Appearances:

Counsel for the Appellant:	Bernard Gaudreau and Sébastien Gingras
Counsel for the Respondent:	Marie-Claude Landry

JUDGMENT

The appeals from the reassessments made under the *Income Tax Act* for the taxation years ended September 30, 2002 and 2003, are dismissed, with costs, in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 21st day of April 2010.

"François Angers"

Angers J.

Translation certified true
on this 1st day of June 2010.

François Brunet, Revisor

Citation: 2010 TCC 146
Date: 20100421
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BETWEEN:

LES GESTIONS PIERRE ST-CYR INC.,

Appellant,

and

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AMENDED REASONS FOR JUDGMENT

Angers J.

[1] This is an appeal from the reassessments made on July 20, 2005, and confirmed on July 5, 2007, for the taxation years ended September 30, 2002 and 2003. The Minister of National Revenue ("the Minister") disallowed the amounts of $29,602 and $41,273, respectively, deducted by the Appellant as current expenditures for those taxation years.

[2] In making these reassessments, the Respondent also determined that an amount of $58,350, consisting of $28,106 paid in the years prior to 2002 and $30,244 paid in 2002 for the acquisition of remote monitoring service contracts in 2003, constituted eligible capital expenditures as defined in subsection 14(5) of the *Income Tax Act* ("the Act").

[3] Accordingly, under paragraph 20(1)(*b*) of the Act, the Respondent allowed additional deductions of $3,053 for the taxation year ended September 30, 2002, and $9,110 for the taxation year ended September 30, 2003, as a cumulative eligible capital amount.

[4] The issue here is therefore whether the purchases of remote monitoring contracts made by the Appellant during its fiscal years ended September 30, 2002 and 2003, constituted capital or current expenditures.

[5] The Appellant's commercial activities began in 1973. It installed, repaired and maintained alarm systems. In 1981 it began operating an alarm communications centre to receive remote signals. Having diversified its business, it ceased selling, installing and maintaining alarm systems in 1996 to concentrate solely on operating an alarm systems monitoring centre.

[6] At that time, the Appellant's customers had contracts either with the Appellant or with alarm system installers which the Appellant invoiced directly. According to the Appellant's president, the alarm system industry has four sectors: sales, installation, services and monitoring. The Appellant operates a monitoring business.

[7] Thus, the Appellant had its own customers which it invoiced directly and also had installers which it invoiced for the monitoring service it provided to the installers' customers. Between 1998 and 2003, the Appellant acquired a dozen of its installers, which, according to its president, enabled the Appellant to protect its source of revenue by becoming a party to the monitoring service contracts of the installers' customers.

[8] According to the Appellant's CEO, the term of the monitoring contracts ranged from one year to five years but averaged roughly 36 months. Approximately 12% of contracts were cancelled owing to circumstances such as people moving, couples separating, etc. According to the industry, the purchase price of contracts with customers is between 18 and 24 times the monthly fee they are billed.

[9] Altogether, the Appellant bought some 1,300 contracts with installers' customers and now deals directly with the installers' former customers. According to the evidence, approximately 60 of those customers were not connected to the Appellant's monitoring centre. The Appellant therefore acquired 60 new customers.

[10] Eight contracts covering the period from October 28, 1998, to March 12, 2003, were filed in evidence. Each of those contracts provides for the sale of the service contracts and all files of customers connected to the Quebec alarm monitoring centre or to any other monitoring centre belonging to the vendor's business. Certain contracts stipulate that the Appellant has the right to use the vendor's business name. One contract in particular stipulates in its preamble that the vendor sells its business line. Another contract provides for the sale of the [TRANSLATION] "customer base", goodwill, all customer files, the telephone numbers of the vendor's business, the cellular telephone, business name – in short, the entire business.

[11] All of the contracts contain a non-compete clause with terms and conditions that vary from one contract to another, as does the amount of the penalty in the event of a breach of the undertaking by the vendor. The purchase price represents between 18 and 22 times the recurring monthly revenue.

[12] The statutory provisions relevant to this case are found in sections 18 and 20 of the Act. Paragraph 18(1)(*a*) provides that an outlay or expense is deductible only to the extent that it was made or incurred to derive income from a business or property. Paragraph 18(1)(*b*) specifies that capital outlays are not deductible except as permitted by the Act.

