Docket: 2006-82(IT)G

BETWEEN:

SHOPPERS DRUG MART LIMITED,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on October 11, 2007, at Toronto, Ontario.

Before: The Honourable D.G.H. Bowman, Chief Justice

Appearances:

Counsel for the Appellant:	Al Meghji, Patrick Marley and D'Arcy Schieman
Counsel for the Respondent:	Marie-Thérèse Boris and Brent Cuddy

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JUDGMENT

The appeal from the assessment made under the *Income Tax Act* for the 1999 taxation year is allowed with costs and the matter is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the amounts paid to Imasco Limited to reimburse it for the Cash Surrender Chargeback and the Make-up Chargeback are payments on revenue account and are deductible in computing the appellant's income.

Signed at Ottawa, Canada, this 14th day of November 2007.

"D.G.H. Bowman"

Bowman C.J.

Citation: 2007TCC636
Date: 20071114
Docket: 2006-82(IT)G

BETWEEN:

SHOPPERS DRUG MART LIMITED,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Bowman, C.J.

[1] This appeal is from an assessment made under the *Income Tax Act* for the 1999 taxation year. The issue is whether the appellant, Shoppers Drug Mart Limited ("SDM"), was prohibited from deducting in computing its income for 1999 the amounts of $54,447,037 and $537,067 by reason of paragraph 18(1)(*b*) of the *Act.* These amounts were paid to its parent Imasco Limited ("Imasco") to reimburse it for payments made by Imasco to SDM's employees on the surrender of options held by them to acquire shares of Imasco under the Imasco Stock Option Plan (the "Imasco SOP"). No *viva voce* evidence was called.

[2] The parties entered into a Statement of Agreed Facts ("SAF") and it is attached as Schedule A to these reasons. Also, a number of documents were entered on consent and some portions of the examinations for discovery were read into evidence.

[3] Paragraph 18(1)(*b*) of the *Act* reads as follows:

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

The French version of paragraph 18(1)(*b*) reads:

> 18. (1) — Dans le calcul du revenu du contribuable tiré d'une entreprise ou d'un bien, les éléments suivants ne sont pas déductibles :
>
> > *b*) — une dépense en capital, une perte en capital ou un remplacement de capital, un paiement à titre de capital ou une provision pour amortissement, désuétude ou épuisement, sauf ce qui est expressément permis par la présente partie;

[4] It is important to emphasize that the Minister on assessing, and the respondent before this court, did not rely upon or argue paragraph 18(1)(*a*) of the *Act*. That paragraph prohibits the deduction of any amount in the computation of income from a business or property except to the extent that "it was made or incurred for the purpose of gaining or producing income from the business or property".

[5] I specifically asked counsel for the respondent if she was relying upon paragraph 18(1)(*a*) and she agreed that she was not. From this I take it to be accepted that the payments were made or incurred for the purpose of gaining or producing income from SDM's business.

[6] I shall not repeat the details in the SAF. It is sufficient that I summarize the facts that appear relevant to the appeal.

[7] SDM was a wholly owned subsidiary of Imasco and it carried on the drugstore business. Its officers and key employees (as well as those of Imasco and Imasco's other subsidiaries) were granted options to purchase Imasco shares. Employees holding vested options could elect to exercise their options and receive Imasco shares upon payment of the option price. In 1995 the Imasco SOP was amended to permit Imasco to offer an option holder the right to surrender the option for cash rather than exercising it.

[8] Paragraph 10 of the Imasco SOP, as amended in 1995, read as follows:

> **10. ELECTION TO SURRENDER OPTION FOR CASH (AVAILABLE IN CERTAIN CIRCUMSTANCES)**
>
> From time to time, the Corporation may offer an Optionee the right to elect, at the Optionee's discretion, to surrender an option, or any portion thereof, in lieu of exercising same, and to receive upon such surrender a cash payment equal to the amount of the excess of the then market value of one Share over the purchase price per Share specified in the option multiplied by the number of Shares purchasable upon exercise of the option, or portion thereof, so surrendered. For this purpose, the market value of one Share shall be the closing price per Share on The Toronto Stock Exchange on the day the option, or portion thereof, is surrendered, or if Shares are not traded on The Toronto Stock Exchange on such day, then the next preceding trading day on which such a trade took place shall be used.

[9] This was simply a formal confirmation of what Imasco had occasionally done prior to the 1995 amendment. It still left it within Imasco's discretion whether to offer an optionee a right to surrender the option for cash.

