S & C Ross Enterprises Ltd. v. The Queen

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Judges and Taxing Officers: Gordon Teskey
Subjects: Income Tax Act

Date: 20020913

Docket: 1999-4601-IT-G

BETWEEN:

S & C ROSS ENTERPRISES LTD.,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Reasons for Judgment

Teskey, J.

[1] The Appellant S & C Ross Enterprises Ltd. ("Enterprises") appeals its reassessment of income tax for the taxation years 1992, 1993 and 1994 wherein the Minister of National Revenue (the "Minister") disallowed the Appellant's claim for the small business deduction in each of the years and also disallowed the deduction of certain expenses pursuant to paragraph 18(1)(*p*) of the *Income Tax Act* (the "*Act*").

Issue

[2] The issue before the Court is whether the business of Enterprises in providing services to Clearly Canadian Beverage Corporation ("Clearly Canadian") is a personal services business, as defined in section 125(7) of the *Act*. If Enterprises is found to be a personal services business, then it is not entitled to the small business deduction and the expenses to earn the income are disallowed by the provisions of paragraph 18(1)(*p*).

[3] Section 125(7) is a definition section and defines "Active Business" as:

"active business carried on by a corporation" means any business carried on by the corporation other than a specified investment business or a personal services business and includes an adventure or concern in the nature of trade;

and it also defines "Personal Services Business" as:

"personal services business" carried on by a corporation in a taxation year means a business of providing services where

(*a*) an individual who performs services on behalf of the corporation (in this definition and paragraph 18(1)(*p*) referred to as an "incorporated employee"), or

(*b*) any person related to the incorporated employee is a specified shareholder of the corporation and the incorporated employee would reasonably be regarded as an officer or employee of the person or partnership to whom or to which the services were provided but for the existence of the corporation, unless

(*c*) the corporation employs in the business throughout the year more than five full-time employees, or

(*d*) the amount paid or payable to the corporation in the year for the services is received or receivable by it from a corporation with which it was associated in the year;

[4] Paragraph 18(1)(*p*) sets out the limitation re personal services business expenses and reads:

(*p*) Limitation re personal services business expenses - an outlay or expense to the extent that it was made or incurred by a corporation in a taxation year for the purpose of gaining or producing income from a personal services business, other than

(i) the salary, wages or other remuneration paid in the year to an incorporated employee of the corporation,

(ii) the cost to the corporation of any benefit or allowance provided to an incorporated employee in the year,

(iii) any amount expended by the corporation in connection with the selling of property or the negotiating of contracts by the corporation if the amount would have been deductible in computing the income of an incorporated employee for a taxation year from an office or employment if the amount had been expended by the incorporated employee under a contract of employment that required him to pay the amount, and

(iv) any amount paid by the corporation in the year as or on account of legal expenses incurred by it in collecting amounts owing to it on account of services rendered

that would, if the income of the corporation were from a business other than a personal services business, be deductible in computing its income;

[5] Stuart Ross ("Ross") is the sole owner and officer of Enterprises.

[6] It is common ground that:

(a) at all material times Ross was a "specified shareholder" of the Appellant within the meaning of that term in subsection 248(1) of the *Act*;

(b) Enterprises did not employ more than five full-time employees during the years under appeal;

(c) Ross performed services (the "Services") on behalf of Enterprises for Clearly Canadian;

(d) Enterprises and Clearly Canadian were not associated during the years under appeal;

(e) during the years under appeal Ross was a director and the Executive Vice-President of Clearly Canadian;

[7] This appeal is the third appeal before this Court wherein the Minister alleged that a corporation dealing with Clearly Canadian was a personal services corporation. The first two are: *Criterion Capital Corporation v. The Queen,* 2001 DTC 921 ("*Criterion*") and *Bruce E. Morley Law Corporation v. The Queen* 2002 DTC 1547 ("*Morley*").

[8] The appeal by *Criterion* was allowed and my colleague O'Connor J. found that *Criterion* was not a personal services corporation.

[9] The appeal by *Morley* was dismissed by my colleague Hershfield J. as he found *Morley* to be a personal services corporation.