> **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;

[13] Through paragraph 18(1)(*b*), therefore, paragraphs 20(1)(*a*) and (*b*) allow a capital outlay to be deducted in respect of depreciation.

> 20.(1) **Deductions permitted in computing income from business or property** – Notwithstanding paragraphs 18(1)(*a*), 18(1)(*b*) and 18(1)(*h*), in computing a taxpayer's income for a taxation year from a business or property, there may be deducted such of the following amounts as are wholly applicable to that source or such part of the following amounts as may reasonably be regarded as applicable thereto
>
> (*a*) **Capital cost of property [CCA] –** such part of the capital cost to the taxpayer of property, or such amount in respect of the capital cost to the taxpayer of property, if any, as is allowed by regulation;
>
> (*b*) **Cumulative eligible capital amount** – such amount as the taxpayer claims in respect of a business, not exceeding 7% of the taxpayer's cumulative eligible capital in respect of the business at the end of the year except that, where the year is less than 12 months, the amount allowed as a deduction under this paragraph shall not exceed that proportion of the maximum amount otherwise allowable that the number of days in the taxation year is of 365;

[14] The phrases "current expenditures" and "capital expenditures" are not defined in the Act. One must therefore turn to the case law to see what tests are used to distinguish them. The leading case on this issue is *Canada v. Johns-Manville Canada Inc.*, [1985] 2 S.C.R. 46. Justice Estey, writing for the Court, cited the remarks of Justice Fauteux in *Minister of National Revenue v. Algoma Central Railway*, [1968] S.C.R. 447:

> Parliament did not define the expressions "outlay . . . of capital" or "payment on account of capital". There being no statutory criterion, the application or non-application of these expressions to any particular expenditures must depend upon the facts of the particular case. We do not think that any single test applies in making that determination …

[15] Estey J. drew up a list of factors and tests based on the Canadian, Australian and British case law and wrote as follows:

> There is almost an endless rainbow of expressions used to differentiate between expenditures in the nature of charges against revenue and expenditures which are capital. It has been said that the terminology employed is merely an attempt to identify particular factors which may tilt the scale in a particular case in favour of one or the other conclusions.

[16] He also mentioned the idea expressed by Lord Reid in *Regent Oil Co. v. Strulz* that the weight which must be given to a particular circumstance in a particular case must depend rather on common sense than on strict application of any single legal principle. In his analysis, still relying on the case law, Estey J. added that the characterization of an expenditure can be approached by examining the calculated effect of the expenditure from a practical and business point of view rather than the juristic classification of legal rights.

[17] According to the case law cited in *Johns-Manville*, an expenditure made "once and for all" with "a view to bringing into existence an asset or an advantage for the enduring benefit of a trade" is capital in nature. Moreover, "enduring" does not necessarily mean "permanent" or "perpetual". An outlay "made to meet a continuous demand" is a current expenditure, even if it is not incurred annually.

[18] According to Judge Tremblay of our Court, in *Robert Verrier & Fils Ltée v. M.N.R.*, 92 DTC 2344, the purchase of a customer list is a capital expenditure if made in the context of the purchase of a business. He drew up a list of indicators that the courts have established to help determine the nature of a purchase, and noted:

> . . . The list of these guidelines, tests or indicators is not exhaustive. Moreover, each of them is not necessarily of the same weight. A single test may be of greater significance in one case and lesser in another. Each case must be considered on its merits. In one case, a guideline may be very significant, but in another, because of different circumstances, its probative force may be negligible or it may have weight only because of the existence of other guidelines or indicators.
>
> Indicators or guidelines which support the position that the expense is deductible
>
> 1. When the sole subject-matter of the sale is a list of persons or customers;
> 2. When the purchaser is prohibited from using the vendor's name;
> 3. When the purchaser and the vendor were free to try to acquire customers from the list.
>
> Indicators or guidelines which support the position that it was a capital outlay
>
> 1. When the subject-matter of the sale, in addition to a list of customers, also consists in goodwill;
> 2. When the aim of the transaction is to eliminate a competitor;
> 3. When the transaction includes a covenant not to compete on the part of the vendor;
> 4. When the payments are based on income in the years to come;
> 5. When the price is payable over several years;
> 6. When key employees of the vendor go to work in the purchaser's business;
> 7. When the benefit received is spread over a number of years;
> 8. When the transaction expands the income structure of the purchaser's business.

