Date: 20090227

Docket: A-344-08

Citation: 2009 FCA 60

CORAM: **DESJARDINS J.A.**
EVANS J.A.
RYER J.A.

BETWEEN:

GOFF CONSTRUCTION LIMITED

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Heard at Toronto, Ontario, on February 9, 2009.

Judgment delivered at Ottawa, Ontario, on February 27, 2009.

REASONS FOR JUDGMENT BY: RYER J.A.

CONCURRED IN BY: DESJARDINS J.A.
EVANS J.A.

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REASONS FOR JUDGMENT

RYER J.A.

[1] This appeal from a decision of the Tax Court of Canada (the Tax Court), *Goff Construction Ltd. v. Canada*, 2008 TCC 322, by Mr. Justice Campbell Miller (the Tax Court Judge), concerns the tax treatment of an amount received by the appellant in settlement of a lawsuit framed in the tort of negligence.

The facts

[2] The facts are not in dispute. They can be summarized in the following manner.

[3] A third party (the purchaser) agreed to purchase some vacant land from the appellant provided that the land could be re-zoned. The law firm that represented the purchaser appealed the initial unfavourable re-zoning application to the Ontario Municipal Board (the OMB). The appeal was unsuccessful and the OMB held the purchaser and the appellant jointly and severally liable for costs in the amount of $1.35 million.

[4] The appellant applied to the OMB to have the cost award against it reduced or eliminated on the basis that it had no involvement in or control over the initial OMB proceeding. The application was largely successful in that the OMB reduced the cost award against the appellant to $135,000.

[5] In its 1992 to 1997 taxation years, the appellant deducted approximately $662,000 on account of the OMB cost award and expenses incurred in seeking the reduction or elimination of the initial OMB cost award. These deductions were accepted by the Minister of National Revenue.

[6] In 1996, the appellant filed a claim in negligence against the law firm that erroneously purported to represent it in the initial proceeding before the OMB.

[7] In 1999, a settlement in the amount of $400,000 was reached between the law firm and the appellant.

[8] The appellant did not include this settlement payment in computing its income for its 1999 taxation year. It claimed that the settlement payment was a non-taxable capital receipt. The Minister of National Revenue reassessed the appellant for its 1999 taxation year to include the settlement

payment on the basis that it was income from a business pursuant to subsection 9(1) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (the Act).

[9] The appellant appealed to the Tax Court of Canada.

Tax Court of Canada Decision

[10] The Tax Court Judge made a factual finding that the settlement payment was intended to compensate the appellant for expenditures incurred by it on capital account (specifically, the cost award and the expenses incurred by the appellant in seeking a reduction in the cost award). The Tax Court Judge agreed that the cost award and legal expenses incurred by the appellant, despite being on capital account, were deductible pursuant to paragraph 20(1)(*cc*) of the Act. He held that the *surrogatum* principle required the appellant to include the settlement payment in income, notwithstanding that the settlement payment and the underlying expenditures were on capital account, considering that the settlement payment was intended to compensate the appellant for expenditures that were deductible.

Issue

[11] The issue to be decided in this appeal is whether the appellant must include the settlement payment in computing its income under subsection 9(1) of the Act for the taxation year 1999.

[12] The appellant recognizes that the resolution of this issue depends on the interpretation and application of the *surrogatum* principle. It submits that the Tax Court Judge erred in law in applying the *surrogatum* principle in the way that he did. The appellant states at paragraph 28 of its

memorandum that "the case law establishes that the tax treatment of the expenditures underlying a damages or settlement payment (i.e., whether they are deductible or deducted) is not relevant to the application of the *surrogatum* principle and the tax consequences of receiving the damages payment. In the cases where the damages relate to a recovery of expenditures, the Courts have continued to hold that the *surrogatum* principle looks to the nature of the damages payment and the underlying outlays as income or capital, and the tax treatment to the recipient is determined under the Act based on such characterization".

Analysis

[13] The *surrogatum* principle is a judge-made law which operates in the following manner as described by Charron J. in *Tsiaprailis v. R.,* [2005] 1 S.C.R. 113, at paragraph 7. Commenting on the principle that awards and settlement payments are inherently neutral for tax purposes, she wrote:

> … in assessing whether the monies will be taxable, we must look to the nature and purpose of the payment to determine what it is intended [page118] to replace. The inquiry is a factual one. The tax consequences of the damage or settlement payment is then determined according to this characterization. In other words, the tax treatment of the item will depend on what the amount is intended to replace. This approach is known as the *surrogatum* principle….

