Federal Court of Appeal

Cour d'appel fédérale

Date: 20111110

Docket: A-35-11

Citation: 2011 FCA 308

CORAM: **NADON J.A.**
SHARLOW J.A.
DAWSON J.A.

BETWEEN:

IMPERIAL TOBACCO CANADA LIMITED
(Successor by Amalgamation to Imasco Limited)

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Heard at Toronto, Ontario, on October 26, 2011.

Judgment delivered at Ottawa, Ontario, on November 10, 2011.

REASONS FOR JUDGMENT BY: SHARLOW J.A.

CONCURRED IN BY: NADON J.A.
DAWSON J.A.

Federal Court of Appeal

Cour d'appel fédérale

Date: 20111110

Docket: A-35-11

Citation: 2011 FCA 308

CORAM: **NADON J.A.**
SHARLOW J.A.
DAWSON J.A.

BETWEEN:

IMPERIAL TOBACCO CANADA LIMITED
(Successor by Amalgamation to Imasco Limited)

Appellant

and

HER MAJESTY THE QUEEN

Respondent

REASONS FOR JUDGMENT

SHARLOW J.A.

[1] The issue in this case is whether Imasco Limited ("Imasco"), in computing its income for income tax purposes, is entitled to deduct payments made to its own employees and employees of its subsidiaries for surrendering options to acquire Imasco shares. Imasco made such payments in its 1999 and 2000 taxation years, and claimed deductions for the payments on the basis that they were employee compensation. The Minister, relying on paragraph 18(1)(*b*) of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), reassessed Imasco to disallow the deductions on the basis that the payments were on account of capital. Imasco (represented by the appellant Imperial Tobacco Canada Limited, its successor by amalgamation) appealed to the Tax Court of Canada. Justice Bowie dismissed the

appeal for reasons reported as *Imperial Tobacco Canada Ltd. v. Canada*, 2010 TCC 648. Imperial now appeals to this Court. For the reasons that follow, I would dismiss the appeal.

Standard of review

[2] This case involves a dispute as to whether certain payments are on account of capital or income. The resolution of the dispute requires the application of legal principles to the facts, which is a question of mixed fact and law (*Canada v. Johns-Manville Corp.*, [1985] 2 S.C.R. 46, at page 62). Therefore, this Court cannot intervene in the absence of a palpable and overriding error or an "extricable error in principle with respect to the characterization of the standard or its application, in which case the error may amount to an error of law" (*Housen v. Nikolaisen*, 2002 SCC 33, [2002] 2 S.C.R. 235, at paragraph 37).

[3] The relevant facts are undisputed. The case in the Tax Court proceeded on the basis of a statement of agreed facts supplemented by passages read into the record from the pre-trial examinations for discovery of both parties. There was no oral testimony. Imasco's argument essentially is that Justice Bowie erred in applying the principles derived from the jurisprudence.

Facts

[4] During Imasco's taxation years ending December 31, 1999 and February 1, 2000, it was a public corporation and a taxable Canadian corporation. Imasco and its subsidiaries were active in a number of businesses. On May 11, 1983, Imasco instituted an employee stock option plan under which employees of Imasco and its subsidiaries could be granted the right to purchase Imasco shares for their fair market value as of the date of the grant of the option. At the time of the transactions relevant to this case, options issued under the Imasco employee stock option plan

represented rights to acquire approximately 5 million Imasco shares (slightly over 1% of the shares then outstanding).

[5] According to the terms of the employee stock option plan, an option would "vest" 2 years after being granted (meaning that it could not be exercised within 2 years of its grant). An unexercised option would expire 10 years after being granted or upon the termination of the option holder's employment (otherwise than by retirement under an approved retirement plan). Options were not transferable or assignable except by will or pursuant to the laws of succession.

[6] By virtue of a 1995 amendment to the stock option plan, Imasco had the right to offer an option holder the right to surrender the option for cash equal to the amount by which the market value of the Imasco shares that could be acquired by exercising the option exceeded the exercise price. An option holder who was granted that right and exercised it would be in the same financial position as if the stock option had been exercised and the shares immediately sold (disregarding income tax considerations and transaction costs, if any). There is evidence that, even before the 1995 amendment, Imasco occasionally paid cash to an employee as consideration for the surrender of a stock option, and that the 1995 amendment merely formalized what was already being done from time to time.

[7] In March of 1999, British American Tobacco p.l.c. ("BAT") approached Imasco to discuss a proposal for a "going private transaction" under which BAT would acquire, directly or indirectly, all of the Imasco shares held by public shareholders. It is not clear from the record how many shares that represented in March of 1999, but on December 14, 1999, BAT indirectly owned 42.5%

of the Imasco shares then outstanding. The acquisition proposal was the subject of a press release on June 7, 1999.

