ALBERTA EXPROPRIATION ASSOCIATION – FALL CONFERENCE 2001

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TAX - A COMPENSATION ISSUE

For more than a decade tax gross-ups – payment of an additional amount to counter the tax impact of an award – have been accepted in personal injury actions. The same cannot be said for cases involving compensation for compulsory land acquisitions.

Are there legal, philosophical or logistical reasons for this dichotomy of approaches? Or have we in the land compensation game been slow on the uptake?

In this paper I will examine the theory behind tax gross-ups, discuss the tax impacts of expropriation, and review some examples that demonstrate the need to think of tax as another monetary head of damage consequential to expropriation.

The Theory Behind Tax Gross-ups

Tax gross-ups for personal injury awards were given the nod by the Supreme Court in *Watkins* v. *Olafson*[1]. In that case, the Court recognized the need to soften the tax impact on personal injury plaintiffs receiving large lump sum awards for the cost of future care. It pointed out that, if no allowance were made for the fact that the unused portion of the fund would be invested by the recipient, and earn income – taxable income under the *Income Tax Act* - then any judgment for the cost of future care would be insufficient for the purpose. That purpose is to fund the care required by the recipient for his or her predicted life span. Hence the need for "grossing up" – augmenting the award to compensate the plaintiff in a personal injury action for the tax that will accrue.

In awarding a tax gross-up, the Supreme Court in *Watkins* v. *Olafson* said "yes" to the question of whether or not the taxation impact was a factor that the courts should properly consider in determining the amount required to provide for a plaintiff's future care. It concluded, after reviewing the history of various courts' treatment of this issue (including the Supreme Court's own treatment of this issue in previous cases) that, so long as the necessary evidentiary foundation is laid, there is no reason that a court cannot take into account the tax implications in making an award for the cost of future care. In reaching this conclusion, the Supreme Court quoted these words of various authorities, all in the context of personal injury suits: "recognition of the effect of taxes, no matter how difficult to calculate, seems essential if awards are to be fair to the plaintiff"[2]; "without

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[1] *Watkins* v. *Olafson* et al (1989) 61 D.L.R. (4th) 577; [1989] 2 S.C.R. 750.

[2] Feldthausen and McNair, "General Damages and Personal Injury Suits: The Supreme Court's Trilogy" 28 U.T.L.J. 381 (1978), quoted from in *Watkins* v. *Olafson* et al, *supra*, at p. 588.

gross-up, such a fund is clearly inadequate for the purpose for which it is intended"[3]; and "if this impact [of taxation] is ignored, … then the award cannot accomplish its prime purpose, which is to assure that the plaintiff should be adequately cared for during the rest of his life".[4]

Watkins v. *Olafson* also put to rest the argument against tax gross-ups on the basis that the calculation is speculative, and therefore should not be attempted at all. According to the Supreme Court:

(a) any calculation difficulties are a weak basis for the refusal to award a plaintiff damages to which she or he is, in principle, entitled;
(b) the entire exercise of damage assessment in respect of future care, which normally spans a period of many years, is also fraught with uncertainty, and yet the courts must do their best to calculate those damages in order to give effect to an injured plaintiff's right; and
(c) the calculation of the potential tax ramifications of damage awards would not be particularly difficult, where there is evidence before the court from chartered accountants and actuaries as to the tax impacts of awards for the cost of future care.

As will become apparent below, it is my position that some of the principles enunciated in the personal injury cases have application in expropriation cases, particularly given the fundamental mandate behind expropriation theory and legislation. Rule One is: No individual or business expropriated should be out-of-pocket as a result of the expropriation.

If It Is Good Enough For The Personal Injury Victim…

Under Alberta's ***Expropriation Act***, R.S.A. 1980, c. E-16, any owner of property, or anyone who has a particular estate or interest in the property, or anyone who is in possession or occupation of the property, must be compensated by an expropriating authority taking away the property. Under ss. 42 and 50 of the ***Act***, compensation payable to an "owner" is based on four types of financial loss:

(a) the market value of the lands expropriated;
(b) disturbance damages that are the natural and reasonable consequences of the expropriation;
(c) any value to the "owner" related to the special economic advantage enjoyed by the owner arising from his ownership or occupation of the land;
(d) damages for injurious affection.

Further, under s. 53 of the ***Act***, when a landowner is carrying on business on expropriated lands, the expropriating authority is obliged to compensate that owner for any business losses resulting from the disturbance and the related business relocation.

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[3] *Scarff* v. *Wilson* (1988), 55 D.L.R. (4th) 247 at p. 260; [1989] 3 W.W.R. 259 (BCCA).
[4] *McErlean* v. *Sarel* (1987) 42 D.L.R. (4th) 577 at p. 613; 61 O.R. (2nd) 396 (CA), leave to appeal refused, 46 D.L.R. (4th) vi.