[14] Further down, at paragraph 15, she suggested the following two steps for analysis:

> The determinative questions are: (1) what was the payment intended to replace? And, if the answer to that question is sufficiently clear, (2) would the replaced amount have been taxable in the recipient's hands?

[15] At paragraph 7 of her decision, Charron J. cited the authors Hogg, Magee and Li in the *Principles of Canadian Income Tax Law*, 4th edition. In their latest edition (6th), those authors describe the principle as follows (which is not dissimilar from the earlier edition):

> A person who suffers harm caused by another may seek compensation for (a) loss of income, (b) expenses incurred, (c) property destroyed, or (d) personal injury, as well as punitive damages. For tax purposes, damages or compensation received, either pursuant to a court judgment or an out-of-court settlement, may be considered as on account of income, capital, or windfall to the recipient. The nature of the injury or harm for which compensation is made generally determines the tax consequences of damages.
>
> Under the *surrogatum* principle, the tax consequences of a damage or settlement payment depend on the tax treatment of the item for which the payment is intended to substitute:
>
>> Where, pursuant to a legal right, a trader receives from another person, compensation for the trader's failure to receive a sum of money which, if it had been received, would have been credited to the amount of profits (if any) arising in any year from the trade carried on by him at the time when the compensation is so received, the compensation is to be treated for income tax purposes in the same way as that sum of money would have been treated if it had been received instead of the compensation.
>>
>> ...
>>
>> The recovery of an expense is not income, unless the expense was deducted.
>
> [Emphasis added.]

[16] The appellant concedes that a compensatory payment received in replacement for an expenditure that is made on revenue account must be included in the income of the recipient. However, where the expense in respect of which the compensatory payment is received is made on capital account, the appellant contends that the recipient is not required to include the receipt in its income. According to the appellant, this is so even if the Act permits the full amount of the capital expenditure to be deducted in the taxation year in which that amount is paid.

[17] In support of this proposition, the appellant cites a number of cases: *Ipsco Inc. v. R.,* [2002] C.T.C. 2907(T.C.C.); *Prince Rupert Hotel (1957) Ltd. v. Canada*, [1995] 2 C.T.C. 212 (F.C.A.); *Coughlan v. R.*, [2001] 4 C.T.C. 2004 (T.C.C.); *Westcoast Energy Inc. v. R.*, [1991] 1 C.T.C. 471,

aff'd [1992] 1 C.T.C. 261 (F.C.A.); *Ikea Ltd. v. R.*, [1998] 1 S.C.R. 1996 and *Consumers' Gas Co. v. R.*, [1987] 1 C.T.C. 79 (F.C.A.).

[18] In my view, none of these cases were concerned with a situation in which a taxpayer received an amount as compensation for a capital expenditure, which the taxpayer was required to incur, the whole amount of which was properly permitted as a deduction in the year that the amount was paid.

[19] In *Ipsco*, an amount received by the taxpayer as compensation for damage to its pipeline, a capital property the cost of which was subject to the capital cost allowance provisions of the Act, was not required to be included in the income of the taxpayer under subsection 9(1) of the Act.

[20] In *Prince Rupert Hotel*, an amount received by the taxpayer as compensation for negligence on the part of a law firm was held to have been received in replacement for business profits that the taxpayer failed to receive, and not for the loss or destruction of a capital property. Accordingly, that amount was required to be included in the income of the taxpayer.

[21] In *Coughlan*, an amount received by a taxpayer as compensation for costs incurred in conducting litigation that was required to protect his reputation as a businessman was not required to be included in the income of the taxpayer under subsection 9(1) of the Act. In this case, Mr. Coughlan had been allowed to deduct certain legal costs that he had incurred in the litigation, although the trial judge observed that such deduction had been improperly allowed.

[22] In *Westcoast*, an amount received by the taxpayer as compensation for damages to its pipeline, a capital property the cost of which was subject to the capital cost allowance provision of the Act, was not required to be included in the income of the taxpayer under subsection 9(1) of the Act.

[23] In *Ikea*, an amount received by the taxpayer as part of its ordinary business operations and not linked to any capital purpose was required to be included in the income of the taxpayer under subsection 9(1) in the year of the receipt.

