Current Cases

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FEDERAL COURT OF APPEAL

THE TAXATION OF "EGREGIOUS OR REPULSIVE" CONDUCT AND THE TREATMENT OF PREJUDICIAL, SCANDALOUS, OR ABUSIVE PLEADINGS

Canadian Imperial Bank of Commerce v. Canada
2013 FCA 122

KEYWORDS: PUBLIC POLICY ■ BUSINESS EXPENSES ■ DEDUCTIONS ■ CLASS ACTION ■ LITIGATION ■ GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

Introduction

The recent appeals of two interlocutory motions in *Canadian Imperial Bank of Commerce v. Canada*[1] provided the Federal Court of Appeal with the opportunity to consider whether it is necessary to evaluate the morality of a taxpayer's conduct in assessing the deductibility of business expenses. In studying the question, the court considered the role of unlegislated public policy considerations in interpreting the Income Tax Act,[2] and canvassed the case law examining the taxation of illegal conduct. In concluding, on behalf of the court, that the morality of a taxpayer's conduct is generally irrelevant in assessing whether the taxpayer's business expenses are deductible, Sharlow J resolved a certain ambiguity that had arisen in respect of Supreme

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1 2013 FCA 122.

2 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this feature are to the Act.

Court of Canada jurisprudence. She also provided interesting insight into the Crown's litigation strategy, as well as helpful guidance with regard to the drafting of pleadings.

Facts

The court decided three appeals regarding two interlocutory orders issued by Rossiter ACJ at the Tax Court of Canada ("the first order"[3] and "the second order,"[4] respectively). The interlocutory orders were heard in the course of ongoing income tax appeals before the Tax Court that were launched by the Canadian Imperial Bank of Commerce (CIBC) in respect of notices of reassessment issued for the 2002, 2003, 2005, and 2006 taxation years.

The main issue in each of the four income tax appeals was the deductibility of expenses totalling approximately $3 billion incurred by CIBC in connection with the settlement of certain legal claims that arose following the bankruptcy of Enron Corporation ("Enron"). Most of the $3 billion was paid to settle certain law suits (referred to in the decision as the "Newby Litigation" and the "MegaClaim Litigation") in which CIBC and several of its affiliates were named as defendants. The remainder of the impugned expenditures were attributable to payments of interest and legal fees relating to the settlements.

The Newby Litigation and MegaClaim Litigation were launched in the United States and alleged that Enron had issued materially misleading financial reports that caused the complainants to suffer losses for which Enron was liable. The source of the alleged errors in the Enron financial statements was a series of transactions that were allegedly mischaracterized as asset sales rather than loans as required under US accounting standards. The lawsuits alleged that this mischaracterization caused Enron's debts to be materially understated in its financial statements.

The lawsuits alleged that CIBC or its affiliates financed certain of the impugned transactions and had sufficient knowledge of Enron's affairs to render them jointly and severally liable with Enron and various other defendants for the complainants' losses.

CIBC and its affiliates entered into a settlement agreement with the complainants pursuant to which the settlement payments were made. The settlement agreement discharged the claims against CIBC and its affiliates with no admission of wrongdoing or liability. CIBC alleged in its notice of appeal before the Tax Court that the settlement was legally and commercially prudent, that it permitted CIBC to avoid the adverse effects of ongoing litigation, and that it enabled CIBC to avoid becoming jointly and severally liable with other defendants to the litigation.

CIBC deducted the settlement payments for financial statement purposes in purported compliance with generally accepted accounting principles (GAAP). Similarly, CIBC asserted that the settlement payments were properly deducted for tax purposes

3 *Canadian Imperial Bank of Commerce v. The Queen*, 2011 TCC 568.

4 *Canadian Imperial Bank of Commerce v. The Queen*, 2012 TCC 237.

pursuant to sections 3 and 9 of the Act. The minister reassessed CIBC, denying the deduction of the settlement payments.

Procedural History

The interlocutory orders were made in connection with CIBC's motion to strike the Crown's reply pursuant to rule 53 of the Rules of the Tax Court of Canada (General Procedure).[5] Rule 53 reads as follows:

> 53. The Court may strike out or expunge all or part of a pleading or other document, with or without leave to amend, on the ground that the pleading or other document,
> (a) may prejudice or delay the fair hearing of the action,
> (b) is scandalous, frivolous or vexatious, or
> (c) is an abuse of the process of the Court.

At the Tax Court, it was noted that the Crown's replies and CIBC's motions to strike the replies were similar from year to year. Accordingly, argument at both the Tax Court and the Federal Court of Appeal was focused on the Crown's reply to CIBC's 2002 notice of appeal with the understanding that the courts' decisions would be applied to the other taxation years.

