1990 CarswellNat 370, [1990] 2 **C.T.C**. 439 #2, 90 D.T.C. 6603

Kaiser Petroleum Ltd. v. Canada

Her Majesty the Queen v. **Kaiser Petroleum** Ltd.

Federal Court of Appeal

Marceau, Desjardins and Linden, JJ.A.

Judgment: October 10, 1990
Docket: Court No. A-8-90

© Thomson Reuters Canada Limited or its Licensors (excluding individual court documents). All rights reserved.

Proceedings: on appeal from the Federal Court — Trial Division, reported [1990] 1 C.T.C. 62

Counsel: *Terrance I. McAuley* for the appellant.

Ian Pitfield for the respondent.

Subject: Income Tax (Federal)

Income tax --- Business and property income — Expenses — Capital expenditures.

Income tax — Federal — Income Tax Act, R.S.C. 1952, c. 148 (am. S.C. 1970-71-72, c. 63) — 9(1), 18(1)(b) — Whether payment to terminate stock option plan a deductible expense.

A Ltd. was controlled by A Inc., a U.S. company. The two companies had an employees' stock option plan. In July 1978, A Inc. agreed to sell its shares in A Ltd. to Kaiser Resources Ltd. at $33.50 per share. At that time there were 126,370 shares of A Ltd. subject to options under a stock option plan which granted employees the right to purchase the shares over a period of years. In August 1978 the Board of Directors of A Ltd. passed a resolution amending the stock option plan to provide that any restrictions previously applicable to the exercise of outstanding options should be removed. As a result A Ltd. became liable to pay $2,772,317 to the employees. Subsequently A Ltd. cancelled the plan (and changed its name to Kaiser Petroleum Ltd.). In its 1978 income tax return A Ltd. deducted the sum of $2,772,317 as a current expense, which the Minister disallowed as being a capital outlay under paragraph 18(1)(b). The Federal Court — Trial Division allowed the company's appeal.

HELD:

The company's disbursement was once and for all and was not an operating expenditure coming within paragraph 18(1)(b). Crown's appeal allowed.

Annotation

The question in this case was the deductibility of a "once and for all" payment to certain employees in order to cancel a stock option plan established when the taxpayer company was a subsidiary of a U.S. company. The Federal Court — Trial Division held that the amount was a current expense. The Federal Court of Appeal reversed that decision and held that it was a capital outlay within paragraph 18(1)(b).

The Federal Court of Appeal relied on the Supreme Court of Canada judgment in *M.N.R. v. Algoma Central Ry.*, [1968] C.T.C. 161, where it was stated, and quoted in the present judgment, that the term "outlay of capital" is not defined in the Act, that there is no simple test and that the question must depend upon the facts of the particular case. Fauteux, J. relied on the Privy Council decision in *B.P. Australia Ltd. v. Commissioner of Taxation of the Commonwealth of Australia*, [1966] A.C. 224. In that case, B.P. agreed to pay garage owners for their promise to buy gasoline exclusively from B.P. In a similar case, however, *Regent Oil v. Strick*, [1966] A.C. 295, the House of Lords held that the payment was a capital payment. In *Elias Rogers Co. v. M.N.R.*, [1972] C.T.C. 601, Jackett, C.J. stated at page 604 that the *Regent Oil* case was not relevant. In the *Elias Rogers* case the company sold fuel oil and also leased oil-fired water heaters, the installation of which was sought to be deducted as an expense. The Federal Court of Appeal allowed the deduction.

In another decision of the Supreme Court of Canada, *B.C. Electric Ry. Co. v. M.N.R.*, [1958] C.T.C. 21, a company paid for road improvements in order to get consent from certain municipalities to abandon its rail services and permission to operate buses instead. It was held that the payments were capital.

The Court rejected the argument that the payments that were made should be allowed because the taxpayer could have arranged for annual payments that would have been allowable. What was considered to be important was not the taxpayer's purpose but rather its actions and its methods.
Cases referred to:

M.N.R. v. Algoma Central Ry., [1968] S.C.R. 447, [1968] C.T.C. 161, 68 D.T.C. 5096;

B.P. Australia Ltd. v. Comr. of Taxation of the Commonwealth of Australia, [1965] 3 All E.R. 209, [1966] A.C. 224;

Canada Forgings Ltd. v. The Queen, [1983] C.T.C. 94, 83 D.T.C. 5110.

