WINDFALLS IN THE TAX COURT

Henco Industries Limited v. The Queen
2014 TCC 192

KEYWORDS: CUMULATIVE ELIGIBLE CAPITAL ■ GOODWILL ■ GOVERNMENT ■ INVENTORY ■ REAL ESTATE

A former land developer in *Henco Industries Limited v. The Queen*[32] successfully argued before the Tax Court that a $15.8 million payment from the Ontario government should be characterized as a non-taxable capital receipt and a separate payment of $650,000 from the Ontario government should be characterized as a non-taxable windfall. Although the decision is noteworthy for concluding that these payments are not taxable, the decision by Miller J should also interest members of the tax community because of its analysis of various other issues discussed in the final ruling, including the distinction between eligible capital amounts and non-taxable capital receipts, the scope of paragraph 12(1)(x), the nature of inventory in the context of section 23, and the applicability of the parol evidence rule in interpreting agreements before the Tax Court.

Although legislative amendments may in part limit the relevance of the *Henco* decision to future cases attempting to delineate the boundary between eligible capital amounts and non-taxable capital receipts, the case raises broader structural questions about the nature of Canadian taxation and the types of payments that are subject to taxation under the Act. As noted by Miller J in his decision on costs,

> [f]inding a payment to be a non-taxable capital receipt is not something any Tax Court of Canada judge does lightly. It can have serious repercussions in our overall system of taxation as to what is a source of income that is subject to Government taxation. Circumstances are rare that a payment, perhaps shrouded in a commercial light, is non-taxable. But cases that peak under that shroud, and give both Government and taxpayers alike guidance as to what can and cannot be swept into the taxing regime, should be of keen interest.[33]

Facts

Henco was in the business of developing land in and around Caledonia in southwestern Ontario. As of February 2006, Henco's landholdings included properties described in the decision as (1) the Douglas Creek Estates (DCE), (2) the Seneca property, and (3) the Morrison property.[34]

---

32 2014 TCC 192.

33 2014 TCC 278, at paragraph 9.

34 The court also made rulings relating to (1) the fair market value of the Seneca and Morrison properties and (2) whether the Seneca property was held on income or capital account.

Beginning in February 2006, protests on or near the site of the DCE land by certain First Nation members and their supporters made development of the land impossible. The protesters were reported to dispute, among other things, whether the land had been properly surrendered by the First Nation during the 19th century. According to the agreed statement of facts, the protests were held "to try to stop, or at least disrupt, further development of the subdivision."[35]

Henco obtained certain injunctions from the Ontario Superior Court of Justice to clear the protesters from the DCE land. However, the Ontario Provincial Police declined to enforce the injunctions following a failed attempt to disperse the protest in April 2006.

After the police failed in their attempt to disperse the protest, the Ontario government offered Henco the $650,000 payment. The documentation accompanying the payment indicated that it was made "to mitigate the impact of continued occupation of DCE."[36] The documentation also stated that the DCE "Funding Assistance is in respect of development, building and other related costs and expenses that have been incurred by Henco in connection with the [DCE land] because of the occupation."[37] Henco's representatives indicated that the terms were not negotiated nor agreed to by Henco. Although Henco accepted payment on May 3, 2006, it signed nothing to confirm its acceptance of the offered terms and nothing to confirm that it was to do or refrain from doing anything as consideration for the payment.

In its T2 income tax return for the taxation year that ended on April 29, 2006, Henco wrote down the value of the land inventory in respect of the DCE to $7. The Canada Revenue Agency (CRA) and Henco each had valuation reports prepared that confirmed that the DCE property had only nominal fair market value on May 1, 2006.

Representatives of the protesters, the Ontario government, and the federal government entered into a three-party agreement on May 16, 2006, agreeing to halt any development on the DCE land for an indeterminate period of time. Provincial zoning regulations enacted on May 17, 2006 generally prohibited development of the DCE land.

Before February 2006, Henco estimated that it would earn profits of approximately $30 million in respect of the development of the DCE land on revenues of approximately $45 million.