Both the Crown and CIBC launched appeals of the first order striking out certain portions of the Crown's reply and refusing to strike out others. Pursuant to the terms of the first order, the Crown submitted a draft amended reply to the Tax Court, which purported to comply with the terms of the first order. The Tax Court's second order struck out portions of the draft amended reply that remained non-compliant with the first order. The Crown appealed the second order.

The CIBC Appeal

CIBC's appeal of the first order ("the CIBC appeal") was in respect of the Tax Court's refusal to grant CIBC's motion to strike paragraph 134 of the Crown's reply (reproduced below) and all other references to the taxpayer's alleged "egregious or repulsive" conduct.[6] It appears that the parties were in agreement that the motion would be granted "only if it is plain and obvious, assuming the facts as pleaded in the reply are true, that the reply fails to state a reasonable basis for concluding that the reassessment under appeal is correct."[7]

Paragraph 134 of the Crown's reply, as reproduced in the decision, stated:

> The misconduct of [CIBC and its affiliates] was so egregious and repulsive that any consequential settlement payments . . . cannot be justified as being incurred for the purpose of gaining or producing income from a business or property within the meaning

5 Tax Court of Canada Rules (General Procedure), SOR/90-688a, as amended.

6 Supra note 1, at paragraph 21.

7 Ibid., at paragraph 7.

> of paragraph 18(1)(a) of the Act. The [CIBC affiliates] knowingly aided and abetted Enron to violate the United States' federal securities laws and falsify its financial statements. The misconduct of [the CIBC affiliates] in enabling Enron to perpetrate its frauds, known to [CIBC], or the misconduct of [CIBC] itself, was so extreme, and the consequences so dire, that it could not be part of the business of a bank.[8]

The Tax Court had concluded that it was not plain and obvious that the minister's denial of the deduction could not be sustained on the basis that CIBC's alleged conduct was so "egregious and repulsive" that it could not have been incurred for the purpose of gaining or producing income from a business or property within the meaning of paragraph 18(1)(a).[9] The relevant portion of paragraph 18(1)(a) states:

> 18(1) In computing the income of a taxpayer from a business . . . no deduction shall be made in respect of
>
> (a) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business.

The plain text of paragraph 18(1)(a) does not suggest that an evaluation of a taxpayer's moral culpability is required in determining the deductibility of an expense that is otherwise permissible under subsection 9(1).[10] The Crown's theory that expenses in connection with egregious or repulsive conduct could not be deducted pursuant to paragraph 18(1)(a) relied on the following obiter dictum of Iacobucci J, writing for the majority of the Supreme Court of Canada in *65302 British Columbia Ltd. v. Canada* (frequently referred to as "the *Egg* case"):

> It is conceivable that a breach [of the law] could be so egregious or repulsive that the fine subsequently imposed could not be justified as being incurred for the purpose of producing income.[11]

In deciding the *Egg* case, the majority of the Supreme Court rejected a line of cases that had held that certain fines and penalties were not deductible as business expenses pursuant to paragraph 18(1)(a), on the basis that such deductions would undermine the public policy objective of the imposition of the fine or penalty. In rejecting this line of cases, the Supreme Court adopted the competing view that it is solely for Parliament, and not the courts, to determine public policy exceptions in matters of fiscal law. Rather than giving effect to unlegislated public policy

8 Ibid., at paragraph 20.

9 Supra note 3, at paragraph 30.

10 Subject to various exceptions listed in the Act, an amount that is deductible in computing profit under well-accepted business principles, including GAAP, is generally deductible in computing a taxpayer's income from a business for the purposes of subsection 9(1).

11 [1999] 3 SCR 804, at paragraph 69.

considerations, the Supreme Court encouraged Parliament to legislate any such public policy limits deemed appropriate by the legislature.

Parliament responded to the *Egg* case by enacting section 67.6. Subject to certain exceptions, section 67.6 generally limits the deduction of fines or penalties imposed under law or by a person or public body authorized to impose such a fine or penalty. Similarly, section 67.5 generally prohibits deductions in respect of outlays or expenses where the payment is incurred for the purpose of doing anything that is an offence under certain specified sections of the Corruption of Foreign Public Officials Act (Canada) or the Criminal Code (Canada). Notably, neither section 67.5 nor section 67.6 addresses amounts paid to settle civil litigation—particularly where the payer did not admit wrongdoing.

