Federal Court Of Appeal Confirms Tax Deductibility Of Oversight Expenses In M&A Transactions

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On June 25, 2018, the Federal Court of Appeal upheld the 2016 decision of the Tax Court of Canada in Rio Tinto Alcan Inc. v. The Queen1 that investment banking and professional advisory fees incurred by a corporation in order to obtain advice for the board of directors "in their discharge of oversight responsibilities" are fully deductible. This is an important decision for widely-held corporations for two reasons: (1) it confirms the tax treatment of often significant expenses; and (2) it is judicial recognition of the fact that board members are increasingly expected to understand management's proposals and to seek independent professional advice to guide their decision-making process, rather than simply acquiescing to these proposals without further scrutiny.

Background

In 2002, the taxpayer, Rio Tinto Alcan Inc. ("Rio Tinto"), was considering the possibility of acquiring Pechiney S.A. ("Pechiney"), a French public company. Rio Tinto retained the investment banks Morgan Stanley & Co. Incorporated ("Morgan Stanley") and Lazard Frères & Co. LLC ("Lazard Frères") to assist in assessing a potential transaction, and specifically, to analyze and prepare financial models of the possible transaction. Morgan Stanley and Lazard Frères each conducted an independent analysis of various strategies and alternatives for a potential transaction and made a number of presentations to the board of directors of Rio Tinto. In addition, Morgan Stanley and Lazard Frères each provided advice with respect to a related spin-off of certain assets to satisfy conditions imposed by competition authorities with respect to the Pechiney transaction.

In connection with these transactions, Rio Tinto incurred approximately $100 million in transaction expenses, including investment banking, legal, and professional advisory fees. Rio Tinto deducted the expenses in the taxation years in which they were incurred, pursuant to section 9 of the Income Tax Act2 (the "Tax Act"). The Canada Revenue Agency ("CRA") disallowed the deductions pursuant to paragraph 18(1)(b) of the Tax Act on the basis that the fees were incurred on account of capital.

The Tax Court of Canada Judgment

The Tax Court of Canada (the "TCC") rejected the CRA's long-held view that expenses incurred in the context of an M&A transaction are of a capital nature, and thus are not deductible. Instead, they noted a distinction between "oversight expenses", which are current expenses that were incurred by the board of directors in the discharge of its oversight of Rio Tinto's income generating process, and "execution costs", i.e., expenses relating to the actual implementation of a capital transaction, which are outlays in the nature of capital.

In order to determine whether an expense is an "oversight expense", and therefore deductible, or an "execution cost", and therefore a capital expense, the TCC looked at the primary purpose of the work performed — e.g. to assist the board of directors in the management of the corporation, or for the implementation of a capital transaction. The TCC noted that: "if the expense gives rise to a lasting or enduring benefit, it should be treated as a capital expenditure […] By contrast, if the impact of the expense does not extend beyond the taxation year in which it was incurred, a current expenditure deduction should be available."3 The TCC concluded that 65 per cent of the Morgan Stanley fee and 35 per cent of the Lazard Frères fee constituted oversight expenses and were therefore currently deductible.

The CRA appealed.

The Federal Court of Appeal Judgment

In a unanimous judgment,4 the Federal Court of Appeal (the "FCA") upheld the decision of the TCC, noting that although the term "oversight expenses" may be novel, the reasoning of the TCC was not. Further, the fact that an expenditure was incurred in the course of determining whether or not to acquire a capital asset does not necessarily mean that the expense is made on account of capital. Rather, in determining whether an expense was a capital payment or a payment on current account, "regard must be had to the business and commercial realities of the matter."5 The FCA remarked that in light of Rio Tinto's long history of acquisitions prior to the Pechiney transaction, "a careful evaluation of corporate opportunities" was "intrinsically linked to [Rio Tinto's] income-earning process."

The FCA also rejected Rio Tinto's cross appeal and ruled that certain additional advertising and reporting expenses (which were held not to be deductible by the TCC) related to the implementation of the transactions and thus were capital expenses, cautioning that "the fact that an outlay is made for the purpose of gaining or producing income does not preclude a finding that it was made on capital account."

The TCC's decision and the FCA's affirmation of it, are welcome rejections of the CRA's traditionally hard-line approach to business expense deductibility in favour of an approach that applies a "common sense approach"6 that takes into consideration the taxpayer's business and commercial realities.

Corporations should be cautioned, however, that the evidentiary burden remains with the taxpayer to establish that an expense is currently deductible. Indeed, one of the reasons for dismissing the cross-appeal related to the insufficiency of evidence from the

service providers who performed the work.7 Accordingly, parties to a transaction should take care to ensure that they — and their advisors — make a clear distinction between the “oversight” and “implementation” components of a transaction, and allocate fees charged accordingly. Appropriate structuring of retainers of external advisors can make the difference between deductibility of significant fees and the inability to do so.

Both the TCC and the FCA also specifically recognized that the test for deductibility of advisors’ expenses should be on a “case by case basis”.8 Should you require advice about your specific situation, please contact any member of the BLG Tax Group.

1 2016 TCC 172 [*Rio Tinto* (TCC)].

2 RSC 1985 c. 1 (5th Supp.) [Tax Act].

3 *Rio Tinto* (TCC), para. 76.

4 *Rio Tinto Alcan Inc. v The Queen*, 2018 FCA 124 [*Rio Tinto* (FCA)]

5 *Rio Tinto* (FCA), para. 69.

6 *Rio Tinto* (TCC), para. 79.

7 *Rio Tinto* (FCA), para. 116.

8 *Ibid*, para. 21, citing Rio *Tinto* (TCC), para 79.

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