An agreement was signed in June 2006 pursuant to which Henco sold the DCE land and certain related business assets to the government of Ontario in exchange for $15.8 million. Henco was also obliged under the terms of the agreement to stop developing the DCE land, take steps to have the injunction removed, and release Ontario from any and all claims in respect of the land. As part of the agreement, the government of Ontario agreed to reimburse Henco for reasonable costs relating to

35 Supra note 32, at paragraph 9.

36 Ibid., at paragraph 29.

37 Ibid.

the retention of consultants, legal advisers, appraisers, experts, advisers, or other third parties, subject to a maximum amount of $300,000.

Parol Evidence

At the beginning of the trial, the Crown brought a motion seeking to exclude, among other things, extrinsic evidence that Henco might try to admit to interpret or contextualize the agreement. The Crown brought the motion on the basis that this evidence was not admissible pursuant to the parol evidence rule. Quoting Waddams, the Crown described the parol evidence rule as follows:

> By the general rules of the common law, if there be a contract which has been reduced into writing, verbal evidence is not allowed to be given of what passed between the parties, either before the instrument was made, or during the time that it was in a state of preparation, so as to add to, or subtract from, or in any manner to vary or qualify the written contract.[38]

The Crown acknowledged that there are certain exceptions to the parol evidence rule that permit courts to review extrinsic evidence to interpret a contract. In argument, it suggested that these circumstances are limited to situations in which there is either a patent or a latent ambiguity in the contract. Accordingly, the Crown took the position that evidence concerning the circumstances at the time of contracting should be admitted only when the words of the contract, viewed objectively, bore two or more reasonable interpretations.

However, the Crown acknowledged that certain courts have accepted extrinsic evidence to establish the "factual matrix" or "surrounding circumstances" that led to the formation of an agreement to assist them in determining the parties' contractual intentions as they would be determined by a reasonable person.[39] A factual matrix or the surrounding circumstances can help a court to understand what the parties meant by the words that they used in a contract. Henco went further, suggesting that such an analysis was necessary to the proper interpretation of a contract, citing *River Hills Ranch Ltd. v. The Queen*, in which it was found that "the objective contextual scene in which the written agreement was made is an integral part of the interpretive process and is not something that is resorted to only where the words viewed in isolation suggest some ambiguity."[40]

In considering the parties' positions, Miller J observed that "there is no discernible bright line establishing a factual matrix (clearly admissible) and evidence of subjective attention [sic] (perhaps inadmissible)."[41]

---

38 S.M. Waddams, *The Law of Contracts*, 6th ed. (Aurora, ON: Canada Law Book, 2010), at paragraph 320, note 10, quoted in *Henco*, supra note 32, at paragraph 82.

39 Supra note 32, at paragraph 84.

40 2013 TCC 248, at paragraph 42.

41 Supra note 33, at paragraph 88.

The court noted the difference between the task before the civil courts, where two parties to a contract may be disputing the presence or significance of unwritten contractual rights or obligations, and the task before the Tax Court, which must assess the correctness of the characterization of the nature of a payment by a third party, the government of Canada. In the latter case, the court noted that the factual matrix is essential in determining the true nature of the payment for the purposes of assessing tax.

The court expressed concern that a contract may be drafted without due consideration of its tax implications or, more significantly, may be misleadingly drafted to affect the character of the transaction for tax purposes. A broad interpretation of the parol evidence rule in these circumstances could produce inappropriate results that are inconsistent with the object and purpose of the Act. As an example, the court cited the line of jurisprudence distinguishing employment relationships from independent contractor relationships. In these circumstances, the courts are required to look beyond the text of the contracts to the actions of the parties. Similarly, section 68 requires the courts to look beyond the stated allocation of the parties to determine a reasonable allocation in the circumstances. Such an inquiry into reasonableness would almost certainly necessitate an examination of the surrounding circumstances.