[10] In March 1999, British American Tobacco p.l.c. ("BAT") approached Imasco to discuss a proposal that BAT would acquire the common shares of Imasco held by the public. Prior to entering into an agreement with respect to this proposal, Imasco on June 9, 1999, amended the Imasco SOP so that paragraph 10 read as follows:

> **10. ELECTION TO SURRENDER OPTION FOR CASH**
>
> At the Optionee's discretion, an Optionee may elect to surrender an option, or any portion thereof, in lieu of exercising same, and to receive upon such surrender a cash payment equal to the amount of the excess of the then market value of one Share over the purchase price per Share specified in the option multiplied by the number of Shares purchasable upon exercise of the option, or portion thereof, so surrendered. For this purpose, the market value of one Share shall be the closing price per Share on The Toronto Stock Exchange on the day the option, or portion thereof, is surrendered, or if Shares are not traded on The Toronto Stock Exchange on such day, then the next preceding trading day on which such a trade took place shall be used.

[11] The effect of the amendment was to give the holder of the option the right to surrender the option for a cash payment equal to the excess of the fair market value of the share over the option price.

[12] On August 2, 1999, a Transaction Proposal Agreement was entered into by BAT, British American Tobacco (Canada) Limited ("Bidco") and Imasco. It is fair to say that this agreement contemplated significant changes in Imasco's holdings and share structure. Among the changes contemplated were the acquisition by BAT, through its subsidiary Bidco, of all of the outstanding Imasco shares not held by BAT indirectly through Bidco, a change in the articles relating to the Imasco shares converting them into special shares and a disposition of the business of SDM. It is worthwhile to set out the recitals to the Transaction Proposal Agreement as they demonstrate the extent of the reorganization. They read:

Transaction Proposal Agreement, as amended and restated

THIS TRANSACTION PROPOSAL AGREEMENT as amended and restated as of August 2, 1999.

AMONG:

BRITISH AMERICAN TOBACCO p.l.c., a corporation incorported in England and Wales, ("BAT")

— and —

IMASCO LIMITED, a corporation continued under the laws of Canada, ("Imasco")

— and —

BRITISH AMERICAN TOBACCO (CANADA) LIMITED, a corporation formed under the laws of Canada, ("Bidco")

RECITALS

WHEREAS:

1. BAT is the indirect holder of 184,174,155 common shares of Imasco. In this Agreement, the term "Imasco Shares" shall refer to all of the outstanding common shares in the capital of Imasco, the term "Subject Imasco Shares" shall refer to the Imasco Shares indirectly held by BAT and the term "Imasco Shareholders" shall refer to all holders of Imasco Shares.
2. At July 28, 1999, there were 432,906,353 Imasco Shares outstanding and 8,185,260 Imasco Shares issuable at prices between $7.00 and $34.00 upon exercise of stock options.

3. Imasco is the indirect holder of 117,174,584 common shares of CT Financial Services Inc. ("CTFS"). In this Agreement, the term "CTFS Shares" shall refer to all of the outstanding common shares in the capital of CTFS and the term "Subject CTFS Shares" shall refer to CTFS Shares indirectly held by Imasco.

4. Bidco is a wholly-owned indirect subsidiary of BAT.

5. Bidco wishes to acquire all of the Imasco Shares.

6. The parties have agreed on a transaction structure which would make it possible for Bidco to acquire all of the Imasco Shares not then owned by Bidco. The transaction structure agreed upon by the parties includes an amendment to the articles of Imasco (the "Reorganization"), pursuant to which, among other things, the rights, privileges, restrictions and conditions attaching to the Imasco Shares will be changed so as to provide, upon a notice being provided by Imasco to its transfer agent, for the transfer to, and acquisition by, Bidco of such shares as set out therein. Following the Reorganization, in this Agreement the Imasco Shares as so amended are referred to as the "Special Shares".

7. Following the Reorganization, subject to the terms and conditions of this Agreement, Imasco and BAT have agreed to exchange the Special Shares indirectly held by BAT for common shares in the capital of Imasco (the "BAT Exchange") and following such exchange, upon a notice being provided by Imasco to its transfer agent and subject to the terms and conditions of this Agreement, Bidco has agreed to acquire all of the outstanding Special Shares in accordance with the share provisions thereof (the "Going Private Transaction").