[10] I recommend the readers of these reasons to pause here and read both of these reasons for judgment.

[11] I agree with the result of both of these appeals and do not find them in conflict.

[12] Whether a corporation is a personal services business or not is one of fact and the facts in *Criterion* are quite different from *Morley*.

Facts

[13] Ross completed high school in 1962 and had various professional jobs up to 1969. In 1969, he enrolled in a Certified General Accounting program. He completed four of the required five years.

[14] From 1969 onward, Ross had a series of professional jobs. Each one progressively required a higher degree of skill.

[15] During the period of 1969 to 1986, Ross became a highly skilled professional able to perform all the usual functions of a Chief Financial Officer for various companies together with a sound knowledge of what is required generally to take a private corporation and turn it into a public corporation with an initial public offering of stock. He has learned how to evaluate potential purchases of not only land and assets but also operating companies. As of 1986, he now would make a very valuable employee for any company and be a very valuable consultant for any company.

[16] In 1986, he along with Bruce Horton ("Horton") and Douglas Mason ("Mason") started up a new company to manufacture and distribute under a license agreement a high caffeine Cola called ("Jolt").

[17] In 1987, Mason brought forth a new idea of selling changed water in a distinctive purple bottle, the product to be called "Clearly Canadian".

[18] Within the year it became obvious that the product was a winner, the "Jolt" franchise was dropped and the Corporation changed its name to Clearly Canadian.

[19] The Clearly Canadian sales for the five-year period starting in 1988 demonstrated unbelievable growth. They are:

YEAR	**SALES**
1988	$2 million
1989	$8 million
1990	$10 million

1991	$120 million
1992	$187 million

[20] In 1989, Clearly Canadian, who had been using outside consultants for certain services, decided that it could receive just as good consulting advice from their own three main personnel, that is Horton, Mason and Ross.

[21] Horton, Mason and Ross, each in 1989, incorporated their respective consulting companies and signed contracts for consulting services with Clearly Canadian.

[22] The uncontradicted testimony of both Ross and Mason was to the effect that the wages Ross received from Clearly Canadian was to run the Company on a day-to-day basis and that the consulting fees paid to Enterprises fell into exactly the same category as the fees to Criterion, that is they were for out of the ordinary duties and were for services that normally consultants would be hired to perform.

[23] By having these three people Horton, Mason and Ross who ran Clearly Canadian also do this extraordinary and technical work, it saved a great deal of time as they were always up to speed and thus saved a great deal of money.

[24] The skyrocketing of the sales required acquisitions, distribution, partners, multiple financing packages and patents. The effort put out by these three to keep up with the tiger was extraordinary.

[25] Enterprises was particularly doing the due diligence work as well as analyzing financial statements to compare with Clearly Canadian to see if the proposed acquisition was viable. The services provided by Enterprises were distinct and separate from the duties Ross performed as a director employee.

[26] Ross' job as an employee of Clearly Canadian was to oversee the production of its financial statements, keep tabs on the receivables and payables and to make sure the general ledger was posted correctly. He managed the day-to-day financial operation of Clearly Canadian. He also supervised the support staff under him.

[27] Enterprises had, over the period, several other contracts for consulting work and was paid by stock option, some of which became very valuable. It also owned property in Arizona which it managed.

[28] I find that for all intent and purposes the facts before me regarding Enterprises are almost identical to the facts in the Criterion appeal.

[29] The evidence demonstrates that the activities of President and Executive Vice-President do not involve due diligence investigations or any of the other types of activities described in the 1994 management agreement.

The Pertinent Law

[30] McLachlin, J. of the Supreme Court of Canada, as she then was, said in *Shell Canada Limited v. The Queen et al.*, 99 DTC 5669 in paragraph 39:

[39] This Court has repeatedly held that courts must be sensitive to the economic realities of a particular transaction, rather than being bound to what first appears to be its legal form: *Bronfman Trust, supra*, at pp. 52-53, *per* Dickson, C.J.; *Tennant*, *supra*, at para. 26, *per* Iacobucci, J. But there are at least two caveats to this rule. First, this Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer's *bona fide* legal relationships. To the contrary, we have held that, absent a specific provision of the *Act* to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases. Recharacterization is only permissible if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect: *Continental Bank Leasing Corp. v. Canada* [98 DTC 6505], [1998] 2 S.C.R. 298, at para. 21, *per* Bastarache, J.