Applying the above principles to the *Henco* decision, the court found that a review of the factual matrix or surrounding circumstances giving rise to the signing of the agreement was imperative in interpreting the nature of the payments made under the agreement. Rather than being an ordinary commercial arrangement that was committed to writing, the agreement was drafted in "exceptional circumstances" in which market forces did not play a material role.[42]

Moreover, the terms of the contract itself invited the use of extrinsic evidence: the preamble stated "[w]hereas based on circumstances relating to the use and development of the property."[43] The court also found that the agreement was ambiguous because it failed to allocate the payment among the assets being sold. The parties' failure to make such an allocation made the examination of extrinsic facts necessary in order to allocate these amounts for tax purposes.[44]

Income or Windfall: The $650,000 Payment

The Crown argued that the $650,000 payment fell within the scope of paragraph 12(1)(x). In general terms, paragraph 12(1)(x) deems certain amounts to be included in a taxpayer's income from a business or property, including certain amounts paid

42 Ibid., at paragraph 92.

43 Ibid., at paragraph 95.

44 Ibid., at paragraph 98. Paragraphs 100-16 of the court's reasons considered which forms of extrinsic evidence would be admitted into evidence under one of the exceptions to the hearsay rule. The court found that certain government press releases were admissible into evidence, but it prohibited the admission of the affidavits of certain public officials. If counsel for Henco wished to have the evidence admitted, Henco would have to have called the public officials as witnesses.

by a government that are received by a taxpayer in the course of earning income from a business or property, to the extent that the payment can reasonably be considered to have been received as assistance in respect of an outlay or expense.

The court summarized the four criteria that would have to be satisfied for the $650,000 payment to be included in Henco's income pursuant to paragraph 12(1)(x):

1) The $650,000 must have been received by Henco "in the course of earning income from a business or property";
2) The payment must have been from a government;
3) The payment can reasonably be considered to have been received as assistance in respect of an outlay or expense;
4) The payment was not for the acquisition of Henco's business or property.[45]

Henco's position before the court was that the $650,000 payment did not fall within the scope of paragraph 12(1)(x) because (1) the payment had not been received in the course of earning income from a business or property, and (2) the payment could not reasonably be considered to have been received as assistance in respect of an outlay or expense. In the alternative, Henco argued that the $650,000 had been received in respect of Henco's disposition of the DCE land.

In the Course of Earning Income from a Business or Property

Henco emphasized that the first requirement could be satisfied only if the $650,000 payment were received by Henco "in the course of earning income from a business or property." This wording contrasts with the wording in paragraph 12(1)(a), which merely requires a payment to have been received "in the course of a business." Commenting on this distinction, the court observed that it would be possible that a taxpayer could receive a payment while in business yet not in the course of earning income from a business.

Henco was clearly in business and receiving revenue in the course of earning income from a business in 2005 and the first part of 2006 (until the protests began in February 2006). However, the court observed that the $650,000 payment was not made in respect of this period. Rather, it was made in respect of the period beginning in late February 2006 and ending on May 3, 2006, when the payment was received. The court found that it was this latter period that must be examined to determine whether the payment was made in the course of earning income from a business or property.

The court concluded that Henco was not taking steps in the course of earning income from a business during the protests. Rather, it was attempting to preserve the business itself, with an expectation that the protests would eventually cease, thereby permitting it to resume earning income in the course of a business. An example of a step taken by Henco during the protests was the seeking of the injunctions before the Superior Court of Justice.

45 Supra note 32, at paragraph 119.

The three-party agreement to stop developing the DCE land was signed on May 16, 2006, and corresponding zoning amendments, each described in greater detail above, were made on May 17, 2006. Accordingly, the May 3, 2006 payment was received before Henco was legally prohibited from developing the DCE land, notwithstanding the practical impediments that had existed since the protests began in February 2006. The court therefore found that Henco was in business at the time of the payment but had not received the payment in the course of earning income from a business. It observed that "[t]hough this may seem a fine distinction, it is clearly a distinction that the legislation itself makes."[46]

Although the differences in the wording between paragraphs 12(1)(a) and 12(1)(x) invite comparison, it seems that the distinction between an entity that has received a payment "in the course of earning income from a business" and an entity that has merely received a payment "in the course of a business" may be difficult to make in practice. The timing of receipts also takes on greater significance under this interpretation since their taxation depends on the magnitude of the business obstacles (strike, fire, and so on) encountered by a taxpayer at a particular time to determine if the taxpayer receives these amounts "in the course of earning income from a business" or merely "in the course of a business."