[19] In *Gifford v. Canada*, [2004] S.C.J. No. 13, the Supreme Court, applying the tests set out in *Johns-Manville*, held that the purchase of a client list was a capital expenditure. Justice Major, writing for a unanimous Court, noted that the purchase expanded Mr. Gifford's client network and secured an enduring benefit. In the opinion of Major J., the purchase of someone else's accumulated goodwill was not the same as the recurring marketing expenses the appellant would have had to incur to create his own goodwill.

[20] The "enduring benefit" test was applied in *Southam Business Publications Limited v. M.N.R.*, 67 DTC 5150, to qualify an expenditure as a capital outlay.

[21] In *Cumberland Investments Limited v. The Queen*, [1975] F.C.J. No. 511, the appellant had agreed to pay $750,000 over a six-year period to purchase the sub-agency accounts of a competitor operating a supervising general insurance agency. The vendor had agreed not to compete with the appellant and had contacted the sub-agents to inform them of the sale and to ask them to cooperate with the appellant.

The appellant submitted that the amount paid represented a current expenditure. It argued that rather than purchasing its competitor's accounts, it could have employed persons to solicit the business of the sub-agents and then deducted that cost as a current expenditure.

[22] Justice Urie of the Federal Court of Appeal did not accept that argument and stated that the determination of the nature of an expenditure is not in any way assisted by reference to a course of action which might have been followed which did not require such a determination. According to Justice Thurlow, the appellant had made a capital outlay in purchasing the list. At paragraph 3, he wrote:

> . . . [W]hat, from the point of view of the appellant, the outlay of $150,000 and the follow-up procedure carried out to establish the necessary relationships with the former MacInnes agents were calculated to achieve was the absorption by the appellant of the supervising insurance agency business of W.R. MacInnes & Co. and at the same time the effective elimination of that concern and its owner as a competitor. The expenditure was thus, in my view, incurred to work an immediate and substantial expansion of the appellant's business and to expand and enhance the goodwill attaching thereto by adding to it as much of the business and goodwill of W.R. MacInnes & Co. as, with the blessing of its owner, Austin E. Hayes, the appellant could retain.

[23] Thurlow J.A. also took note of the following factors and wrote that he did not regard them as leading irresistibly to the conclusion that the expenditure was one of capital, but also that he saw nothing in the facts which would serve to rebut that conclusion:

> . . . To buy out competitors was not a recurring need or constant demand of the appellant's operation of receiving applications and writing insurance. . . . It was a lump sum payable to a competitor to persuade him to yield up his business and goodwill and thus not an ordinary expense incident to the insuring process . . . it was not anticipated that it would be a short lived advantage but must have been expected to be one that would be of enduring benefit to the business.

[24] That said, the courts must apply the tests laid down by the case law while basing their judgment on common sense in the light of the particular circumstances of each case.

[25] The Appellant submits that the expenditures in this case are recurring expenses and are part of the process of operating its business. In my opinion, the facts in this case do not support that submission. Each expenditure, in my view, was made once and for all, since, once they were purchased, these contracts with customers became

the property of the Appellant. The Appellant could not have purchased the same contracts or a business name (contracts 7-A and 7-H) more than once. Furthermore, claiming that the expenditures are an integral part of doing business for the Appellant strikes me as wrong inasmuch as the expenditures were not necessary to the operation of the business because it had some 20,000 customers. The Appellant failed to demonstrate that it could not have continued to operate its business without making the expenditures in issue.

[26] One must not forget that before making the purchases, the Appellant invoiced the installers (vendors) for monitoring services and they in turn billed their customers for a higher amount in order to earn a profit. The price paid by the customers for the monitoring service remained unchanged after the purchases, but the Appellant's gross income increased because those purchases enabled it to invoice the subscribers directly. It also acquired some 60 new customers at the same time. The Appellant submits that its profits did not increase because the rise in administrative costs associated with the new invoicing offset the increase in gross income. However, the Appellant cites no cases to support its contention that it is the profits and not the gross income of a business that must be examined in order to determine whether an expenditure secures an enduring benefit.