[8] On June 9, 1999, the Imasco board of directors passed a resolution to amend section 10 of the employee stock option plan to give all option holders the right to surrender their options for cash. The effect of that amendment was that the discretion to initiate the surrender of an option for cash rested with each option holder, rather than Imasco.

[9] It is reasonable to infer, as Justice Bowie did at paragraph 12 of his reasons, that this amendment was one of the steps taken by Imasco to facilitate the going private transaction. Imasco contended that the amendment was made to ensure that option holders were treated fairly if the going private transaction was completed. That is also consistent with the documentary evidence. I see no conflict between the objective of facilitating the going private transaction and the objective of treating option holders fairly.

[10] In July of 1999, British American Tobacco (Canada) Limited (“Bidco”) was incorporated as an indirect wholly owned subsidiary of BAT to acquire the Imasco shares.

[11] On August 2, 1999, an agreement entitled “Transaction Proposal Agreement” was entered into by BAT, Bidco, and Imasco dealing with the going private transactions. It also contemplated a number of other transactions, including the disposition of certain Imasco assets that BAT did not wish to acquire. Those dispositions were to precede the going private transaction. After the going private transaction, Bidco and Imasco were to be amalgamated.

[12] Article 5 of the Transaction Proposal Agreement is entitled “The Going Private Transaction and Related Transactions”. Article 5.2 indicates that the parties agreed that certain internal reorganization transactions (referred to as the “reorganization”) would occur once all parties were satisfied that certain contractual conditions had been met. The reorganization involved essentially amending the terms of the Imasco shares so that the transfer of the Imasco shares to Bidco could be triggered by a direction from Imasco. That ensured that the transfer of the Imasco shares would be automatic once the agreed conditions to the going private transaction were met.

[13] Article 5.8 of the Transaction Proposal Agreement is entitled “Outstanding Stock Options and Employment Arrangements of Imasco”. In that provision, Imasco agreed that its board of directors would unanimously resolve to encourage all holders of employee stock options to exercise them or surrender them immediately prior to the completion of the reorganization. Imasco also agreed that, subject to regulatory and stock exchange approvals, its board of directors would take the steps required to ensure that all employee stock options would vest before the reorganization so that they could be exercised prior to the completion of the reorganization. That was done, but the immediate vesting of the employee stock options above was subject to the condition that if certain closing steps of the reorganization were not completed, the immediate vesting would be deemed never to have occurred.

[14] The acceleration of the vesting of employee stock options, coupled with the provision for the surrender of stock options for cash at the election of option holders, would ensure that Imasco had taken all possible steps to ensure that Bidco would be a position, after the reorganization, to

acquire all Imasco shares. Of course it was possible that some option holders would choose not to surrender their options or to exercise them. As events unfolded, however, that did not occur.

[15] On November 18, 1999, the Transaction Proposal Agreement was amended. Among other things, the amendment set the purchase price of the Imasco shares at $41.60 per share. It also included a favourable recommendation from Imasco's board of directors. A special meeting of the Imasco shareholders was called for January 28, 2000 to consider the going private transaction. The transaction was approved by the shareholders on that date and completed on February 1, 2000.

[16] Prior to the closing, employees holding in aggregate options to acquire 4,848,600 Imasco shares elected to surrender their options for cash equal to the difference between $41.60 per share and the exercise price. The surrender payments totalled approximately $118 million. A small number of options (62,800) were not surrendered. They were exercised before the closing, and the shares issued as a result were acquired by Bidco on the closing date. The result was that after the going private transaction, Imasco had no further obligations under the Imasco stock option plan.

[17] The surrender payments included an additional amount intended to compensate employees who surrendered their options for cash and who, for that reason, might not be entitled to a deduction under paragraph 110(1)(*d*) of the *Income Tax Act*. That deduction would be available to those who exercised their options and sold the shares. Neither party suggests that this top-up is relevant to the deductibility of the payments Imasco made to employees who surrendered their options.

Statutory provisions and jurisprudence

[18] Subsection 9(1) of the *Income Tax Act* is the general rule for determining, for income tax purposes, a taxpayer's income from a business or property. It reads as follows:

9. (1) Subject to this Part, a taxpayer's income for a taxation year from a business or property is the taxpayer's profit from that business or property for the year.	9. (1) Sous réserve des autres dispositions de la présente partie, le revenu qu'un contribuable tire d'une entreprise ou d'un bien pour une année d'imposition est le bénéfice qu'il en tire pour cette année.

The word "profit" in subsection 9(1) generally is taken to mean profit as determined under well accepted business principles, subject to the established case law and provisions of the *Income Tax Act* (*Canderel Ltd. v. Canada*, [1998] 1 S.C.R. 147, at paragraph 53).