Assistance in Respect of an Outlay or Expense

In the alternative, the court also found that the $650,000 payment had not been received as assistance in respect of an outlay or expense, and therefore failed to satisfy the third criterion identified above. The court noted that there was only limited evidence concerning what the payment was for. Although correspondence from Ontario associated with the payment suggested that it was for the purpose of assisting in respect of costs and expenses incurred because of the protests, there was no requirement that the money be spent on these expenses, there was no requirement for an accounting, and Henco did not participate in the preparation of the correspondence.

The court noted that the agreement provided that Henco would be reimbursed, to a maximum of $300,000, in part for "the reasonable costs . . . [that Henco] incurred since February 28, 2006 relating to the occupation of the DCE lands, including all of [Henco's] costs relating to the retention of consultants, legal advisors, appraisers, experts and other third party advisors."[47] Accordingly, without further evidence, the court was unable to determine the other "outlays or expenses" that the $650,000 payment may have covered.

The court concluded that the $650,000 payment was "effectively a no-strings-attached, to use common vernacular, 'freebie,' not swept into income by the application of paragraph 12(1)(x) of the Act."[48] It observed that the Crown had "not presented

46 Ibid., at paragraph 124.

47 Ibid., at paragraph 127.

48 Ibid., at paragraph 129.

any alternative to paragraph 12(1)(x) of the Act for bringing such a payment into income—for good reason."[49] Accordingly, it did not feel obliged to review the requirements of a windfall that were set out in *R v. Cranswick*.[50]

$15.8 Million Payment: Income, Taxable Capital, or Non-Taxable Capital?

The court had to decide on a number of subissues in order to determine the character of the $15.8 million payment; on the basis of its character, the court also had to decide what tax, if any, was applicable. The court adopted the following framework to address these questions:

> 1) Did Henco receive the $15,800,000 for the DCE land?
> 2) If the $15,800,000 was for the DCE land, was the receipt on account of income, pursuant to sections 9 and 23 of the *Act* or on account of capital?
> 3) If the $15,800,000 was for something other than land, was the receipt of the $15,800,000 on account of income or capital, and if on capital account did it result in a capital gain or was it an eligible capital amount or a non-taxable capital receipt?[51]

Was the $15.8 Million Payment Attributable to the DCE Land?

As a preliminary matter, the court had to determine what portion of the $15.8 million payment was attributable to the DCE land. The Crown took the position that the wording of the agreement unequivocally allocated the entire payment to the DCE land. In contrast, Henco argued that the text of the agreement did not reflect the true nature of the arrangement between the parties, which included compensation for the drop in value of Henco's business. As noted above, Henco took the position that the parol evidence rule permitted the court to consider evidence beyond the text of the agreement in assessing the portion of the payment that was attributable to the DCE land.

The agreement did not expressly state that the payment was consideration for the sale of the land. Rather, it cited a number of assets that were sold in addition to the land, including certain contracts, tangible property, and intangible property. The agreement also adopted terminology, such as "compensation," that is more typically associated with contracts for services or payments for damages than with the acquisition of real property.[52]

The agreement did not include an allocation schedule or clause that allocated the $15.8 million payment among the assets being sold. The compensation payable under the agreement was to be determined by reference to the fair market value of

---

49 Ibid., at paragraph 118.

50 [1982] 1 FC 813 (CA).

51 Supra note 32, at paragraph 148.

52 Ibid., at paragraphs 151-52.

the purchased assets on February 27, 2006, immediately before the protests began. The court cited this as evidence that the agreement was atypical in avoiding a valuation on the date of sale.

Further, the court observed that the document contained several clauses that would not ordinarily be included in an agreement to purchase land. For example, one clause required Henco to obtain an order setting aside the injunctions. Another clause required Henco to cease all business.

Accordingly, the court found that the text of the agreement did not accord with a simple transfer of land, as asserted by the Crown. The court instead thought it necessary to review the surrounding circumstances to determine what the payment was for. Among the relevant facts cited by the court were the following: (1) both parties' appraisals found that the land had no value, (2) there was no commercial market for the land, (3) the government of Ontario was not motivated by commercial needs, and (4) the protests had had serious effects.