[31] In order for the Appellant to be successful, I must find that he was an independent contractor and not an employee.

[32] This issue was dealt with by the Supreme Court of Canada in *671122 Ontario Ltd. v. Sagaz Industries Canada Inc.*, [2001] 2 S.C.R. Although this was a vicarious liability case, the Court dealt with the employee issue at length. Major J., for the Court, dealing at length with MacGuigan J.A.'s decision of *Wiebe Door Services Ltd. v. M.N.R.,* 87 DTC 5025, said at paragraphs 46, 47 and 48:

46. In my opinion, there is no one conclusive test which can be universally applied to determine whether a person is an employee or an independent contractor. Lord Denning stated in *Stevenson Jordan, supra*, that it may be impossible to give a precise definition of the distinction (p. 111) and, similarly, Fleming observed that "no single test seems to yield an invariably clear and acceptable answer to the many variables of every changing employment relations . . ." (p. 416). Further, I agree with MacGuigan J.A. in *Wiebe Door*, at 563, citing *Atiyah*, *supra*, at p. 38, that what must always occur is a search for the total relationship of the parties:

It is exceedingly doubtful whether the search for a formula in the nature of a single test for identifying a contract of service any longer serves a useful purpose. ... The most that can profitably be done is to examine all the possible factors which have been referred to in these cases as bearing on the nature of the relationship between the parties concerned. Clearly not all of these factors will be relevant in all cases, or have the same weight in all cases. Equally clearly no magic formula can be propounded for determining which factors should, in any given case, be treated as the determining ones.

47. Although there is no universal test to determine whether a person is an employee or an independent contractor, I agree with MacGuigan J.A. that a persuasive approach to the issue is that taken by Cooke J. *Market Investigations, supra*. The central question is whether the person who has been engaged to perform the services is performing them as a person in business on his own account. In making this determination the level of control the employer has over the worker's activities will always be a factor. However, other factors to consider include whether the worker provides his or her own equipment, whether the worker hires his or her own helpers, the degree of financial risk taken by the worker, the degree of responsibility investment and management held by the worker, and the worker's opportunity for profit in the performance of his or her tasks.

48. It bears repeating that the above factors constitute a non-exhaustive list, and there is no set format as to their application. The relative weight of each will depend on the particular facts and circumstances in the case.

[33] In regards to *Wiebe Door, supra,* it has been produced so often it is of no value to set out passages therefrom.

[34] The Federal Court of Appeal on May 21 of this year in *Precision Gutters Ltd. v. M.N.R.*, 2002 FCA 207, again visited this question. Therein, Isaac J., after referring to the above decision, stated the central question is whether the person who has been engaged to perform services is performing them as a person in business on his own account. He then went on to examine four factors set out in *Wiebe Door*, that is control, ownership of tools, chance of profit or risk of loss.

[35] A week later the Federal Court of Appeal in *Meredith v. The Queen*, 2002 FCA 258 stated that lifting the corporate veil is contrary to long established principles of corporate law.

[36] The Court also went on to say that the well-established principle that a corporation has its own judicial identity distinct from its shareholders and that this principle applies equally to closely held corporations.

[37] Dealing with employee, the Court said at paragraph 15: *..."The importance lies in the corporation's legal power to control the employees, not whether the employees feel subject to that control...*".

[38] The Court went on and said that it was irrelevant that the Appellant was the sole shareholder and director of the Corporation.

Dealing with the four factors

Control

[39] Clearly Canadian exerted no control over Enterprises and had no right to do so.

Business Tools & Equipment

[40] Enterprises rented at its own expense the necessary business tools from Clearly Canadian, an agreement made with the board of Directors.

