
CURRENT CASES

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THE FEDERAL COURT OF APPEAL

ELIGIBLE CAPITAL AMOUNT: THE MIRROR IMAGE TEST

The Queen v. Toronto Refiners and Smelters Limited
2003 DTC 5002; [2003] 1 CTC 365

KEYWORDS: CAPITAL EXPENDITURE ■ ELIGIBLE CAPITAL AMOUNT ■ CAPITAL PROPERTY

The Queen v. Toronto Refiners and Smelters Limited considered the meaning of “eligible capital amount” for the purposes of subsection 14(5) of the Income Tax Act.¹ The taxpayer, Toronto Refiners and Smelters Limited (“Refiners”), had received \$9 million as damages because it could not relocate its business after surrendering its property to the city of Toronto. The issue addressed by the court was whether the payment was an eligible capital amount or a non-taxable capital receipt.

The definition of “eligible capital amount” requires that the taxpayer be put into the position of a payer in order to determine whether a payment received by the taxpayer is an “eligible capital amount.” The language in the definition suggests that the question the court should have asked was: Had Refiners purchased the property transferred to the city in exchange for the \$9 million, would any

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¹ 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.

payment made by Refiners have been an “eligible capital expenditure”? This is not the approach adopted by either the Tax Court or the Federal Court of Appeal.

Refiners carried on a secondary lead-refining business in Toronto on land and in buildings that it owned. Apparently, the city wanted to purchase the real property because it had pollution- and noxious use-related concerns about Refiners’ use of the property. For several years, Refiners and the city negotiated unsuccessfully about the sale of the real property conditional on Refiners’ being able to relocate its business. In 1988, Refiners entered into an agreement to transfer its real property to the city. Under this agreement, which was made in accordance with section 31 of the provincial Expropriations Act,² Refiners consented to the acquisition of the property by the city under the following terms:

- the transfer was not conditional on Refiners’ being able to relocate its business;
- the city and Refiners agreed that the other party could apply to the Ontario Municipal Board (OMB) under section 31 of the Expropriations Act for an assessment of the compensation that Refiners would have been entitled to receive had the city expropriated the property;
- if Refiners did not relocate its business, the city agreed to acknowledge in all future proceedings that such a relocation was not feasible;
- Refiners could recover inventory, equipment, and chattels located on the property and dispose of it on its own account; and
- if Refiners claimed compensation for the loss of its business, it would disclose the proceeds from the sale of the inventory, equipment, and chattels, and these amounts would be taken into account in the calculation of its compensation entitlement.

In this connection, it should be noted that section 13 of the Expropriations Act provides that the compensation payable by the statutory authority is based on the market value of the expropriated land, damages attributable to “disturbance” and injurious affection, and “any special difficulties in relocation.” Section 19 of the Expropriations Act provides that compensation may also include an amount not exceeding the value of the goodwill of a business that it is not feasible for the owner of the business to relocate.

On February 20, 1989, Refiners transferred vacant possession of its land and buildings to the city after it had disposed of most of its other assets located on the property. The city made an initial payment of \$1 million to cover Refiners’ legal, appraisal, and other costs. Refiners did not relocate its business and in 1989 applied to the OMB for a determination of the compensation it should receive under the agreement. The valuers retained by Refiners and the city for the purposes of the OMB hearing valued the goodwill of the business at between \$3.85 million and \$8 million. The property was valued at between \$1 million and \$6.8 million.

2 RSO 1980, c. 148 (for the purposes of this case).

After the hearing started but before the OMB made a determination, the parties entered into, and the OMB approved, a settlement. Under the settlement, dated January 27, 1992, the city agreed to pay Refiners

- \$2.9 million for the land,
- \$100,000 for the buildings, and
- \$9 million for damages arising from Refiners' inability to relocate its business.

Refiners included the \$9 million of damages it received in its income for financial statement purposes in 1992. For tax purposes, however, it did not include the \$9 million in income, claiming that it was a non-taxable capital receipt. The minister reassessed Refiners on the basis that three-quarters of the \$9 million was an "eligible capital amount" and should be treated as a capital gain. Refiners appealed.

"Eligible capital amount" is defined in subsection 14(1) of the Act, by reference to the definition of "cumulative eligible capital" in subsection 14(5), as

an amount which, as a result of a disposition . . . , 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.

Historically, courts applying this definition have adopted the "mirror image" rule; that is, they have looked to the payer's position when determining whether a payment received by a taxpayer should be treated as an eligible capital amount.³ In the Tax Court decision in *Toronto Refiners*, Bell TCCJ embraced this approach, stating that "the actual payor's circumstances must be taken into account" to establish whether "the payment of damages . . . [was] an eligible capital expenditure within the definition" in subsection 14(5).⁴ In other words, whether an amount received by a taxpayer is an eligible capital amount depends on the particular circumstances of the payer. Accordingly, in *Toronto Refiners*, the pivotal question was whether the payment was an eligible capital expenditure for the city.