8. If the Going Private Transaction is completed, Imasco shall effect a consolidation of the Special Shares and thereafter Bidco and Imasco shall amalgamate (the "Bidco Amalgamation"). In this Agreement, the term "BAT Canada" shall refer to the corporation to be formed on the Bidco Amalgamation.

9. Imasco and BAT have agreed to undertake an auction process in respect of the business of the Shoppers Drug Mart group ("SDM") with the objective of BAT and a third party purchaser reaching a binding agreement that will provide, subject to the completion of the Going Private Transaction, for the purchase and sale of the shares of a company that would own all or substantially all of the business of SDM.
10. Imasco will undertake an auction process in respect of the business of Genstar Development Company, a division of Imasco Enterprises Inc., Genstar Land Company and their respective subsidiaries (collectively

"Genstar") with the objective of reaching one or more binding agreements with one or more third party purchasers for the purchase and sale of all or portions of Genstar.

11. The Board of Directors of Imasco believes it appropriate for the auction process in respect of the SDM business and the auction process in respect of the Genstar business to be substantially advanced or completed and for the Going Private Price (as such term is defined in Section 3.1 of this Agreement) to be determined prior to making a determination whether to recommend that the Imasco Shareholders vote in favour of the Reorganization.

12. The Board of Directors of Imasco believes it appropriate for the Imasco Shareholders generally and the holders of Imasco Shares other than the Subject Imasco Shares separately to have an opportunity to consider the Reorganization by way of shareholder vote provided that this Agreement has not been terminated in accordance with its terms prior to the time of such a shareholder vote.

13. BAT has advised Imasco that contemporaneously with the execution of this Agreement, BAT and The Toronto-Dominion Bank ("TD") have entered into an agreement (the "Support Agreement") pursuant to which TD has agreed to make an offer (the "Offer") to purchase all of the CTFS Shares and BAT has agreed, subject to completion of the Going Private Transaction, to cause BAT Canada to enter into an agreement to deposit the Subject CTFS Shares to the Offer. BAT has provided Imasco with a copy of the Support Agreement.

[13] Section 5.8 of the Agreement reads:

Section 5.8 Outstanding Stock Options and Employment Arrangements of Imasco.

Imasco agrees and represents that its board of directors will unanimously resolve to encourage all persons holding options to purchase Imasco Shares pursuant to Imasco's employee stock option plan, to exercise or surrender their options immediately prior to the completion of the Reorganization. Imasco further agrees and represents that the board of directors of Imasco will also resolve and will authorize and direct Imasco to, subject to the receipt of any necessary regulatory and stock exchange approvals, cause the vesting of option entitlements under its employee stock option plan to accelerate prior to the completion of the Reorganization, such that all outstanding options to acquire Imasco Shares become exercisable prior to the completion of the Reorganization, and to arrange for all Imasco Shares that are fully paid thereunder to be distributed to those persons entitled thereto so as to be able to be acquired by Bidco in connection

> with the Going Private Transaction and to thereafter satisfy all other obligations of Imasco under such plan.
>
> BAT and Bidco acknowledge that the completion of the Going Private Transaction will constitute a "Fundamental Change" under Imasco's incentive and other employment related arrangements resulting in the acceleration of the vesting, funding and/or payout of rights under such arrangements, a summary of which plans and arrangements are contained in the disclosure letter provided by Imasco to BAT on the date hereof (the "Imasco Disclosure Letter").

[14] On November 18, 1999, the Transaction Proposal Agreement was amended to set the purchase price of the Imasco common shares at $41.60. On December 14, 1999, Imasco accelerated the vesting of the options. In fact, 88.73% of the options had already vested.

[15] On January 27, 2000, SDM wrote to Imasco as follows:

> **Payments Related to the Imasco Employee Stock Option Plan**
>
> As you know, a number of employees and former employees (the "Employees") of Shoppers Drug Mart Limited ("Shoppers") participate in the Imasco Employee Stock Option Plan (the "Plan"). We understand that certain Employees of Shoppers who participate in the Plan have surrendered or may surrender their Imasco stock options for cash and are or will be entitled under the Plan to receive the difference between the closing price of Imasco common shares on The Toronto Stock Exchange on the date of the surrender of such stock options and the exercise price under such stock options.
>
> In consideration for the undertaking by Imasco Limited to fund the cash payments forthwith upon the surrender by such Employees of Shoppers of their Imasco stock options, which Shoppers acknowledges directly benefit Shoppers' business, Shoppers hereby irrevocably and unconditionally agrees to pay Imasco Limited an amount equal to all such cash payments to be made by Imasco Limited to Employees of Shoppers.