The court concluded that "Ontario paid Henco to go away and in doing so enable Ontario to get rid of the injunction, acquire control of the volatile situation and restore peace. The effect was to destroy Henco's business."[53] Although land was transferred as part of the deal, the court concluded that the transfer was not a major component. As the court noted, it would be difficult to conclude that Henco received the $15.8 million for selling property that had been appraised as valueless.

If the Payment Was Attributable to the DCE Land, Was the Receipt on Income or Capital Account?

Although the court concluded that the $15.8 million payment was not solely attributable to the acquisition of the of the DCE land, it considered in obiter dicta whether the payment would have been on income or capital account had it been attributable to the DCE land.

The Crown argued that section 23 would have been applicable in these circumstances, deeming the proceeds to have been received on income account. Section 23 reads as follows:

> (1) Where, on or after disposing of or ceasing to carry on a business or a part of a business, a taxpayer has sold all or any part of the property that was included in the inventory of the business, the property so sold shall, for the purposes of this Part, be deemed to have been sold by the taxpayer in the course of carrying on the business. . . .
>
> (3) A reference in this section to property that was included in the inventory of a business shall be deemed to include a reference to property that would have been so included if the income from the business had not been computed in accordance with the method authorized by subsection 28(1) or paragraph 34(a).

53 Ibid., at paragraph 162.

The court described the section as having been put in place to deem property to have been sold on income account when the property had lost its character as inventory because a corporation had gone out of business. Any subsequent sale of the property during the period in which the corporation was not in business would be deemed to have been sold on income account pursuant to section 23.

The Crown submitted that amounts paid to Henco in respect of the DCE land would be deemed to have been on income account pursuant to section 23 since the DCE land had previously formed part of the inventory of Henco's land development business, and no clear and unequivocal act had converted the DCE land from inventory to capital. Although Henco wrote down the value of the land for tax and accounting purposes, the Crown noted that this act was not inconsistent with holding property as inventory.

Conversely, Henco argued that the land had effectively been converted from inventory to capital before its disposition to the Ontario government, making section 23 inapplicable.

In siding with Henco, the court found that the land ceased to be held as inventory once it became unsuitable for development, following which the corporation ceased to carry on business. The court acknowledged that it neither became an investment (it was worthless) nor a capital asset of a business (there was no business) on ceasing to be inventory. The court further determined that the DCE land was not held as an adventure in the nature of trade since there was no adventure, and its ultimate disposition to the government could not be viewed as being in the nature of trade in any commercial sense.

The court described the label "change of use" as a misnomer in this case since the DCE land was first used as a trading asset and then had no use at all. However, the court concluded that there was a conversion pursuant to which the DCE land ceased to be held as inventory. As a result, the court found that if the property was not held as inventory, it must be held as capital. Accordingly, if the court had attributed any portion of the payment to the DCE land, the allocated portion would have been taxable as a capital gain (or loss).

Since the court concluded that only a de minimis amount of the $15.8 million should be allocable to the DCE land, its views on section 23 are obiter dicta. However, the court's suggestion that inventory can lose its character as inventory merely because it becomes useless or worthless to a business is somewhat surprising. Many industries have inventory that at one time or another becomes obsolete or can no longer be sold at a profit.

The court appears to have taken a somewhat narrow view of the section's application in relation to the timing of a change in use. It indicated that inventory that changes use before a corporation ceases to carry on business is not subject to section 23. However, this viewpoint can lead to ambiguity about the respective timing of when a corporation ceases to carry on business and when an asset becomes useless or worthless and therefore ceases to be characterized as inventory (pursuant to the above-noted test).

If the Payment Was Not Attributable to the DCE Land, Was the Receipt on Income or Capital Account?

Since the court concluded that the $15.8 million payment was not attributable to the DCE land, it reasoned that the payment was either made to compensate Henco for the loss of its business or paid as consideration for the extinction of (1) the right to sue the government of Ontario and (2) the right to take steps to have the injunctions enforced.[54]

Henco argued that the compensation paid pursuant to the agreement was attributable to its waiving of its right to sue Ontario. Accordingly, Henco submitted that the payment was on capital account and could in certain circumstances be attributable to eligible capital property. Yet, as a result of an election that Henco filed to have the former rules under subsection 14(5) apply, Henco submitted that the payment was made in respect of capital property that was not eligible capital property and was therefore a non-taxable receipt.