***Desjardins, J.A.*:**

1 The sole question for determination in this appeal is whether a payment made by the respondent, in order to extinguish a stock option plan held in favour of certain of its officers and key employees, constitutes a deductible expense or an outlay on account of capital. The trial judge held it was a charge against revenue. [Reported at [1990] 1 C.T.C. 92, 90 D.T.C. 6034.] He vacated the reassessment dated April 18, 1983 with respect to the respondent's taxation year 1978.

2 With respect, I disagree with his characterization of the matter.

The Facts

3 The respondent, formerly known as Ashland Oil Canada Ltd. ("Ashland Canada") was a corporation en-

© 2011 Thomson Reuters. No Claim to Orig. Govt. Works

gaged in the oil and gas business. It was effectively controlled by Ashland Oil Inc. (Ashland U.S.) which held some 10,989,918 common shares of its subsidiary out of a total of some 13,000,000 shares outstanding. On July 11, 1978, Ashland U.S. entered into an agreement with Kaiser Resources Ltd. of Vancouver for the sale of its shares in Ashland Canada. The agreed price was $33.50 per share.

4 Ashland Canada had in force, at the relevant time, a "Preferred Employees Stock Option Plan" ("stock option plan"), The stock option plan was designed to operate as an additional incentive to ensure superior performance by qualified employees, and to enhance the ability of the company and its subsidiaries to attract and retain valued employees.

5 Under the terms of the plan, Ashland Canada was obliged to deliver the optioned shares at the option price whenever the option was exercised. The exercise of the option, which was personal to each employee and could not be assigned, was dependent upon the employee being in the employ of the company at the time of exercising the rights. The terms and conditions of each option granted under the plan appeared in a written option agreement between the company and each optionee, and signed by both parties.

6 As of June 30, 1978, 126,370 shares of Ashland Canada were subject to option agreements of which the options were exercisable for 108,620 and not exercisable for 17,750 shares.

7 According to the evidence at trial, a prospective takeover of Ashland Canada by Kaiser Resources Ltd. caused Ashland Canada's management concern about ensuring that their key employees would be persuaded to continue as employees with the company following completion of the takeover. It was also felt that since the shareholders were realizing their investment in the growth of the company, the employees should also have the opportunity of realizing their contribution to that gain. There was also a desire to eliminate any uncertainty about the effects which new ownership might have upon the value of the plan (Transcript at 19-21). Clause 4.2 of the sale agreement of July 11, 1978 between Ashland U.S. and Kaiser Resources Ltd. provided as follows:

> 4.2 *Employee Stock Options*. Prior to the Closing Date, AOCL shall (i) make an offer to each of its employees who holds an employee stock option of AOCL to obtain the cancellation of such option upon the payment by AOCL to such employee of an amount per share covered by such option equal to the difference between the exercise price per share under such option and Cdn.$33.50 per share and (ii) upon the request of any such employee, to the extent such employee's option may not be exercisable by its terms, amend such terms so that the option shall become immediately exercisable.
>
> (Appeal Book at 93)

8 On August 8, 1978, the Board of Directors of Ashland Canada adopted a resolution providing that any restriction otherwise applicable to the exercise of any of the outstanding options should be removed and the stock option plan was amended accordingly.

9 The offer made by Ashland Canada to its employees pursuant to clause 4.2 of the sale agreement was accepted by the holders of the options in respect of 120,970 shares on or before September 30, 1978. Ashland Canada became liable, at that date, to pay the sum of $2,772,317 to the offerees. Subsequently, the Board of Directors of Ashland Canada cancelled the stock option plan (Appeal Book at 27).

10 In its 1978 tax return, Ashland Canada included the sum of $2,772,317 as a current and deductible expense. Revenue Canada, by notice of reassessment dated April 18, 1983, disallowed that sum as a deductible ex-

© 2011 Thomson Reuters. No Claim to Orig. Govt. Works

pense and claimed it was an outlay or payment on account of capital within the meaning of paragraph 18(1)(b) of the *Income Tax Act*, R.S.C. 1952, c. 148 (am. S.C. 1970-71-72, c. 63) (the "Act"). In the meantime, Ashland Canada had its corporate name changed to Kaiser Petroleum Ltd., and the tax records were amended accordingly.