[16] On January 28, 2000, the holders of Imasco shares voted to approve the BAT–Imasco Transaction. In January of 2000, employees of SDM exercised 62,800 options to receive Imasco shares and on January 28, 2000, SDM employees holding 2,190,380 options to acquire Imasco shares elected to surrender their options in return for the difference between the TSE closing price of Imasco shares ($41.40) and the price of the options. A payment was also made to reflect the difference between the price paid by BAT ($41.60) and the TSE closing price ($41.40). This point is not germane to the issue here.

[17] Also, the payments made to the option holders to surrender their options were grossed up to reflect the fact that it was believed that the cash payments for the surrender of the options did not attract the economic equivalent of the capital gains treatment under paragraph 110(1)(*d*) that was accorded to subsection 7(1) benefits. Whether I agree or disagree with this view is not relevant. The payments were made.

[18] The total amount paid by SDM to Imasco to reimburse it for the payments (called the "Cash Surrender Chargeback") which it made to the employees to surrender their options was $54,447.037. The additional amount paid by SDM to reimburse Imasco for the gross up to achieve the paragraph 110(1)(*d*) result (called the "Make-Up Chargeback") was $537,067. The total amount in issue is therefore $54,984,104.

[19] The question is whether these amounts are "outlays of capital" or "payments on account of capital". The distinction between these two expressions is not relevant to the question here. Jackett P. (as he then was) in *Algoma Central Railway v. M.N.R.*, 67 DTC 5091 at 5093 said:

> Leaving aside allowances in respect of depreciation, obsolescence or depletion, section 12(1)(*b*) prohibits the deduction of
>
> (*a*) "an outlay . . . of capital",
> (*b*) "a(n) . . . loss . . . of capital",
> (*c*) "a(n) . . . replacement of capital",
> or
> (*d*) "a payment on account of capital".
>
> As far as I know, the precise significance of these various expressions in section 12(1)(*b*) has not been the subject of judicial consideration. Whether or not there might be "an outlay . . . of capital"* that would escape the prohibition in section 12(1)(*a*) and would not fall within the expression "a payment on account of capital", I need not consider, for, as far as the expenditures in dispute are concerned, I am satisfied that, if they are not payments on account of capital, they are not, within the meaning of section 12(1)(*b*) outlays "of capital". I propose to consider, therefore, whether the expenditures in dispute were payments "on account of capital". In other words, the question, as I understand it, is: Is such an expenditure in substance "a revenue or a capital expenditure"? (See *British Insulated and Helsby Cables v. Atherton*, (1926) A.C. 205, per Viscount Cave, L.C. at page 213.)
>
> [*The usual test*]

The "usual test" applied to determine whether such a payment is one made on account of capital is, "was it made 'with a view of bringing into existence an advantage for the enduring benefit of the appellant's business'"? See *B.C. Electric Ry. Co. Ltd. v. Minister of National Revenue*, (1958) S.C.R. 133 [58 DTC 1022], per Abbott J. at pages 137-8, where he applied the principle that was enunciated by Viscount Cave in *British Insulated and Helsby Cables, Ltd. v. Atherton, supra*, and that had been applied by Kerwin J., as he then was, in *Montreal Light, Heat & Power Consolidated v. Minister of National Revenue*, (1942) S.C.R. 89 at 105 [2 DTC 535 at 537].

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* A distribution on winding up or on reduction of capital would presumably be an outlay "of capital" but not a payment "on account of capital". It may be that all outlays "of capital" are adequately covered by section 12(1)(*a*) and need not have been covered by section 12(1)(*b*).

[20] Jackett P.'s judgment in *Algoma Central Railway* was upheld by the Supreme Court of Canada, [1968] S.C.R. 447. The Supreme Court of Canada quoted the Privy Council in *B.P. Australia Ltd. v. Comr. of Taxation of the Commonwealth of Australia,* [1966] A.C. 224 at 264. In that decision Lord Reid said:

> . . . Nor on the other hand can any useful comparison be made with *British Insulated and Helsby Cables v. Atherton*. There a company's contribution of over £30,000 to form the nucleus of a fund and provide the amount then necessary to provide pensions for its staff was held to be a capital payment on the ground that:
>
> > "when an expenditure is made, not only once and for all but with a view to bringing into existence an asset or advantage for the enduring benefit of a trade . . . there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital."
>
> Those words are useful as an expression of general principle on prima facie indications, but the benefit in the particular case was the foundation of a fund that would endure for the whole life of the company and provides no analogy to the present case.

