CANADIAN INTERNATIONAL TRADE TRIBUNAL
TRIBUNAL CANADIEN DU COMMERCE EXTÉRIEUR

Ottawa, Friday, February 21, 1997

Appeal No. AP-95-304

IN THE MATTER OF an appeal heard on October 17, 1996, under section 81.19 of the *Excise Tax Act*, R.S.C. 1985, c. E-15;

AND IN THE MATTER OF a decision of the Minister of National Revenue dated December 20, 1995, with respect to a notice of objection served under section 81.15 of the *Excise Tax Act*.

BETWEEN

KOTT TRUSS INC. **Appellant**

AND

THE MINISTER OF NATIONAL REVENUE **Respondent**

DECISION OF THE TRIBUNAL

The appeal is allowed.

Arthur B. Trudeau
Arthur B. Trudeau
Presiding Member

Lyle M. Russell
Lyle M. Russell
Member

Charles A. Gracey
Charles A. Gracey
Member

Susanne Grimes
Susanne Grimes
Acting Secretary

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UNOFFICIAL SUMMARY

Appeal No. AP-95-304

KOTT TRUSS INC. **Appellant**

and

THE MINISTER OF NATIONAL REVENUE **Respondent**

This is an appeal under section 81.19 of the *Excise Tax Act*. The appellant was in the business of manufacturing wooden trusses and sold all of its production to a related company, Kott Lumber Company. Kott Lumber Company, in turn, sold the trusses to various builders in the Greater Ottawa and Eastern Ontario areas. Federal sales tax was calculated and remitted based on the appellant's sale price to Kott Lumber Company. The respondent assessed the appellant for additional tax on the basis that the tax payable should have been calculated using the sale price from Kott Lumber Company to its customers, rather than the appellant's sale price.

The issue in this appeal is whether federal sales tax should have been calculated based on the price that the appellant charged Kott Lumber Company for trusses or on Kott Lumber Company's sale price to its customers.

HELD: The appeal is allowed. The Tribunal is of the view that the two entities at issue were operated independently and that the sales from the appellant to Kott Lumber Company were real or *bona fide* sales. As such, the Tribunal is of the view that federal sales tax should be calculated based on the appellant's sale price to Kott Lumber Company.

Place of Hearing:	Ottawa, Ontario
Date of Hearing:	October 17, 1996
Date of Decision:	February 21, 1997
Tribunal Members:	Arthur B. Trudeau, Presiding Member Lyle M. Russell, Member Charles A. Gracey, Member
Counsel for the Tribunal:	John L. Syme
Clerk of the Tribunal:	Anne Jamieson
Appearances:	Craig Robertson, for the appellant Frederick B. Woyiwada, for the respondent

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CANADIAN INTERNATIONAL TRADE TRIBUNAL
TRIBUNAL CANADIEN DU COMMERCE EXTÉRIEUR

Appeal No. AP-95-304

KOTT TRUSS INC. **Appellant**

and

THE MINISTER OF NATIONAL REVENUE **Respondent**

TRIBUNAL: ARTHUR B. TRUDEAU, Presiding Member
LYLE M. RUSSELL, Member
CHARLES A. GRACEY, Member

REASONS FOR DECISION

This is an appeal under section 81.19 of the *Excise Tax Act*[1] (the Act) of a decision of the Minister of National Revenue dated December 20, 1995.

During the assessment period, August 1, 1989, to December 31, 1990, the appellant was in the business of manufacturing wooden trusses, primarily for use in residential construction. The appellant is owned by Kott Lumber Company (Kottco). All of the trusses manufactured by the appellant during the relevant period were sold to Kottco. Kottco, in turn, sold the trusses to various builders in the Greater Ottawa and Eastern Ontario areas. The price at which the appellant sold the trusses to Kottco was determined by multiplying Kottco's sale price to its customers by a factor of 0.9. The appellant remitted federal sales tax based on its sale price to Kottco.

By notice of assessment dated December 23, 1992, the respondent assessed the appellant for unpaid taxes in the amount of $29,463.20, which included amounts in respect of interest and penalty and a credit in respect of certain transportation costs. The assessment reflected a calculation based on the price at which Kottco sold the trusses to its customers, rather than on the price charged to Kottco by the appellant. By notice of objection dated March 18, 1993, the appellant objected to the respondent's assessment. However, by notice of decision dated December 20, 1995, the respondent disallowed the objection and confirmed the assessment. In that decision, the respondent concluded that, during the relevant period, the appellant and Kottco operated as one commercial entity and that Kottco was a conduit between the appellant and the appellant's customers, the builders who were the ultimate purchasers of the trusses.

The issue in this appeal is whether federal sales tax should have been calculated based on the price that the appellant charged Kottco for trusses or on Kottco's sale price to its customers.