After reviewing various cases that both preceded and followed the *Egg* case, the Federal Court of Appeal concluded that the Crown's submission regarding the deductibility of expenses incurred in respect of egregious or repulsive conduct was based on a misinterpretation of Iacobucci J's obiter dictum in the *Egg* case. The court rejected the Crown's suggestion that the Supreme Court, having rejected the superimposition of a non-legislated public policy test on paragraph 18(1)(a), would accept a judicially superimposed non-legislated requirement that a taxpayer's conduct not be "egregious or repulsive" in order to satisfy the requirement for claiming a deduction under paragraph 18(1)(a).

Rather than accepting the Crown's position that Iacobucci J's obiter dictum supported the proposition that an otherwise acceptable business expense could be denied under paragraph 18(1)(a) solely because the taxpayer's conduct was egregious or repulsive, the court interpreted the obiter dictum as simply noting that certain conduct could be so egregious or repulsive as to be factually disconnected from the taxpayer's business. Under this interpretation, it was suggested that egregious or repulsive conduct could simply be an indication that an expense was not incurred for the purpose of gaining or producing income from a business, rather than being a determinative factor with regard to whether an expense was deductible. Accordingly, the court concluded that the only question to be asked in determining whether paragraph 18(1)(a) prohibits a deduction is "Did the taxpayer incur the expense for the purpose of earning income?"

At the hearing, the Crown advanced the alternative argument that it should nevertheless be entitled to rely on subsection 9(1) to plead that CIBC's conduct was so outrageous that it fell outside the scope of the business of a bank, and for that reason, the settlement payments were not deductible under well-accepted business principles or GAAP. The lack of case law in support of this proposition led the court to conclude that no such morality test could deny the deduction of an expense that was otherwise properly deductible under well-accepted business principles and was not precluded by any specific statutory measures.

On the basis of the conclusions above, the court overturned the Tax Court's decision to let paragraph 134 of the Crown's reply stand and ordered that that paragraph, and all factual assumptions or allegations elsewhere in the reply that asserted a moral evaluation of CIBC's conduct, be struck from the Crown's reply.

The Crown Appeals

In response to CIBC's 13-page notice of appeal, the Crown filed a 94-page reply (11 pages of which consisted of two schedules). Although the Federal Court of Appeal acknowledged that pleadings should not be viewed as objectionable merely because of their length, the Tax Court[12] found that the Crown's reply contained unnecessary and repetitious detail, and lengthy references to evidence. The Tax Court further held that many of the factual assumptions in the Crown's reply were actually conclusions of law or mixed law and fact.

The Tax Court also found that many of the statements in the Crown's reply used language that was scandalous, prejudicial, an abuse of process, or some combination of the three, and suggested that improperly drafted pleadings could "poison the mind of the trial judge."[13] Among the offending words and phrases used by the Crown were "fraud," "misrepresented," "fraudulent purpose," "fraudulent conduct," "aided and abetted," "knowingly aided and abetted Enron to violate the United States' federal securities laws," "manipulated [Enron's] reported financial results," and "criminal conduct." The Tax Court also objected to the Crown's use of the defined phrase "Disguised Loan" to refer to the impugned transactions.[14]

The Tax Court directed the Crown to amend the replies in accordance with a detailed schedule of prescribed changes contained in the first order[15] to address the above concerns.

As required by the first order, the Crown submitted to the Tax Court a draft amended reply purportedly addressing the concerns identified in the first order.[16] The Tax Court concluded that significant portions of the draft amended reply remained non-compliant with the first order. The Tax Court observed that many of the problematic words or phrases were simply replaced with near synonyms and that "[s]everal of the additional paragraphs are replete with conclusions of mixed fact and law . . . ; they are prejudicial and an abuse of process."[17] Accordingly, the Tax Court issued a second order requiring the Crown to conform the draft amended reply with a detailed schedule of prescribed changes addressing these additional concerns.

The Crown appealed both the first order and the second order of the Tax Court.

The Federal Court of Appeal denied the Crown's appeals. The court acknowledged that the Tax Court's orders to delete listed words and phrases was not a precise way of dealing with the problems presented by the Crown's reply and draft amended

12 Supra note 3.

13 Ibid., at paragraph 38.

14 See "Motion To Strike Table: Text To Strike with Reasons," appended to the Tax Court's decision, supra note 3.

15 Ibid.

16 Supra note 4.

17 Ibid., at paragraph 8.

reply, since deleting the words and phrases left a number of incomplete and incoherent sentences. However, the court agreed that the Crown's use of the impugned words was intended to colour the facts in a way that would invite the judge hearing the appeal to evaluate the propriety of the conduct of CIBC, its employees, and its affiliates. Accordingly, the court agreed with the Tax Court's finding that the inclusion of such words and phrases was prejudicial and vexatious.