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. Although the categories of capital and income expenditure are distinct and easily ascertainable in obvious cases that lie far from the boundary, the line of distinction is often hard to draw in border line cases; and conflicting considerations may produce a situation where the answer turns on questions of emphasis and degree. That answer:
>
> > "depends on what the expenditure is calculated to effect from a practical and business point of view rather than upon the juristic classification of the legal rights, if any, secured employed or exhausted in the process":
>
> *per* Dixon J. in *Hallstroms Pty. Ltd. v. Federal Commissioner of Taxation.* As each new case comes to be argued felicitous phrases from earlier judgments are used in argument by one side and the other. But those phrases are not the deciding factor, nor are they of unlimited application. They merely crystallise particular factors which may incline the scale in a particular case after a balance of all the considerations has been taken.

[21] "Felicitous phrases", to use Lord Reid's expression, can be found in the cases to support either conclusion that an expenditure is revenue or capital but they are essentially descriptive, not defining. The ultimate answer, as Lord Reid said, depends upon a common sense appreciation of all of the guiding factors. This statement, which was adopted by the Supreme Court of Canada in *Algoma Central Railway*, *supra*, has a fine authoritative ring to it, but so far as providing any guidance in determining questions of this sort it is of little assistance.[1]

[22] I start from the premise that in the ordinary course a payment made by an employer to an employee for the surrender of his or her option under a stock option plan to acquire shares of the company is a deductible expense to the company. This conclusion is not based on any specific provision of the *Income Tax Act*. It is

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[1] Experience has taught me to be wary of relying on my own common sense in questions of this type. My common sense led me to believe that an extensive survey of the lands adjacent to Algoma Central Railway's rail line, designed to attract industries and towns over the ensuing decades, was intended to bring into existence an advantage for the ending benefit of the trade. Apparently not according to the Supreme Court of Canada. I think that one problem at least in the Exchequer Court, lay in Jackett P.'s comment in the footnote to his judgment quoted above that "it may be that all outlays 'of capital' are adequately covered by section 12(1)(*a*) and need not have been covered by section 12(1)(*b*)". This view of the respective functions of paragraph 12(1)(*a*) and 12(1)(*b*) (now 18(1)(*a*) and 18(1)(*b*)) appears to be inconsistent with the judgment of the Supreme Court of Canada in *B.C. Electric Railway Co. Ltd. v. M.N.R.*, 58 DTC 1022 where Abbott J. said:

> > Since the main purpose of every business undertaking is presumably to make a profit, any expenditure made "for the purpose of gaining or producing income" comes within the terms of s. 12(1)(*a*) whether it be classified as an income expense or as a capital outlay.
> >
> > Once it is determined that a particular expenditure is one made for the purpose of gaining or producing income, in order to compute income tax liability it must next be ascertained whether such disbursement is an income expense or a capital outlay.

simply part of employee compensation and is therefore a cost of doing business under section 9.[2]

[23] Why then does a payment to employees who are option holders become a capital expense just because it is made in the course of a corporate reorganization of the parent company? The short answer is that it does not. The business of SDM continued throughout the reorganization of the Imasco corporate structure. SDM, as a separate corporate entity, was not being reorganized. It had payrolls to meet and expenses to pay. It may possibly be that the reason for accelerating the vesting of the stock options was to enable as many employees as possible either to exercise their options or surrender them so that BAT could achieve its goal of obtaining all outstanding shares of Imasco. This does not turn the payment of what is patently a revenue expense into a capital expense.

[24] On assessing the Minister relied upon a decision of the Federal Court of Appeal in *The Queen v. Kaiser Petroleum Ltd.*, 90 DTC 6603. In that case, Desjardins J.A. of the Federal Court of Appeal stated that the sole question for determination was 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, constituted a deductible expense or an outlay on account of capital. The facts upon which the Federal Court of Appeal based its decision to reverse Joyal J. are set out in the judgment. In summary, they are these: the taxpayer, Kaiser Petroleum Canada Ltd., formerly known as Ashland Oil Canada Limited ("Ashland Canada") was controlled by Ashland Oil Inc. ("Ashland US"). Ashland US entered into an agreement to sell its shares of Ashland Canada to Kaiser Resources Ltd. ("Kaiser Resources"). Ashland Canada had an employees stock option plan. Clause 4.2 of the agreement between Ashland US and Kaiser Resources provided as follows:

> 4.2 *Employee Stock Options*. Prior to the Close 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

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[2] It is true that section 7 of the *Income Tax Act* provides a code with respect to the tax treatment of employees with respect to employee stock options and that treatment differs from that according to stock options under *Abbott v. Philbin*, [1961] A.C. 352. Section 7 does not however deal with the tax treatment of the employer where a payment is made to surrender the option. It was not argued (correctly, in my view) that paragraph 7(3)(*b*) dealt with the SDM situation or that *The Queen v. Placer Dome Inc.*, 92 DTC 6402 had any application.

> exercisable by its terms, amend such terms so that the option shall become immediately exercisable.

[25] This was done: the plan was amended, the offer was made to the option holders, who accepted it, the plan was cancelled and the payment of $2,722,317 was made to the option holders. Joyal J. held the payment was on revenue account. Desjardins J.A., with whom Marceau and Linden JJ.A. agreed, held it was on capital account. She quoted from *Algoma Central Railway* and *B.P. Australia Ltd.*, to which reference was made above. It is important that I set out in full her reasoning:

> Undoubtedly, the reasons for establishing the Stock Option Plan was 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 monies would then have been added to the company's working capital.
>
> 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. Monies were offered which represented the difference between the exercised price per share under the option and Cdn. $33.50 per share.
>
> 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 the hands of the potential owners of the shares of the Stock Option Plan through a share acquisition, had the plan properly unfolded. Monies, 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.

> 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 DTC 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 Limited, 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 Limited, offered to buy and eventually bought 85% of all the outstanding shares of Canada Forgings Limited at $17 per share. In November 1979, the president and vice-president of Canada Forgings Limited entered into an agreement with Canada Forgings Limited 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 Limited 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 Limited 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 Limited 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 Limited 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.
>
> 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 Limited. 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.
> The payment was therefore properly treated as an “outlay . . .of capital” under paragraph 18(1)(b) of the Act.

[26] It is of some interest to note that the Canada Revenue Agency (“CRA”) in its administrative practice stated in effect that *Kaiser* should be confined to its own facts. In Technical Interpretation 2000-0048355 the CRA, after quoting at some length from the Federal Court of Appeal judgment in *Kaiser* stated:

> In our view, the result in Kaiser follows from the facts in that particular case and is not inconsistent with our position that the payment by an employer of cash

> rather than shares pursuant to the terms of a stock option plan, in the absence of evidence to the contrary (e.g. the fact situation in Kaiser), will be a deductible expense to the employer.

[27] The administrative practice of the CRA is of course not determinative but it may in some circumstances be of interest.

[28] In *Kaiser* Desjardins J.A. based her conclusion on the factual finding made by her that:

> . . . The disbursement made was a once and for all payment which had a direct effect on the capital structure of the corporation. . . .

[29] Here, the rearrangement of the Imasco corporate structure did not impinge in any way on the corporate structure of SDM. Desjardins J.A. appears to have felt that the cancellation of the stock option plan of the appellant, Kaiser Petroleum Ltd., was an advantage for the lasting benefit of the appellant. I do not see how a payment by SDM to Imasco to reimburse it for payments made to employees of SDM created or achieved anything of lasting benefit to SDM. The business of SDM went on as usual.

[30] The payment was made to reimburse Imasco for payments it made to SDM's employees but the practical effect was identical to that which would have prevailed if SDM had made the payments directly to its employees. It was the options issued by Imasco to acquire Imasco shares that were affected by the offer to pay for the surrender of the options. The option holders could exercise the options, surrender them for cash or do nothing.

[31] Counsel for the appellant in his written and oral argument drew a number of other distinctions between this case and *Kaiser*. He emphasized two however. The first was that in *Kaiser* the payment was made to terminate the stock option plan and here it was not. The second is that in *Kaiser* the genesis of the payment was the takeover agreement and here it was in the stock option plan itself. Whatever may be the merits of this second distinction it is sufficient to add that here, no lasting benefit of a capital nature was achieved by the payment. The fact that a subsidiary reimburses its parent for compensation paid to the subsidiary's employees does not turn the payment into a capital expenditure just because the parent company is in the midst of a corporate reorganization.