11 Ultimately, Kaiser Petroleum Ltd. acquired all the shares of Ashland Canada owned by Ashland U.S. and the majority of the remaining publicly traded shares of Ashland Canada (Transcript at 35).

The Trial Judge's decision

12 After a careful review of the case law on point, the trial judge stated that the stock option plan was in furtherance of a company policy to offer a form of reward to its employees which in turn was a taxable benefit in their hands under section 7 of the *Income Tax Act*. About the undertaking of July 11, 1978, the trial judge said the following at page 70 (D.T.C. 6038):

> There is little doubt that without that undertaking, the plaintiff would not have incurred the expense. Upon the exercise of their several options, the employees would have been issued shares producing a benefit to the employees but at no cost to the plaintiff. What transpired, however, is that the plaintiff did bear a cost which, according to generally accepted accounting principles, was an expense properly charged against revenue.

The trial judge concluded at page 71 (D.T.C. 6039):

> What we are facing here is essentially a payment by a plaintiff to its employees in fulfilment of a term and condition of employment. Common sense dictates that salaries, wages, bonuses and commissions paid to employees are proper charges against revenue. No evidence or argument was advanced that the payment was otherwise than a bona fide one. It was not tainted by any artificiality or by any discernible tax avoidance purpose. Therefore the employees' acceptance of a cash payment with the seeming novations of the original deal does not change its essential character.
>
> If the payment was made under the guise of an option rights purchase, its true character was one of taxable compensation to employees in lieu of a taxable benefit which the employees would otherwise have enjoyed. In essence, the option rights formula at the equivalent takeover price of $33.50 was the formula which the plaintiff agreed to adopt, but it remains no less a form of compensation, the cost of which is a charge against revenue.

The Contentions of the Parties

13 The appellant submits that the payment by Ashland Canada to its employees for the termination of rights to exercise their stock options was a once and for all transaction which brought into existence an enduring benefit to Ashland Canada, namely the elimination of extraneous shares or share possibilities. Ashland Canada was not in the business of dealing in shares but in the oil and gas business. The payment to terminate rights under the option agreements did not form part of the operation of the profit-making entity. It was designed to acquire a facet of the business entity, namely more certainty about potential shareholders. The company's original purpose in creating the stock option agreement may have been to create an incentive or form of compensation for employees. However, the company's purpose in terminating the stock option agreement at the time of the takeover was not as a compensation for employees. It was a capital structuring of the company.

© 2011 Thomson Reuters. No Claim to Orig. Govt. Works

14 The respondent's contention is that the sum at issue was paid upon the termination of an agreement initiated to compensate certain key employees for services rendered by them to the respondent. Absent unusual circumstances not present in this case, amounts paid and benefits received in relation to the plan represent taxable benefits to the employees and deductible outlays to the payor. Until such time as shares were acquired under the plan, the plan was an integral part of a member's compensation package. It is only at the time that shares are actually acquired by an employee pursuant to an option agreement that the contract ceases to be a matter in respect of employment and compensation to become a matter between shareholders and company.

Discussion

15 A convenient starting point in dealing with the issue, as to whether the payment made by the respondent should be computed under subsection 9(1) of the Act[FN1] or whether it represents an amount coming under the exception of paragraph 18(1)(b) of the Act[FN2], is the statement made by Fauteux, J. in *Minister of National Revenue v. Algoma Central Ry.*, [1968] S.C.R. 447, [1968] C.T.C. 161, 68 D.T.C. 5096 at 162 (D.T.C. 5097):

> 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] 3 All E.R. 205; (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.

16 Also in the case of *B.P. Australia Ltd. v. Comr. of Taxation of the Commonwealth of Australia*, [1965] 3 All E.R. 209; (1966) A.C. 224 at 271 the Privy Council said: "Finally, were these sums expended on the structure within which the profits were to be earned or were they part of the money-earning process?"

17 Undoubtedly, the reasons for establishing the stock option plan [were] to motivate key employees and to better the respondent's business. Had the respondent pursued the compensation plan, shares would have been issued in due course in return of the employees' payment as agreed under the individual option agreements. Such moneys would then have been added to the company's working capital.