The appellant's representative called one witness, Mr. Paul Kruyne, President of Kott Truss Inc. Mr. Kruyne is also President of Kott Lumber Company. Mr. Kruyne testified that he and his wife, through their respective holding companies, formed a partnership which purchased Kottco in 1986. At that time, Kottco was in the business of supplying lumber to the building trade. It also had an operating division which manufactured trusses. In 1989, it was decided that the truss business should be organized into a separate

1. R.S.C. 1985, c. E-15.

legal entity from Kottco. At that time, the appellant was incorporated. It purchased all of Kottco's truss manufacturing assets. Mr. Kruyne testified that the appellant was incorporated to insulate Kottco from the potential liability associated with the truss business and to establish the truss business as an independent profit centre. It was felt that establishing a separate corporate entity would engender, in the minds of the truss division's employees, the notion that the truss business was separate from the lumber business and that, to survive, it would have to be independently viable. He stated that, if the appellant was not able to turn a profit on its business within a reasonable time, it would be wound up.

Through Mr. Kruyne, the appellant's representative introduced into evidence a map of the premises where the appellant and Kottco are located. The 23-acre property, which is owned by Mr. Kruyne and his wife personally, is located in the city of Nepean. The representative led Mr. Kruyne through the layout of the property and the location of the appellant's and Kottco's businesses. In summary, Mr. Kruyne's evidence was that the activities of each entity are physically segregated. Mr. Kruyne testified that both the appellant and Kottco separately pay him and his wife rent in respect of their use of the property.

Mr. Kruyne also testified that the books, income tax returns and excise tax and Goods and Services Tax filings were kept separate for each company. Moreover, each company has its own employees and prepares T-4 slips in respect of same. Mr. Kruyne indicated that the only employee "shared" by the two entities is Mr. Kruyne himself, although he stated that some internal accounting services are shared. The appellant and Kottco have their own telephone numbers, advertisements in the yellow pages and bank accounts. The appellant's representative also introduced into evidence, through Mr. Kruyne, documentation relating to financing obtained by Kottco from the Royal Bank of Canada, which showed that the appellant's assets were excluded from the assets pledged as security for Kottco's financing.

Mr. Kruyne described a typical sale of trusses from the appellant to Kottco to a third party. First, a Kottco salesperson would call upon a prospective customer to solicit orders for lumber and trusses. The salesperson would submit the customer's inquiries for lumber to Kottco and for trusses to the appellant. With respect to trusses, the appellant's designers/estimators would prepare an estimate which would be conveyed to the Kottco salesperson. With respect to trusses, the salesperson would negotiate with the third party a price from Kottco to the third party, bearing in mind the appellant's estimate for the supply of the goods.

Mr. Kruyne led the Tribunal through documentation pertaining to an actual sale of trusses from the appellant to Kottco to a third party. Mr. Kruyne described the documentary trail as follows:

- once the customer ordered goods, Kottco prepared a "delivery slip" identifying the goods;
- the delivery slip was conveyed to the appellant;
- the appellant scheduled the production of the goods;
- when it produced the trusses, the appellant prepared a production summary sheet identifying the goods, the period in which they were produced, the sale price from Kottco to the third party and the sale price from the appellant to Kottco (the sale price from the appellant to Kottco was 90 percent of Kottco's price to the third party);
- using information from the production summaries, on a weekly basis, the appellant invoiced Kottco for the goods that Kottco had purchased; and
- every month, or several months, Kottco paid the appellant's invoices by cheque.

Mr. Kruyne explained that the 90 percent figure, which was used to calculate the appellant's price to Kottco for all truss sales, was established on the basis of the functions performed by Kottco, including sales, delivery and collections. Mr. Kruyne explained that, once Kottco's salesperson obtains the appellant's quotation and undertakes negotiations with the prospective customer, the salesperson must bear in mind that Kottco's price to the customer must at a minimum, when multiplied by 90 percent, cover the appellant's price to Kottco.

During cross-examination, Mr. Kruyne confirmed that the appellant and Kottco maintain separate inventories of raw materials. When the appellant receives an order from Kottco, the necessary materials are taken from that inventory to "cutting tables," cut according to design specifications and then assembled. Mr. Kruyne also confirmed that the appellant's only customer is Kottco.