In *Toronto Refiners*, the city acquired the property in the public interest and in accordance with section 31 of the Expropriations Act, which essentially required the city to fully compensate the taxpayer for its property, including any losses occasioned

³ In *The Queen v. Goodwin Johnson (1960) Ltd.*, 86 DTC 6185; [1986] 1 CTC 448 (FCA), the taxpayer received damages for compensation for the loss of a business caused by the termination of an agreement. The Federal Court put the taxpayer in the notional position of the party making the damage payment to determine whether the payment was an eligible capital amount. The court concluded that the payment did not represent an eligible capital amount because the expenditure was made for the purpose of gaining or producing income. Also see *Pe Ben Industries Company Limited v. The Queen*, 88 DTC 6347; [1998] 2 CTC 120 (FCTD).

⁴ 2001 DTC 876; [2001] 4 CTC 2818, at paragraph 44 (TCC).

by the termination of its business. This section must be read in conjunction with the definition of “eligible capital expenditure” in subsection 14(5) of the Act, which provides that an expense incurred to acquire intangible non-depreciable property will generally constitute an eligible capital expenditure provided that the property is acquired for a business purpose.

After reviewing section 31 of the Expropriations Act and the parties’ agreement, the Tax Court found that the \$9 million payment was not an eligible capital expenditure because it was not made by the city on account of capital for the purpose of gaining or producing income from a business. The city had entered into the agreement with Refiners, under its statutory authority derived from the Expropriations Act, to facilitate the city’s purchase of Refiners’ land and buildings and to provide for the payment of damages by the city if the taxpayer was unable to relocate its business. The evidence indicated that the payment by the city was not incurred for a business purpose, and the Crown conceded this point.

Moreover, the court decided that the \$9 million damage payment by the city to Refiners must be regarded from the city’s perspective as part of the cost of the real property acquired from the taxpayer and on this basis could not be characterized as an “eligible capital expenditure.”

The Crown appealed the decision of the Tax Court to the Federal Court of Appeal. In her judgment, Madam Justice Sharlow closely examined the language in the definition of “eligible capital amount.” After determining that the \$9 million payment made by the city had been received by Refiners in respect of the business it had formerly carried on, Madam Justice Sharlow continued her analysis by reviewing the nature of the consideration given by Refiners for the payment. She found that Refiners’ agreement to release the city from any further claims for compensation under the Expropriations Act was the consideration referred to in section 14. She then applied the mirror image rule to characterize the payment.

In applying the mirror image rule, Madam Justice Sharlow placed Refiners notionally in the position of the city. She stated that the circumstances of this hypothetical payment would have to be the same as the circumstances of the actual payment. Essentially, this meant that the hypothetical payment by Refiners would be made for the same reasons that the city made the payment: that is, statutory compensation related to property expropriated for a civic purpose. Although the court initially appeared to be considering the nature of the payment from Refiners’ perspective, it was the city’s perspective that determined the final characterization of the payment. As a result, Madam Justice Sharlow concluded that the payment would not have been characterized as an eligible capital expenditure had Refiners made the payment for the same consideration, because it would have been made for a civic, non-commercial purpose and not for a business purpose.

Since goodwill is not capital property and cannot be subject to capital gains, the court decided that the correct result, under the circumstances, was that the amount was non-taxable.

In light of the existing case law, the judgment in this case was predictable. Clearly, the Expropriations Act and lack of a business purpose for the transfer were

critical to the result in both the Tax Court and the Federal Court of Appeal. In this case, the tax consequences of the transaction to Refiners were dependent on the unique character of the payer of the damages (that is, the city). Had Refiners sold its property to a competitor that had shut down or moved the business, the portion of the purchase price that related to the goodwill of the business would have been an “eligible capital amount.”

From a policy perspective, this case is disturbing. Taxpayers who, for any reason, dispose of non-depreciable capital property, such as goodwill, should be treated in the same way as taxpayers who dispose of depreciable capital property. The tax consequences of the disposition should depend on the character of the asset to the taxpayer, not the purchaser.

As pointed out above, it appears to be possible to interpret the definition of “eligible capital amount” in a manner that produces more consistent results. Specifically, instead of determining the character of the payment in question in the hands of the actual payer, as the court did in the *Toronto Refiners* case, the court should employ the literal interpretation of the section, which seems to require that the character of the payment be determined on the basis of whether the taxpayer made the payment for the same consideration. However, given the existing jurisprudence, it appears that only an amendment to the definition of “eligible capital amount” would eliminate the possibility of inconsistent results that characterizes the current interpretive approach and bring the treatment of eligible capital property in line with the treatment of capital property.

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TAX INVESTIGATIONS: APPLICATION OF JARVIS PRINCIPLES

Kligman et al. v. MNR
2003 DTC 5100

KEYWORDS: CONSTITUTIONAL LAW ■ CRIMINAL LAW ■ EVASION ■ SEARCH AND SEIZURE ■ TAX EVASION

A recent case comment⁵ discussed the November 2002 decisions of the Supreme Court of Canada in *Jarvis v. The Queen*⁶ and *Ling v. The Queen*.⁷ Both of those cases dealt with the question of when the Charter of Rights and Freedoms⁸ will apply in

5 See James Warnock, “Tax Investigations and the Charter: The Supreme Court Sets Out the Rules,” Current Cases feature (2003) vol. 51, no. 1 *Canadian Tax Journal* 514-38.

6 2002 SCC 73.

7 2002 SCC 74.

8 Canadian Charter of Rights and Freedoms, part I of the Constitution Act, 1982, being schedule B of the Canada Act 1982 (UK) 1982, c. 11 (herein referred to as “the Charter”).