[19] It appears that the surrender payments were deducted by Imasco in determining its profit for income tax purposes and for its financial reporting purposes. The Crown did not allege that the deduction was not appropriate under well accepted accounting principles, and there is no evidence on that point. However, that is of no assistance to Imasco. The computation of profit as described in section 9 is stated to be "subject to this Part". That qualifying phrase refers to the many detailed rules in Part I of the *Income Tax Act* for determining profit for income tax purposes. Section 18 is one of those provisions. It limits or prohibits the deduction of certain amounts. The Crown's position that the surrender payments are not deductible is based on section 18 – specifically paragraph 18(1)(*b*). If the Crown is correct, then it does not matter whether well accepted accounting principles would have permitted the deduction for financial reporting purposes.

[20] Paragraph 18(1)(*b*) reads as follows (my emphasis):

18. (1) In computing the income of a taxpayer from a business or property no deduction shall be made in respect of	18. (1) Dans le calcul du revenu du contribuable tiré d'une entreprise ou d'un bien, les éléments suivants ne sont pas déductibles :
…	[…]
(b) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part….	b) une dépense en capital, une perte en capital ou un remplacement de capital, un paiement à titre de capital ou une provision pour amortissement, désuétude ou épuisement, sauf ce qui est expressément permis par la présente partie […].

[21] The statutory prohibition on the deduction of a payment on account of capital requires consideration of the principles for distinguishing capital and income. The determination is driven primarily by the facts of the particular case, with the cases providing guidance on the factors to be taken into account. That is well expressed in *Minister of National Revenue v. Algoma Central Railway*, [1968] S.C.R. 447, at page 449-50 (my emphasis):

> Parliament did not define the expressions "outlay ... of capital" or "payment on account of capital". There being no statutory criterion, the application or non-application of these expressions to any particular expenditures must depend upon the facts of the particular case. We do not think that any single test applies in making that determination and agree with the view expressed, in a recent decision of the Privy Council, *B.P. Australia Ltd. v. Commissioner of Taxation of the Commonwealth of Australia* [[1966] A.C. 224], by Lord Pearce. In referring to the matter of determining whether an expenditure was of a capital or an income nature, he said, at p. 264:
>
> > The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a commonsense appreciation of all the guiding features which must provide the ultimate answer.

[22] One of the most frequently cited passages on the issue that arises in this case is found in the decision of Viscount Cave L.C. in *British Insulated and Helsby Cables v. Atherton*, [1926] A.C. 205 (H.L.), at pages 213-14:

> … when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital.

[23] As ubiquitous as this passage is, it is not a bright line test. Rather, it is useful guide for identifying some of the factors that may be relevant.

[24] *Johns-Manville* (cited above) confirms that, despite the many cases that have resulted in useful catch phrases, there is no single legal test for distinguishing payments on income account from payments on capital account. *Johns-Manville* is also helpful in identifying some factors that may be considered in determining whether a payment is on account of capital. The taxpayer in *Johns-Manville* was the operator of an open pit mine. It sought current deductions for amounts paid to buy land around the pit which was needed to maintain the slope of the sides of the pit. After a lengthy review of the facts and the jurisprudence, Estey J. (writing for the Court) held that the expenditures were not on account of capital. It appears to me that what was particularly important was that the expenditures were not made to acquire assets of intrinsic or enduring value. Rather, they were an easily discernible and relatively constant part of the taxpayer's operating costs, which would be consumed in the course of the taxpayer's operations.

Application of the principles to the facts of this case

[25] In this case, the Crown argues that the payments in issue are expenditures on capital account because they were made in the context of a reorganization of the capital of Imasco and extinguished all of the outstanding obligations of Imasco to issue shares. As I understand the reasons of Justice Bowie, this is essentially the basis upon which he concluded that the payments in issue were on account of capital.

[26] Imasco argues that the payments in issue are best characterized as employee compensation, and therefore deductible as an ordinary business expenses. This argument relies on *Imperial Tobacco Canada Ltd. v. Canada*, 2007 TCC 636 (referred to as "*Shoppers Drug Mart*"), and in particular on the following statement at paragraph 22 (footnote omitted):

> I start from the premise that in the ordinary course a payment made by an employer to an employee for the surrender of his or her option under a stock option plan to acquire shares of the company is a deductible expense to the company. This conclusion is not based on any specific provision of the *Income Tax Act*. It is simply part of employee compensation and is therefore a cost of doing business under section 9.