[32] In the course of her argument, I asked counsel for the respondent whether, assuming I accepted the factual basis of the Crown's case that the change to the

stock option plan as well as the payments to the employees for the surrender of their options were the result of the overtures made by BAT to acquire the shares of Imasco, this turned the payments to the employees through Imasco into capital payments. I do not think that the Crown could possibly answer that the payments of compensation were transformed into capital payments because they were made in the context of a takeover and reorganization of the shares of SDM's parent. Desjardins J.A. said in *Kaiser* that what was achieved by the extinguishment of the stock option plan was a benefit of an enduring nature to Kaiser. On the evidence before me I cannot make the same finding of fact that paying for the surrender of the Imasco options achieved a benefit of a lasting nature to SDM.

[33] I close these reasons by repeating what Desjardins J.A. said at the termination of her reasons:

> 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 Limited. 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.
>
> [Emphasis added.]

The feature which she set out, if I understand it correctly, evidently dominated all other considerations. No such dominant feature pointing in the direction of a capital expenditure exists in this case.

[34] The appeal is allowed with costs and the assessment is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the amounts paid to Imasco to reimburse it for the Cash Surrender Chargeback and the Make-up Chargeback are payments on revenue account and are deductible in computing the appellant's income.

Signed at Ottawa, Canada, this 14th day of November 2007.

"D.G.H. Bowman"

Bowman C.J.

SCHEDULE 'A'

COURT FILE NO. 2006-82(IT)G

TAX COURT OF CANADA

BETWEEN:

SHOPPERS DRUG MART LIMITED

Appellant,

- and -

HER MAJESTY THE QUEEN

Respondent.

STATEMENT OF AGREED FACTS

The parties to this proceeding admit, for the purposes of this proceeding only, the truth of the following facts:

1. The Appellant, Shoppers Drug Mart Limited, was a taxable Canadian corporation for purposes of the *Income Tax Act* (Canada) (the "Act") and a wholly-owned subsidiary of Imasco Limited ("Imasco") in its taxation years ended December 31, 1999 and February 1, 2000.

2. During the relevant period, the Appellant's business was the licensing of retail outlets in Canada that specialized in prescription and over-the-counter drugs, health and beauty aids, and consumer products; the distribution of products to these retail outlets; and the operation of home health care specialty stores.

3. During the relevant period, Imasco and its subsidiaries were active in the financial services, tobacco, drugstore, and land development industry segments and together employed approximately 20,000 individuals.

4. As part of the overall compensation paid by the Appellant to certain of its current and former officers and key employees (the "Employees"), the Employees were

granted options from time to time under the Imasco Stock Option Plan (the "Imasco SOP").

5. The Imasco SOP was instituted on May 11, 1983. It was an equity-based employee compensation arrangement under which options to purchase Imasco shares were awarded to officers and key employees of Imasco and its subsidiaries, including the Employees, as part of the overall compensation for their services.

6. Pursuant to the terms of the Imasco SOP, as amended on October 27, 1995 **(an authentic copy of which is attached hereto at Tab 1)**, holders of vested options could elect at any time to exercise their options to receive common shares of Imasco upon payment of the exercise price. In addition, Imasco could offer an optionee the right to surrender an option in lieu of exercising it, and to receive a cash payment upon surrender equal to the difference between the market value of one Imasco share at the time of surrender and the exercise price per share specified in the option.

7. Prior to 1995, there were no provisions in the Imasco SOP providing for the surrender of options for cash payments. However, prior to 1995, Imasco had on an ad hoc basis paid cash amounts to terminated employees in consideration for the surrender of their options.

8. On approximately 10 occasions between 1995 and 1999, Imasco paid cash amounts, pursuant to the Imasco SOP, to employees in consideration for the surrender of their options.

9. In March of 1999, British American Tobacco plc ("BAT") approached Imasco to discuss on a preliminary basis a proposal that BAT would acquire the common shares of Imasco held by the public shareholders of Imasco (the "BAT-Imasco Transaction").

10. On June 9, 1999, Imasco amended the Imasco SOP **(an authentic copy of which is attached hereto at Tab 2)** such that all holders of vested options, at their

discretion, could receive a cash payment in lieu of a share upon surrender of their options.

11. On August 2, 1999, a Transaction Proposal Agreement **(an authentic copy of which is attached hereto at Tab 3)** was entered into by BAT, British American Tobacco (Canada) Limited ("Bidco"), and Imasco relating to a revised version of the BAT-Imasco Transaction that was originally proposed by BAT.