With respect to sales from the appellant to Kottco, it was suggested to Mr. Kruyne that there was never any negotiation on price between the parties. Mr. Kruyne disagreed. He stated that, for example, if the appellant provided an estimate of $1,000 to Kottco for a particular job and Kottco was only able to negotiate a price of $900 with its customer, then it would be the appellant that would decide whether to "take another look" at its estimate or to "walk away" from the job. Mr. Kruyne was asked if his role vis-à-vis the appellant had changed since the appellant was incorporated. He indicated that, whereas prior to incorporation he tended to "override certain decisions," he now listens more to the people employed by the appellant. In Mr. Kruyne's words, "now its more of an issue of the Kott Truss people will tell me you can do this or you cannot do this." Mr. Kruyne did acknowledge that, before the appellant could "walk away" from a job, there would have to be some discussion with him. However, he indicated that he would have to advance some very good arguments, if he were proposing that the appellant take a job below its cost. Mr. Kruyne emphasized that, in no way, were the appellant's trusses used as loss leaders for Kottco's lumber business.

Mr. Kruyne acknowledged that, with a few exceptions, most of the companies in the business of manufacturing trusses in Ottawa sell directly to the building trade. In other words, there is generally no wholesale trade level in the truss business.

During questioning by the Tribunal, the rationale for the incorporation of the appellant was probed. In particular, the Tribunal explored whether or not tax planning considerations formed part of that rationale. Mr. Kruyne reiterated that the liability and profitability considerations were the primary considerations in deciding to incorporate. He stated that, had the object been to save tax, a 20 or 30 percent markup could have been established, instead of the more modest 10 percent.

In argument, the appellant's representative made submissions relating to the separate existence of the appellant and Kottco; the notion of "reasonable sale price" within the meaning of section 58 of the Act; and whether the respondent should have assessed Kottco, instead of the appellant, for unpaid taxes under the Act. While the Tribunal appreciates the appellant's representative's thoroughness in argument, in light of the fact that, in argument, counsel for the respondent only addressed the appellant's first submission and the fact that, in the Tribunal's view, the appeal turns on that issue, the Tribunal has not in this statement of reasons addressed the second and third arguments of the appellant's representative.

With respect to the issue of separate commercial entities, the appellant's representative argued that the evidence supports the view that, while the appellant and Kottco are clearly not at arm's length from one another, they operate as separate commercial entities. He submitted that the appellant was incorporated for good business reasons, to shield Kottco from liability and to establish it as an independent profit centre, and that it did not act in any way as a "puppet" of Kottco. In this regard, he noted Mr. Kruyne's evidence of

discussions and negotiation between the two entities. He also cited the fact that the two businesses were run as separate entities, each having its own employees, bank accounts, etc.

Counsel for the respondent stated that, for the respondent to prevail, it was not necessary for the Tribunal to find that Kottco and the appellant were one commercial entity for all purposes. In counsel's submission, it would suffice if the Tribunal were to find, for the purposes of the transactions at issue, that the two entities should be regarded as one. Counsel submitted that, in considering that question, the Tribunal should undertake a two-part analysis. First, it should look at the surrounding circumstances to see if "there exists the context within which the conclusion that the two entities are indeed one can be reached." Second, the Tribunal should look at the details of the sales transactions themselves to determine whether sales had actually taken place between the appellant and Kottco. In support of this approach, counsel relied on the Supreme Court of Canada's decision in *The Palmolive Manufacturing Company (Ontario) Limited* v. *His Majesty the King*[2] and the Tribunal's decision in *The Geo. Cluthé Manufacturing Company Limited* v. *The Minister of National Revenue*.[3] Counsel argued that, like in *Cluthé*, it was open for the Tribunal in this case to find that, in regard to their truss business, the appellant and Kottco were both integral elements of one commercial enterprise.

With respect to the first line of inquiry, counsel for the respondent referred the Tribunal to the following evidence in support of the argument that, with respect to the truss business, the appellant and Kottco were engaged in a single commercial undertaking:

- As trusses are generally made to order according to the specifications of the particular structure and it is thus not possible for manufacturers or wholesalers to carry finished inventory, the truss industry is not separated into trade levels. Counsel argued that this results in the sales and manufacture being "rolled into one process."
- The appellant and Kottco are both managed by the same person.
- Kottco financed the operations of the appellant.
- Kottco and the appellant shared the same accounting staff and purchasing agents.
- All trusses were shipped directly to third parties, despite the fact that those purchasers were invoiced by Kottco.

With respect to the sales transactions themselves, counsel for the respondent argued that the facts support the view that there had not been sales between the appellant and Kottco. Counsel noted that the appellant sells it trusses only to Kottco and that Kottco only sells trusses made by the appellant. He also submitted that the price between the appellant and Kottco was not negotiable. Counsel argued that to have a *bona fide* sale requires two entities exercising independent will and judgement, factors which were absent in the sales between the appellant and Kottco.

2. [1933] S.C.R. 131.
3. 2 T.C.T. 1119, Appeal No. 3031, June 5, 1989.