[27] The Appellant also submits that the purchase of the contracts with the installers' customers was made to preserve its source of revenue and not to secure an "enduring benefit". In support of its argument, it cites *Pantorama Industries Inc. v. Canada*, [2006] 1 F.C.R. 56, in which the Federal Court of Appeal held that money spent to ensure that a business can continue to be operated profitably is on revenue, not capital, account. However, the evidence in this case does not show that the activities of the business would no longer have been profitable if it had not made the expenditures.

[28] The Appellant argues as well that it would have lost its source of revenue if it had not made those purchases, since the installers could have sold contracts with customers to other remote monitoring businesses. In my opinion, the elimination of potential competitors is an indication that the expenditures secured an enduring benefit for the Appellant. The purchases enabled the Appellant to have direct relationships with 1,300 additional subscribers and to encourage them to renew their contracts with it. The loss of 11% to 13% of its customers as a result of those purchases did not cause the Appellant to lose the enduring benefit it secured. The rate of cancellations among these new customers, according to the evidence, is similar to the rate among the Appellant's subscribers, so that it is difficult to attribute them with certainty to the purchase of those contracts. It is also part of the risk of doing

business. This is therefore not a factor leading to the conclusion that the expenditures did not secure an enduring benefit for the Appellant.

[29] On reading the contracts, it is difficult to conclude that the Appellant's sole aim was to keep its revenue stream at the same level by purchasing the contracts with the customers. In some cases, the vendor's business was bought outright. In others, the contracts refer to goodwill. It is true that the vendors' customers were already connected to the Appellant's monitoring centre and that the Appellant could have approached those customers to encourage them to do business directly with it without buying the contracts, but in four of the contracts it is stipulated that the vendors shall provide the Appellant with all codes used by the technicians to program the control panels that were the object of the purchases. The question then is whether the Appellant, at least in the case of those four contracts, could have dealt directly with the installers' customers. There was, in my opinion, a sale of goodwill.

[30] To protect its revenue source, the Appellant tried to eliminate potential competitors or, at least, ensure that the contracts with customers were not sold to a competitor. That aim supports the view that these were capital expenditures.

[31] I must also take into consideration the fact that the contracts contained non-compete undertakings on the part of the vendors. The clauses of some of these contracts required the vendors not to disclose information concerning customer contracts and files to anyone other than the Appellant, and not to solicit customers who had done business with them for a period of five years. A clause in the contract at tab 7-H is even more restrictive. It stipulates that the vendor shall refrain from participating in any manner whatsoever in a business of the same nature as the purchaser's for a period of five years in the Mauricie-Bois-Francs region. These clauses also support the proposition that the expenditures were capital in nature.

[32] Lastly, the value of the contracts is based on revenues in the coming years, which are calculated by multiplying by between 18 and 22 the monthly fees billed to customers who renew their monitoring contracts with the Appellant.

[33] For all these reasons, I find that the outlays were capital expenditures and that the Minister correctly disallowed the amounts deducted by the Appellant as current expenditures and correctly determined that the amounts for the years prior to 2002 and for the taxation years ended September 30, 2002, and September 30, 2003, were paid by the Appellant to acquire remote monitoring service contracts and constituted "eligible capital expenditures" as defined in subsection 14(5) of the Act.

[34] The appeals are dismissed, with costs.

Signed at Ottawa, Canada, this 21st day of April 2010.

"François Angers"

Angers J.

Translation certified true
on this 1st day of June 2010.

François Brunet, Revisor

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APPEARANCES:

Counsel for the Appellant:	Bernard Gaudreau and Sébastien Gingras
Counsel for the Respondent:	Marie-Claude Landry

COUNSEL OF RECORD:

For the Appellant:

Names:	Bernard Gaudreau and Sébastien Gingras
Firm:	Ogilvy Renault Québec, Quebec

For the Respondent:	Myles J. Kirvan Deputy Attorney General of Canada Ottawa, Canada