[27] *Shoppers Drug Mart* dealt with another aspect of the going private transaction considered in this case. It involved the deductibility of a payment made by Shoppers Drug Mart Limited ("SDM") to Imasco, then its parent corporation, as a reimbursement of payments made by Imasco upon the surrender by employees of SDM of stock options issued to them under the Imasco stock option plan. The decision of this Court in *Kaiser Petroleum Ltd. v. Minister of National Revenue* (1990), 116 N.R. 209; [1990] 2 C.T.C. 439; 90 D.T.C. 6603 (F.C.A.) ("*Kaiser*") involving similar facts was distinguished on the basis that the payment by SDM involved no capital restructuring of SMN and

no enduring benefit to SDM. That left only the premise quoted above, which led the judge to conclude that the payment was deductible as employee compensation.

[28] It is arguable that a payment made by a corporation on the surrender of an employee stock option is employee compensation, and therefore deductible by the corporation, if it is one of a number of like transactions undertaken as part of the day to day interaction of the corporation with its employees (perhaps by analogy to *Johns-Manville*). I doubt that I would have concluded that this fairly describes the payment in issue in the *Shoppers Drug Mart* case, but I need not express a final opinion on that point. What is in issue here is whether there is merit to Imasco's position that Justice Bowie erred in failing to characterize the payments in issue in this case as employee compensation.

[29] The specific question is whether Justice Bowie's conclusion in this case was based on an error in his understanding or application of the relevant jurisprudence. A careful review of Justice Bowie's reasons discloses no such error. In my view, there are three factors that point to the conclusion that the payments in issue were on capital account. First, they coincided with a reorganization of the capital of Imasco (the going private transaction and amalgamation). Second, the arrangements put in place for making the payments facilitated and were intended to facilitate the capital reorganization. Third, the payments were intended to and did end all future obligations of Imasco to deal with its own shares, which can fairly be described as a once and for all payment that resulted in a benefit to Imasco of an enduring nature.

[30] There are two factors that arguably could favour the position of Imasco. First, the employee stock option plan itself was entered into to provide a form of employee compensation and the plan

had, at least since 1995, contemplated periodic surrenders of options for cash, albeit at the option of Imasco. Second, the shares represented by the surrendered options represented only a small portion of the Imasco issued shares.

[31] Justice Bowie was clearly aware of these facts, and just as clearly he did not consider them to be of sufficient weight to overcome the factors that supported the conclusion that the payments in issue were outlays on account of capital. In finding as he did, Justice Bowie relied on *Kaiser* (cited above) which he found to be indistinguishable on its facts. The payments in issue in *Kaiser* were held to be on account of capital because their immediate result was to "eliminate extraneous shares or share possibilities", which was characterized as a form of capital restructuring. Imasco argues that *Kaiser* is distinguishable for a number of reasons. It is true that there are some factual differences. They are listed at paragraph 10 of Justice Bowie's reasons. However, he concluded that these were "distinctions without a difference". I agree with Justice Bowie that the facts are sufficiently similar to merit a similar outcome.

[32] Imasco suggests that *Kaiser* is wrong in principle and should not be followed (*Miller v. Canada (Attorney General)*, 2002 FCA 370). This argument seems to be based on the notion that *Kaiser* is not in step with current economic realities because it is more common now for a corporation to adopt an employee stock option as part of the ordinary compensation package for employees at all levels. I see no reason to conclude that the greater use of employee stock option plans, in and by itself, should mean that a transaction like the one considered in *Kaiser* is not on capital account.

[33] In my view, Justice Bowie's conclusion is consistent with the evidence and the applicable legal principles. I can discern no error that would justify the intervention of this Court.

Conclusion

[34] I would dismiss the appeal with costs.

"K. Sharlow"
J.A.

"I agree.
M. Nadon J.A."

"I agree.
Eleanor R. Dawson J.A."

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

DOCKET:	A-35-11
STYLE OF CAUSE:	IMPERIAL TOBACCO CANADA LIMITED v. HER MAJESTY THE QUEEN
PLACE OF HEARING:	TORONTO, ONTARIO
DATE OF HEARING:	OCTOBER 26, 2011
REASONS FOR JUDGMENT BY:	SHARLOW J.A.
CONCURRED IN BY:	NADON J.A. DAWSON J.A.
DATED:	NOVEMBER 10, 2011

APPEARANCES:

Al Meghji Patrick Marley Pooja Samtani	FOR THE APPELLANT
Bobby J. Sood Aleksandrs Zemdegs Rita Araujo	FOR THE RESPONDENT

SOLICITORS OF RECORD:

Osler, Hoskin & Harcourt LLP Barristers and Solicitors Toronto, Ontario	FOR THE APPELLANT
Myles J. Kirvan Deputy Attorney General of Canada	FOR THE RESPONDENT