Both the courts and the Tribunal have considered the issues raised in this appeal in several cases.[4] A review of these cases indicates that the courts and the Tribunal have considered a number of factors in deciding whether a sale between two entities is, for purposes of assessing tax liability, "real" or *bona fide*, including:

- whether the two entities involved had common management;
- whether one of the entities dominated the other or whether each entity made its own decisions about matters such as production, staffing and pricing;
- whether there was a legitimate business reason for the incorporation of the vendor or, to the contrary, whether it was established to avoid the payment of tax;
- whether the businesses activities and operations of the of two entities were co-mingled or operated separately; and
- whether the price for the sale between the two entities was reasonable.

While the Tribunal does not disagree with counsel for the respondent's submission that both the general context in which the businesses operate and the specifics of the individual transactions are important in a case such as this, the Tribunal is not persuaded that it must embark on a linear two-step analysis in considering these issues.

Before embarking on a discussion of the evidence, the Tribunal notes that all of the testimony in this appeal was provided by a single witness, Mr. Kruyne, whom the Tribunal found to be both forthright and credible.

In determining whether or not the appellant and Kottco operated as a single commercial entity in the truss business, the Tribunal considers it important to examine the organization and operation of the two companies. As was readily conceded by the appellant's representative, the appellant and Kottco are related companies and were not dealing with one another at arm's length. With respect to organization and structure, the Tribunal first notes that the two companies are separate legal entities. The Tribunal found Mr. Kruyne's evidence regarding the business reasons for the incorporation of the appellant to be credible. In commercial affairs, it is not unusual for companies to isolate distinct parts of their business, to help them to determine whether those activities are economically viable and, when such activities have an inherently higher potential liability than the main business of a company, to shield the main business from that liability.

In operational terms, the Tribunal notes that both Kottco and the appellant have their own employees; business premises, albeit in close proximity to one another; assets; bank accounts; letterhead; and phone numbers. The only person who is an employee of both entities is Mr. Kruyne. The companies maintain separate inventories of raw materials, and each files its own income tax return.

The Tribunal considered Mr. Kruyne's evidence that, when a Kottco salesperson was asked by a builder for a quotation on trusses, the salesperson would provide the specifications to one of the designers/estimators employed by the appellant. The appellant would provide a quotation on the job to

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4. *Palmolive*, *supra* note 2; *Cluthé*, *ibid*.; *Her Majesty the Queen* v. *Vanguard Coatings and Chemicals Ltd*., [1988] 3 F.C. 560; and *Gerrard-Ovalstrapping, Division of EII Limited* v. *The Minister of National Revenue*, Canadian International Trade Tribunal, 2 G.T.C. 5195, Appeal No. AP-93-289, September 26, 1994.

Kottco. The Kottco salesperson would then go back to the customer with Kottco's price, bearing in mind the appellant's bottom line price. If Kottco's price was not acceptable to the customer, Mr. Kruyne indicated that Kottco might go back to the appellant to see if the appellant could improve on its quotation. The Tribunal considers Mr. Kruyne's testimony that the appellant could "walk away" from a sale that it viewed as unprofitable to be important, in that it suggests that the appellant was, to a significant degree, independent of Kottco. In the Tribunal's view, this evidence is consistent with Mr. Kruyne's often repeated testimony that he viewed the appellant as a separate business that was expected to earn a profit on its operations. Further support for the proposition that the appellant was operationally independent can be found in Mr. Kruyne's testimony that the appellant made decisions concerning the scheduling of production.

The Tribunal notes that, during the relevant period, there was a clear paper trail between the appellant and Kottco in respect of orders and sales. The appellant invoiced Kottco on a weekly basis for the trusses that it produced and sold to Kottco. Throughout the period, Kottco issued cheques to the appellant in payment for goods purchased. In other words, the business and affairs of the two entities were not intermingled.

Finally, the Tribunal is of the view that, in light of the functions performed by Kottco, the 10 percent markup on trusses sold by the appellant to Kottco is reasonable. Had the entities wished to create a scheme to minimize tax, it might be expected that they would have been more aggressive in establishing the markup from the appellant to Kottco. The fact that they established a more modest markup is consistent with Mr. Kruyne's testimony that the appellant was incorporated for legitimate business reasons and not to obtain tax savings.

In summation, the Tribunal is of the view that, notwithstanding the fact that the appellant and Kottco are related companies, they were, at all relevant times, structurally and, for the most part, operationally separate. Moreover, the Tribunal was persuaded by Mr. Kruyne's testimony that, while there was a degree of co-ordination and co-operation between the appellant and Kottco, the appellant made its own pricing, production and staffing decisions.

For all of the foregoing reasons, the appeal is allowed.

Arthur B. Trudeau
Arthur B. Trudeau
Presiding Member

Lyle M. Russell
Lyle M. Russell
Member

Charles A. Gracey
Charles A. Gracey
Member