12. As described in section 5.8 of the Transaction Proposal Agreement, Imasco agreed that its board of directors would resolve to encourage all persons holding options pursuant to the Imasco SOP to exercise or surrender their options prior to the completion of the BAT-Imasco Transaction. Imasco further agreed that its board of directors would resolve, authorize and direct Imasco to accelerate the vesting of options under the Imasco SOP such that all outstanding options would become exercisable prior to the completion of the BAT-Imasco Transaction.

13. On November 18, 1999, Imasco, BAT, and Bidco entered into a Transaction Proposal Amending Agreement **(an authentic copy of which is attached hereto at Tab 4)** that set the purchase price per Imasco common share at $41.60.

14. On December 8, 1999, the Toronto Stock Exchange was notified of the accelerated vesting described in paragraph 12 above and that if certain reorganization closing steps were not completed, the accelerated vesting would be deemed never to have occurred.

15. On December 14, 1999, Imasco advised shareholders of a special meeting to vote on the proposed acquisition by BAT of all of the shares of Imasco held by public shareholders **(an authentic copy of the Notice of the Special Meeting together with the Management Proxy Circular are attached hereto at Tab 5)**. The Management Proxy Circular provided shareholders with, *inter alia*, details of the proposed transaction, the facts and circumstances leading to the transaction, the treatment of the outstanding employee stock options, and various other employee matters.

16. On December 14, 1999, Imasco caused the vesting of those options granted under the Imasco SOP that had not yet vested to accelerate (as described above in paragraphs 12 and 14) prior to the completion of the proposed transaction with BAT, such that all employee options (by value, 88.73% of which had otherwise vested, **as illustrated by the documents authentic copies of which are attached hereto at Tab 6**) became exercisable prior to the completion of the BAT-Imasco Transaction.

17. As confirmed in a letter dated January 27, 2000 **(an authentic copy of which is attached hereto at Tab 7)**, the Appellant agreed to reimburse Imasco for an amount equal to all cash payments made by Imasco to the Employees in respect of their surrender of options under the Imasco SOP.

18. On January 28, 2000, holders of Imasco common shares voted to approve the BAT-Imasco Transaction at a special meeting of shareholders held on that date.

19. In January of 2000, Employees that held 62,800 options exercised their options and received Imasco common shares.

20. On January 28, 2000, certain Employees holding 2,190,380 options elected to surrender their options in exchange for cash payments equal to the difference between the closing price of Imasco shares on the TSE ($41.40) and the exercise price of the options (the "Cash Surrender Payments"). Those Employees signed a form **(an authentic copy of which is attached hereto at Tab 8)** that contained the following condition subsequent to the surrender of their options:

> Notwithstanding the foregoing, my Options shall be deemed never to have been surrendered if Imasco fails to complete certain internal reorganization transactions in contemplation of the capital reorganization as provided for in the Transaction Proposal Agreement between Imasco and British American Tobacco p.l.c.

21. Payments that reflected the difference between the purchase price per Imasco share offered by BAT ($41.60) and the TSE closing price of Imasco shares on the date of surrender ($41.40), grossed-up to reflect the lack of a paragraph 110(1)(d)

deduction in respect of such payments (the "Make-Up Payments"), were made to option holders that had elected to surrender their options in exchange for cash payments.

22. The Appellant made a payment of $55,493,065 (the "Total Chargeback") to Imasco, which included $54,447,037 to reimburse Imasco for the Cash Surrender Payments made by Imasco to the Employees (the "Cash Surrender Chargeback") and $537,067 to reimburse Imasco for the Make-Up Payments made to the Employees (the "Make-Up Chargeback").

The parties hereto agree that this Statement of Agreed Facts does not preclude either party from calling evidence to supplement the facts agreed to herein, it being accepted that such evidence may not contradict the facts agreed.

DATED at the City of Toronto, in the Province of Ontario, this 9th day of October, 2007.

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COURT FILE NO.:	2006-82(IT)G
STYLE OF CAUSE:	SHOPPERS DRUG MART LIMITED v. HER MAJESTY THE QUEEN
PLACE OF HEARING:	Toronto, Ontario
DATES OF HEARING:	October 11, 2007
REASONS FOR JUDGMENT BY:	The Honourable D.G.H. Bowman, Chief Justice
DATE OF JUDGMENT:	November 14, 2007

APPEARANCES:

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