[24] In *Consumers' Gas*, amounts received by the taxpayer as contributions in respect of the cost of relocating pipelines, capital properties the costs of which were subject to the capital cost allowance provisions of the Act, were not required to be included in the income of the taxpayer under subsection 9(1) of the Act.

[25] Each of these cases required a determination of the nature of the amount received by the taxpayer in question. However, as indicated, none of them considered an amount received in replacement for a capital expenditure, the whole amount of which was properly permitted as a deduction in the year that such amount was paid. Accordingly, none of these cases establishes that the Tax Court Judge erred in his understanding of the *surrogatum* principle and its application to the circumstances.

[26] At paragraphs 14, 15 and 16 of his reasons, the Tax Court Judge stated:

> [14] Goff paid a significant amount in legal fees to reduce the OMB costs awarded against it to $135,000. These amounts <u>go to the capital of Goff's business</u> on the basis the

> costs award related to a disposition of capital property and legal expenses related to preserving a capital asset (money). I do not disagree. The only thorny issue to tackle is where capital expenditures, such as those before me, are deductible, how is the surrogatum principle to be applied? The case law referred to by the Appellant does not persuade me that the authors Hogg, Magee and Li have got it wrong. The tax consequences of a settlement payment depend on the tax treatment of the item for which the payment is intended to substitute. Where, as here, the amount is recovery of expenditures, as opposed to lost profits, one must look to the tax treatment of those expenditures. In this case, those expenditures were properly deducted for tax purposes and consequently, applying the *surrogatum* principle, the settlement amount should fall into income. This principle should not be extended to rely upon deductions improperly made as would have been the case in both *Coughlan* and *Ipsco*. Two wrongs should indeed not make a right.
>
> [15] This conclusion is not a conclusion that the settlement amount was compensation for current expenses; it is a conclusion that the settlement amount was compensation for deductible capital expenditures.
>
> [16] I believe that as a judge-made tax principle, the *surrogatum* principle must relate to tax treatment, not just to the nature of the payment, though in most cases the two will go hand-in-hand. This case happens to involve a situation of a capital expenditure receiving income treatment by a provision of the *Income Tax Act* permitting its deductibility. The *surrogatum* principle should apply to assist in reaching a tax result in accordance with the tax legislation, not to encourage a result of either windfall at one end of the spectrum, or double taxation at the other end. The *surrogatum* principle should apply to maintain tax neutrality of damages.
>
> [Emphasis added.]

[27] In *Tsiaprailis* and *London & Thames Haven Oil Wharves, Ltd. v. Attwooll*, [1967] 2 All E.R. 124 (C.A.), compensatory payments received as a consequence of the affected party's failure to receive certain amounts (disability insurance payments and lost profits) were characterized by the courts. Then, the tax treatment of the receipt of those payments was held to be the same as that which would have applied to the amounts that the affected parties failed to receive.

[28] In the present circumstances, the compensatory payment was received by the appellant as a consequence of its having been required to make certain expenditures rather than its having failed to

receive an expected amount. This factual distinction does not preclude the use of the *surrogatum* principle to characterize the compensatory payment that was received by the appellant. Thus, where the payment is intended to replace monies that have been expended by the recipient, the tax treatment to be accorded to that payment must be determined by reference to the tax treatment of the expenditures that were made. Hence, where an expenditure has been deducted in computing the income of the recipient of a compensatory payment, the amount received should be included in the income of the recipient.

[29] In my view, the Tax Court Judge correctly applied the *surrogatum* principle in the circumstances. The amount received by the appellant from the law firm was intended to replace the OMB award and related legal costs that were paid by the appellant in its 1992 to 1997 taxation years. While those expenditures were capital in nature, they were nonetheless fully deductible by the appellant in the taxations years in which they were paid. It follows that the amount received by the appellant from the law firm in its 1999 taxation year must be included in the appellant's income for that taxation year.

[30] For these reasons, I would dismiss the appeal with costs.

"C. Michael Ryer"

"I concur. Alice Desjardins J.A."

"I agree. John M. Evans J.A."

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

DOCKET:	A-344-08

(APPEAL FROM A JUDGMENT OF MR. JUSTICE CAMPBELL J. MILLER OF THE TAX COURT OF CANADA, DATED MAY 28, 2008, (2008 TCC 322))

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DATED:	February 27, 2009

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