Risk of Loss

[41] Operating Costs. The risk of loss is a limited issue for Enterprises. In order to be in a position to provide services to Clearly Canadian and to its other clients, Enterprises incurred its operating costs as confirmed by the financial statements. These are expenses that are not incurred by a person in an employer-employee relationship. These expenses create a risk of loss.

Negligence Claims

[42] Enterprises may make an error in analyzing a new business or financial opportunity for Clearly Canadian. If Clearly Canadian or another client relies on the recommendation and suffers a loss, Enterprises as an independent contractor, may be liable for professional negligence. The loss could be very significant as the transactions involve millions of dollars. This is a risk not typically faced by an employee. The indemnity and insurance provisions in the Management Agreement (which provide that Enterprises is a name insured on Clearly Canadian policies) provide coverage on claims by third parties but there is no limitation on claims that Clearly Canadian was entitled to make. The most likely person to make a claim for negligence against a person providing professional services will be his own client. Enterprises also faced the risks of claims from its other clients.

Effect of Retainer

[43] Risk of loss is not avoided because a person is paid on a retainer basis. There are provisions in the Management Agreement, which would allow it to terminate. In any event, a person who has been operating a successful business for an extended period of time should be in a position where revenues will exceed expenses and a loss is only likely to occur as a result of negligence on a major transaction or an unexpected event (e.g. heart attack).

Chance of Profit

[44] Enterprises is free to offer its services to clients other than Clearly Canadian and the evidence indicates that it does in fact do so. It has resulted in revenue. For services performed during 1992 to 1994 taxation years, Ross stated that the compensation from other clients was limited to stock options. As Enterprises clients are often public companies with limited financial resources, this is a common form of compensation. They have a real value (Enterprises had no wish to work for free) but the compensation was not realized until later years when the options are exercised. Ross's evidence was that Enterprises has in subsequent taxation years, earned significant income from exercising stock options. Later years have also resulted in cash payments for Enterprises consulting services - Lasik Vision (1996) and Lake City Casinos (1998).

Conclusion

[45] Notwithstanding that I do not consider there is any significant differences between this appeal and that of *Criterion, supra,* and that I agree with the reasoning of my colleague O'Connor J. even if that case had not been heard or decided based on the evidence before me, which was uncontested, I find that Enterprises was an independent contractor of Clearly Canadian.

[46] I also find that Enterprises is **not** a personal services corporation and therefore it was entitled to the small business deduction and to deduct from income the expenses for producing the income.

[47] The parties agreed that should I find for the Appellant, then it is entitled to deduct from income expenses in the amount of $87,435.

[48] The appeal is allowed with costs and the assessment is referred back to the Minister for reassessment and reconsideration on the basis that the services provided by the Appellant to Clearly Canadian Beverage Corporation did **not** constitute personal services business and therefore the Appellant is entitled to the small business deduction and is entitled to deduct from income expenses in the amount of $87,435.

Signed at Ottawa, Canada, this 13th day of September, 2002.

"Gordon Teskey"

J.T.C.C.

COURT FILE NO.: 1999-4601(IT)G

STYLE OF CAUSE: S & C Ross Enterprises Ltd., and The Queen

PLACE OF HEARING: Vancouver, British Columbia

DATE OF HEARING: June 27 and 28, 2002

REASONS FOR JUDGMENT BY: The Hon. Judge Gordon Teskey

DATE OF JUDGMENT: September 13, 2002

APPEARANCES:

Counsel for the Appellant: Douglas C. Morley

Sadie Wetzel

Counsel for the Respondent: Lynn M. Burch

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BETWEEN:

S & C ROSS ENTERPRISES LTD.,

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Appeals heard on June 27 and 28, 2002 at Vancouver, British Columbia by

the Honourable Judge Gordon Teskey

Appearances

Counsel for the Appellant: Douglas C. Morley

Sadie Wetzel

Counsel for the Respondent: Lynn M. Burch

JUDGMENT

The appeals from the assessments made under the *Income Tax Act* for the 1992, 1993 and 1994 taxation years are allowed, with costs, in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 13th day of September, 2002.

"Gordon Teskey"

J.T.C.C.