



The Tax Treatment of Corporate Transaction Costs

The costs of completing a corporate transaction (such as a public offering of securities, a divestiture, an acquisition or a restructuring) are significant. They include such things as the costs of borrowing, costs of issuing or selling shares, bankers' fees, professional fees (lawyers, accountants, valuers, economists, etc.) and printing fees. Once the deal has been completed and the bills have been paid, it is necessary for the corporation to determine the appropriate tax treatment of these transaction costs. Sometimes this is a straightforward exercise; however, in many instances the nature of the expenses involved and the specific facts surrounding the transaction may lead to tax results that some may find surprising.

One area that has been the subject of some recent judicial developments is the deductibility of expenses incurred by a corporation facing a takeover bid. Based on old case law, the Canada Revenue Agency (the "CRA") had long taken the view that such expenses were not deductible to the target company because they were incurred to increase shareholder value rather than to produce income. Recent Canadian case law has rejected this view and suggests that the courts may be moving toward an approach that is much more sensitive to, and grounded in, business realities in determining the deductibility of transaction costs.

The Statutory Framework

Transaction costs may be given one of the following treatments for income tax purposes:

- (1) wholly deductible in the year,
- (2) deductible over a five year period,
- (3) capitalized and amortized as an eligible capital expenditure,¹
- (4) added to the cost base of the property acquired,² or
- (5) non-deductible (because they were not considered to have been incurred for the purpose of gaining or producing income).

The steps for determining which of these five tax treatments is appropriate are as follows:

1. Is the expense deductible for the purpose of computing profit in accordance with accepted principles of commercial trading?³ If the answer is "no", then the expenses are not tax deductible. If the answer is "yes", then go to question 2.
2. Was the expense made or incurred for the purpose of gaining or producing income from the business or property?⁴ If the answer is "no", then go to question 4. If the answer is "yes", then go to question 3.
3. Was the expense made on account of capital?⁵ If the answer is "no", then the expense is wholly deductible in the year. If the answer is "yes", then go to question 4.
4. Does any specific provision of the ITA allow for the deduction of the expense, either in the year or over a period of years?⁶ If the answer is "yes", then the expense is deductible in accordance with the applicable provision. If the answer is "no", then the expense is either added to the cost base of the non-depreciable capital property that was acquired as part of the transaction or it is non-deductible.

If a dispute arises with the CRA on the proper tax treatment of a transaction cost, the argument will usually involve questions 2 and 3. Was the expense made or incurred for the purpose of gaining or producing income from the business or property? Was the expense made on account of capital?

³ Subsection 9(1) of the *Income Tax Act* (Canada) (the "ITA").

⁴ Paragraph 18(1)(a) of the ITA.

⁵ Paragraph 18(1)(b) of the ITA.

⁶ Subsection 20(1) of the ITA. For example, there are specific provisions which address the tax deductibility of costs incurred in the course of issuing or selling shares, fees paid in the course of borrowing money or to restructure debt, investment counsel fees (not including commissions), share transfer fees, financial reporting fees, expenses of representation, and the capital costs of depreciable property.

¹ 75% of the eligible capital expenditure is added to the cumulative eligible capital pool, which is deductible at 7% per year.

² This may be deductible over time or non-deductible depending on whether the capital asset that was acquired was depreciable or not.

Recent Case Law

In *Boulangerie St-Augustin*⁷, the Federal Court of Appeal upheld the decision of the Tax Court of Canada and found that legal and accounting expenses incurred by a corporation to send information circulars to its shareholders in connection with a take-over bid were wholly deductible in the year as current expenses. The CRA had taken the position that these expenses were non-deductible on the basis that they were not made to gain income from business and no specific provision allowed for a deduction under section 20 of the ITA. The court disagreed and found that communicating with shareholders is a periodic general administrative expense that a company incurs in the ordinary course of its business and were not on capital account.

In *International Colin*⁸, the Tax Court found that fees paid to professional financial advisors by a financially distressed corporation were wholly deductible in the year as current expenses. The advisors were paid to investigate a range of strategic alternatives aimed at re-capitalizing the company. Based on this advice, the taxpayer merged with a competitor. The CRA had argued that the fees were non-deductible because they were not made to gain income from business, but rather to enhance shareholder value. The court rejected this approach and held that the purpose of the expenses was to improve the corporation's ability to earn income by combining its resources with those of another company.

In *BJ Services*⁹, the taxpayer sought to deduct financial advisory and "white knight" fees of almost \$50 million that it incurred in response to a hostile takeover bid by a competitor. The CRA denied a deduction on the basis that the fees were incurred to maximize shareholder value not to earn income from the business and in the alternative that the expenses were on capital account. The Tax Court found that the fees at issue were incurred due to the duties that directors have under provincial securities laws to secure the highest possible price for the shares. Such duties were found to be "inextricably interwoven with the business of any company". Accordingly, the court concluded that in the modern business world, the costs of satisfying ongoing obligations to shareholders and stakeholders are costs associated with carrying on a business and form an integral part of the income earning process of a business. It also held that the expenses were not on capital account since "no capital asset was acquired, no capital asset was preserved, and no enduring benefit was obtained." Consequently, the fees were found to be wholly deductible in the year as current expenses.

Conclusion

This recent case law suggests that the Canadian courts are becoming more aware of the modern realities of the costs associated with operating a business. Unlike the older cases where costs were non-deductible unless they could be directly tied to an income producing activity, the trend appears to be much more expansive allowing for the deductibility of costs that are more remote or indirectly tied to the income earning process. The BJ Services decision is the best example of this. Unfortunately, the CRA has interpreted these decisions in a narrow manner in its published materials rather than accepting the expansive rationale of the courts.

Given the changing landscape, taxpayers would do well to consult with their tax advisors to evaluate or re-evaluate whether certain of their transaction costs are currently deductible. Wildeboer Dellelce LLP would welcome the opportunity to work with you and your staff and advisors to ensure that your costs are given the proper tax treatment, both to maximize tax savings and to prevent audit exposure.

This update is intended as a summary only and should not be regarded or relied upon as advice to any specific client or regarding any specific situation. If you would like further information regarding the issues discussed in this update or if you wish to discuss any aspect of this commentary, please feel free to contact

Kevin Fritz (416) 361-2933 kfritz@wildlaw.ca
George Nehme (416) 361-4788 gnehme@wildlaw.ca

Wildeboer Dellelce LLP

wildlaw.ca 

1 First Canadian Place
Suite 810, Box 4
Toronto, ON M5X 1A9
Phone: (416) 361-3121
Facsimile: (416) 361-1790

72 Victoria Street South
Suite 305
Kitchener, Ontario N2G 4Y9
Phone: (519) 741-8708
Facsimile: (519) 741-9576

⁷ *Boulangerie St-Augustin Inc. v. The Queen*, 95 DTC 164; [1995] 2 CTC 2148 (TCC); aff'd. 97 DTC 5012 (FCA).

⁸ *International Colin Energy Corp. v. The Queen*, 2002 DTC 2185 (TCC).

⁹ *BJ Services Co. Canada v. The Queen*, 2004 DTC 2032 (TCC).