The court acknowledged that whether a payment is received as a capital or trading receipt is fact specific. Paraphrasing Bowman CJ in *BP Canada Energy Resources Company v. The Queen*,[55] it characterized the existing body of case law as representing a spectrum: one end representing receipts arising in the ordinary course of an ongoing business, and the other end representing a payment compensating a taxpayer for the destruction of an income-earning capital asset (that is, the "sterilization of a capital asset").

Although the court acknowledged that the characterization of the $15.8 million payment was "somewhat fuzzy,"[56] it concluded that the payment was more appropriately characterized as a capital receipt than an income or trading receipt.

If the Payment Was Not Attributable to the DCE Land and Was on Capital Account, Was It an Eligible Capital Amount or a Non-Taxable Receipt?

On the basis of the court's findings that the $15.8 million payment was a capital receipt that was not attributable to the DCE land, the payment would be taxable to Henco only if it was an "eligible capital amount," as defined in subsection 14(1) with reference to clause E of the definition of "cumulative eligible capital" in subsection 14(5).

In 2007, the definition of cumulative eligible capital in subsection 14(5) was amended, generally effective in respect of amounts receivable after May 1, 2006. The amendment eliminated what had previously been referred to as "the mirror-imaging test." However, taxpayers were permitted to file an election to have the former rule apply in respect of amounts that became receivable before August 31,

54 Ibid., at paragraph 170.

55 2002 DTC 2110 (TCC).

56 Supra note 32, at paragraph 176.

2006.[57] Henco filed such an election to have the former mirror-imaging test apply to the payment.

The pertinent portion of the former definition of "cumulative eligible capital" that incorporated the mirror-imaging test (in variable E, which reduces a taxpayer's cumulative eligible capital) read as follows:

> the total of all amounts each of which is ¾ of the amount, if any, by which
>
> (a) an amount which, as a result of a disposition occurring after the taxpayer's adjustment time and before that time, the taxpayer has or may become entitled to receive, in respect of the business carried on or formerly carried on by the taxpayer where the consideration given by the taxpayer therefor *was such that, if any payment had been made by the taxpayer after 1971 for that consideration, the payment would have been an eligible capital expenditure of the taxpayer* in respect of the business
>
> exceeds
>
> (b) all outlays and expenses to the extent that they were not otherwise deductible in computing the taxpayer's income and were made or incurred by the taxpayer for the purpose of giving that consideration.[58]

After citing the above provision, Miller J noted, "I am not surprised in trying to work through this oblique provision, that it has been amended."[59] In summary, the mirror-imaging test asks whether the $15.8 million payment, if made by Henco, would have been an eligible capital expenditure, as defined in subsection 14(5).

The court identified the following four factors as relevant in assessing whether the payment was an eligible capital amount under the former rules. It based these factors on the Federal Court of Appeal's decision in *Canada v. Toronto Refiners and Smelters Ltd.*,[60] as clarified by that court in *RCI Environnement Inc. v. Canada*:[61]

1. Was the amount received as a result of a disposition?
2. Was the amount received in respect of the business carried on by Henco?
3. What consideration did Henco give for the payment?
4. If Henco had paid $15.8 million for the same consideration that it had given to the Ontario government (the mirror-imaging test), would that payment have been an eligible capital expenditure of Henco?

The court addressed the first two issues in reasonably short order. Although there was ambiguity, as discussed above, about how to allocate the payment among the assets disposed of, the court found that the payment was associated with the

57 SC 2007, c. 2, sections 3(6) and (10).

58 Former description of "E" in the definition of "cumulative eligible capital" in subsection 14(5) (emphasis added).

59 Supra note 32, at paragraph 183.

60 2002 FCA 476.

61 2008 FCA 419.

disposition of property. The court also found that the payment was received in respect of the business carried on by Henco. Although it acknowledged that Henco arguably no longer had a business at the time that the agreement was entered into, the clause in the agreement requiring Henco to cease business was nevertheless "in respect of" the business carried on by Henco.