18 This course was not followed. In view of the uncertainty of a change of management and the desire to have key employees realize their gain immediately and develop interest in the new company, amendments were made to the plan following the undertaking under the sale agreement, so as to accelerate the process and make the options exercisable immediately. Moneys were offered which represented the difference between the exercised price per share under the option and Cdn. $33.50 per share.

19 Following the sale offer at Cdn. $33.50 per share, the potential shares of Ashland Canada in the stock option plan had, in all probability, acquired the same market value. This increase would have reflected itself in

© 2011 Thomson Reuters. No Claim to Orig. Govt. Works

the hands of the potential owners of the shares of the stock option plan through a share acquisition, had the plan properly unfolded. Moneys, reflecting the increase in value of the shares, were offered instead of shares. The respondent, in buying out rights under the plan, parted with an asset (the purchase price) and effected a sterilization of future issues of shares. The disbursement made was a once and for all payment which had a direct effect on the capital structure of the corporation. In fact, the stock option plan was later cancelled. Although the plan originated as a form of compensation and immediate compensation was one reason for its termination, and although the arrangement may appear to have been "seeming novations of the original deal", as characterized by the trial judge (probably since the compensation was in money terms instead of shares), it does not follow that the payment, from the point of view of the respondent, had the character of an operating expenditure. What is important is not the purpose pursued by the respondent but what it did and how it did it.

20 Although I come to the same conclusion as the one reached in the case of *Canada Forgings Ltd. v. The Queen*, [1983] C.T.C. 94, 83 D.T.C. 5110 (F.C.T.D.), I note two differences of facts which were pressed upon us by the respondent and which do not make this case applicable. There, the taxpayer corporation, Canada Forgings Ltd., had entered into contracts with its president and vice-president granting to each an option to purchase 25,000 common shares at a price of $4 per share. The offer was to expire in 1980. In 1975, another company, Toromont Industries Ltd., offered to buy and eventually bought 85 per cent of all the outstanding shares of Canada Forgings Ltd. at $17 per share. In November 1979, the president and vice-president of Canada Forgings Ltd. entered into an agreement with Canada Forgings Ltd. whereby they relinquished all their rights to purchase shares pursuant to the option plan. The taxpayer company paid to each in return the sum of $325,000, an amount arrived at by subtracting $4 from the $17, the difference being $13, multiplied by 25,000 shares. Canada Forgings Ltd. treated the amount as a current business expense in its 1976 taxation year since it considered it as a benefit or compensation paid to key employees. The deduction was disallowed. It was clear from the evidence at trial that Toromont Industries Ltd. desired to obtain all the shares in the taxpayer corporation so that there would be no minority group of shareholders therein. It had made separate agreements with the president and vice-president of Canada Forgings Ltd. who undertook not to exercise their options. They further agreed to give Toromont the right to purchase the optioned shares at $17 per share should Canada Forgings Ltd. refuse the agreement for payment of the $325,000 to each officer. The Court concluded that the contractual provisions contained in the documents established an intention to ensure the acquisition by Toromont of such optioned shares rather than a bonus to employees. The expenditure was determined to be attributable to capital and not to revenue.

21 In the case at bar, there is no evidence that the undertaking of July 11, 1978 was conditional to the sale agreement so as to ensure a share acquisition by Kaiser Resources Ltd. There is, however, evidence that compensation was one element pursued when the termination of the stock option plan took place. Nevertheless, the compensation was made by means of a reshaping of the capital structure of the respondent's organization. This feature, in my view, dominates the whole set of circumstances revealed by the evidence and constitutes the guiding element under the test set in the *B.P. Australia Ltd.* case cited above.

22 The payment was therefore properly treated as an "outlay ... of capital" under paragraph 18(1)(b) of the Act.

23 I would allow the appeal. I would set aside the judgment of the trial judge rendered on December 4, 1989. I would confirm the notice of reassessment made by Revenue Canada for the year 1978, dated April 18, 1983.

© 2011 Thomson Reuters. No Claim to Orig. Govt. Works

24 The whole with costs.

***Marceau, J.A.*:**

25 I agree.

***Linden, J.A.*:**

26 I agree.

. . . . .

(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.

Appeal allowed.

FN1 9.(1) Subject to this Part, a taxpayer's income for a taxation year from a business or property is his profit therefrom for the year.

FN2 18.(1) In computing the income of a taxpayer from a business or property no deduction shall be made in respect of

END OF DOCUMENT