Since the court ruled in the CIBC appeal that the morality and legality of a taxpayer's conduct was generally not relevant in determining the deductibility of an expenditure for purposes of the Act, the court also concluded that much of the text ordered to be struck from the reply and the draft amended reply was not relevant for determining the appeals at hand. The court noted that the inclusion of such irrelevant issues in the Crown's pleadings would multiply the resources expended in pretrial discovery, with no bearing on the outcome of the appeals, and would invite unproductive debate. The court also opined that CIBC should not be required to expend resources in refuting assumptions or allegations of fraud or criminal activity that would not assist the Tax Court in determining the deductibility of the settlement payments.

The court did, however, acknowledge that there may be limited circumstances when a mixed statement of fact and law may be permitted to be pleaded by the Crown as a factual assumption. The court suggested that the circumstances in which such a deficient pleading could stand should be limited to circumstances in which the facts are relatively simple, there is little or no debate about the applicable legal principles, or there is little risk that the other party will be prejudiced or will be obliged to waste resources. The court noted that the appeal before it was not such a case.

Conclusion

The court's guidance in the CIBC decision provides welcome clarification about the scope of Iacobucci J's obiter dictum in the *Egg* case. In refusing to give effect to unlegislated public policy considerations, such as whether a taxpayer's conduct was "egregious or repulsive," the court confirmed that the relevant question to be asked in determining whether a business expense is deductible under paragraph 18(1)(a) is simply whether the taxpayer incurred the expense for the purpose of earning income.

The alternative conclusion—that an expenditure may not be deductible solely because of the taxpayer's "egregious or repulsive" conduct—would have introduced intolerable uncertainty into the Act and required courts to evaluate the morality of taxpayers' behaviour. The ambiguity of the "egregious or repulsive" standard would have introduced an element of subjectivity that is inconsistent with the aim of fiscal statutes and could have increased the cost and length of litigation and the scope of discovery.

Had the Crown been successful in its appeals, that outcome could also have had a chilling effect on taxpayers' willingness to settle commercial litigation. Benefits of settling litigation include the avoidance of costs (locating documents, interviewing witnesses, etc.) and the avoidance of public scrutiny of activities that could cause

embarrassment or a loss of future business. If these benefits are removed because taxpayers are compelled to defend their conduct in the Tax Court instead of the civil courts, taxpayers may be less likely to settle such litigation.

The court's interpretation also proved to be more harmonious with the scheme of the Act than was the position put forward by the Crown. The court noted that it has long been accepted in Canada that a taxpayer who conducts an illegal business, or a business conducted unlawfully, is taxable on the profits of that business on the same principles as any other business, except to the extent that a different result is required by a specific provision of the Act.[18] The court cited various cases where taxpayers carrying on an illegal business activity were able to deduct expenses of the illegal business in accordance with well-accepted business principles.[19] Denying such deductions while taxing the gross revenue of an illegal business enterprise would have been inconsistent with the principle of horizontal equity and could result in punitive levels of taxation.[20]

The court also provided a useful reminder regarding the drafting of pleadings. Although the Crown was generally unsuccessful in defending its pleadings in the subject interlocutory motions, there are several outstanding issues that will ultimately need to be resolved in the tax appeal.[21] While the removal of the various allegations of impropriety and illegality by the Crown may lower the temperature of the appeal, the plethora of outstanding issues and large value of the deduction at stake suggest that more controversy may be to come.

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18 Supra note 1, at paragraph 2.

19 See, for example, *Minister of Finance v. Smith* (1926), 1 DTC 92 (PC), and *MNR v. Eldridge*, 64 DTC 5338 (Ex. Ct.).

20 Although the punishment of illegal business enterprises is supportable from a public policy perspective, the Act is arguably ill suited for such a purpose.

21 The Crown's reply identified the following additional grounds to support the denial of the claimed deduction of the settlement amounts (as reproduced in the decision, supra note 1, at paragraph 19):

(a) the settlement payments were not made or incurred by CIBC for the purpose of earning income from its business (paragraph 18(1)(a)—paragraph 133 of the reply);
(b) the settlement payments were made or incurred by CIBC on behalf of one or more of CIBC's affiliates (paragraph 135 of the reply);
(c) the settlement payments were outlays or payments on account of capital (paragraph 18(1)(b)—paragraph 136 of the reply);
(d) the terms or conditions made or imposed in respect of securing releases on behalf of CIBC affiliates differed from those that would have been made between persons dealing at arm's length so that 93% of the settlement payments are not deductible (subsection 247(2)—paragraph 137 of the reply);
(e) the settlement payments were contingent liabilities in the years the deductions were claimed (paragraph 18(1)(e)—paragraph 138 of the reply); or
(f) the settlement payments were not outlays or expenses that were reasonable in the circumstances (section 67—paragraph 139 of the reply).