Regarding the third question, the court agreed with Henco's position that substantially all of the consideration for the payment was attributable to goodwill—that is, the promise to cease business, to take steps to have the injunctions removed, and to release Ontario from any and all claims in respect of the DCE land. The court relied on the residual concept of goodwill articulated in *Transalta Corporation v. Canada*:[62] consideration beyond that allocable to identifiable assets pertains to goodwill. Having determined that the other assets of Henco's business were essentially valueless, the court concluded that the entire $15.8 million payment was allocable to goodwill.

Finally, the court addressed the fourth question regarding the mirror-imaging test. Citing the Federal Court of Appeal in *RCI*, the court noted that the test could be difficult or impossible to apply when the payer of an amount is a public body performing its civic duties, rather than an entity making a payment in the course of gaining or producing income from a business:

> In *RCI*, the Federal Court of Appeal took a pragmatic approach to the mirror-imaging test in the context of a public authority making a payment, writing this about the fourth question: "For all intents and purposes, this made the question underlying item E inapplicable, because no one would pay money to acquire the right to be expropriated."
>
> This sensible view renders the discussion of whether one looks at the mirror-imaging test from the payor's or the recipient's perspective moot. There are some situations, such as this, where the rather technical process for the determination of consideration and the application of the mirror-imaging rule simply does not work.[63]

Notwithstanding the difficulties of applying the mirror-imaging test, the court sought to determine whether, if Henco had paid $15.8 million for the loss of goodwill, it could be said that the payment would have been an eligible capital expenditure. An eligible capital expenditure must be an expense that is incurred for the purpose of gaining or producing income from a business.[64] The court noted that a payment that resulted in the destruction of Henco's business could not possibly be viewed as having been incurred for the purpose of earning income from that business. Conversely, if viewed from the perspective of the government of Ontario, the payment was not made for the purpose of earning income but rather for civic purposes.

---

62 2012 FCA 20.

63 Supra note 32, at paragraph 201, citing *RCI*, supra note 61.

64 Definition of "eligible capital expenditure" in subsection 14(5).

This apparent deficiency in the legislation was corrected by the 2006 amendments, which removed the mirror-imaging test. However, for Henco's purposes, the test's deficiency permitted it to characterize the $15.8 million payment as a non-taxable capital receipt.

CONCLUSION

As a result of the amendments to the definition of eligible capital amount, it appears that Henco will be among the last taxpayers to challenge the application of the mirror-imaging test in court.[65] However, the relevance of the *Henco* decision extends beyond the narrow confines of this test. The court considered a number of substantive and procedural issues that will remain relevant to tax professionals and their clients.

Of particular note, the court's finding that an amount may be received "in the course of a business" without being received "in the course of earning income from a business" could prove useful to taxpayers in other circumstances. On the basis of the court's interpretation, the taxability of an amount could depend on this somewhat narrow distinction.

Similarly, the interpretative framework adopted by the court in assessing the application of section 23 attached a great deal of significance to the time when inventory is converted into capital. The court found that inventory could lose its character as inventory if it was made legally useless. If such an event occurs before a business is shut down, the court's somewhat narrow reading of section 23 implies that the taxpayer may avoid the application of this section, with the result that any gain from the sale of property will be taxed on capital rather than on income account.

Finally, the court's further guidance regarding the application of the parol evidence rule should be of use to both taxpayers and the Crown in future cases.

Andrew Stirling

CAN INTEREST ACCRUE BEFORE A GAAR NOTICE OF ASSESSMENT IS ISSUED?

J.K. Read Engineering Ltd. v. The Queen
2014 TCC 309

KEYWORDS: GAAR ■ TAX LIABILITY ■ INTEREST ■ NOTICE OF ASSESSMENT

When does liability for an assessment of tax based on the general anti-avoidance rule (GAAR) arise for the purposes of interest accruing for the late payment of tax? The Tax Court considered this question in *J.K. Read Engineering Ltd. v. The Queen*.[66] Specifically, the court considered whether interest begins to accrue on the date that

65 The *Henco* decision has not been appealed.

66 2014 TCC 309.