Essentially, the message of the legislators comes out loud and clear through the ***Expropriation Act***: no citizen ousted from his or her property should be out-of-pocket as a result of the expropriation. Taken one step further, one might say that, in recognizing the inherent unfairness of usurping by law a person's property, the legislation seeks to ensure that there is no financial consequence (to go along with the probable emotional consequence) for the expropriated party.

Our courts in *Re: Amdue Holdings Ltd. and City of Calgary*[5] and numerous cases since have repeated that message. In 1983 the Supreme Court added another element to the message. It held that expropriation legislation – given its nature as an interference with private rights – must be strictly complied with[6].

In 1997, the Supreme Court reminded us that expropriation legislation should be flexible enough to allow for indemnification in varying circumstances[7].

On the face of it, then, those with lands expropriated would seem cocooned from both financial harm and procedural anomalies. However, one might question whether the current expropriation regime actually goes that far. Recognition of any tax consequences to an expropriated person's receipt of a large lump sum expropriation settlement is conspicuously absent from both the legislation and the case law.

The Current Tax Regime

Those sections of the ***Income Tax Act*** relevant to expropriation proceedings are:

Section 13(21): **Definitions**: "Disposition of Property" includes any transaction or event entitling a taxpayer to proceeds of disposition of the property.

Section 54: "Proceeds of Disposition" of property includes (b) compensation for property unlawfully taken (d) compensation for property taken under statutory authority … (e) compensation for property injuriously affected … under statutory authority or otherwise.

Section 44(2): Time of disposition and of receipt of proceeds - For the purposes of this *Act*, the time at which a taxpayer has disposed of a property for which there are proceeds of disposition as described in paragraph (b), (c), or (d) of the definition "proceeds of disposition" in subsection 13(21) or paragraph (b), (c), or (d) of the definition "proceeds of disposition" in section 54, and the time at which an amount, in respect of those proceeds of disposition has become receivable by the taxpayer shall be deemed to be the earliest of (b) where a claim, suit, appeal or other proceeding has been taken before one or more tribunals or courts of competent jurisdiction, the day on which the taxpayer's compensation for the property is finally determined by those tribunals or courts…

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[5] *Re: Amdue Holdings Ltd. and City of Calgary* (1980) 112 D.L.R. (3d) 459 (Alta. C.A.); 24 A.R. 541.
[6] *Costello and Dickhoff* v. *Calgary* [1983] 2 W.W.R. 673 (S.C.C.)
[7] *Toronto Area Transit Operating Authority* v. *Dell Holdings Ltd*. [1997] 1 S.C.R. 32.

Section 248(1): "property" means property of any kind whatever whether real or personal or corporeal or incorporeal ….

Canada Customs and Revenue Agency publishes Interpretation Bulletins, which it utilizes as guidelines to interpret the ***Income Tax Act***. Two such Interpretation Bulletins deal in a general sense with damages arising from litigation:

<u>IT365R2 Damages, settlements, and similar receipts</u>

"10. Amounts received by a taxpayer with respect to the loss of business income or business property may fall into one of the following categories:
(a) a non-taxable receipt;
(b) an income receipt;
(c) a receipt resulting from the disposition of a capital property; or
(d) an eligible capital amount.
See IT-182 for a discussion of the factors that determine the tax status of a given receipt."

<u>IT182 Compensation for loss of business income, or of property used in a business</u>

"4. … where a taxpayer has a right to compensation for a property or income loss because of contract, statute law, order-in-council, etc., compensation paid for loss or destruction of capital property is considered to be proceeds received on the disposition of the property, and compensation for loss or destruction of inventory or for loss of profits is considered to be income from the carrying on of the taxpayer's business."

CCRA has issued an Interpretation Bulletin that specifically deals with tax treatment of expropriation compensation. Two of the more important provisions are set out as follows.

<u>IT271R Expropriations – Time and proceeds of disposition</u>

"19. … Whether the proceeds of disposition are on account of income or capital depends entirely upon the nature of the property disposed of.

20. The compensation award determined by the expropriating authority may take into account, in addition to the fair market value of any expropriated property, several other factors such as:
(a) inconvenience, disturbance, disruption to or loss of business,
(b) disturbance of possession,
(c) costs of relocation, including moving costs and legal fees or other costs incurred in acquiring new premises,
(d) legal, appraisal and other costs incurred in determining a fair compensation for the expropriated property.

Amounts in respect of these factors may form part of the proceeds of disposition of the property disposed of. … All compensation paid to a tenant on an expropriation is considered to be for the leasehold interest, regardless of the factors on which the compensation is based.”

Qualified small businesses and farm property owners can take advantage of certain capital gains exemptions under the current tax regime. Section 110.6 of the ***Act*** provides exhaustive definitions of those businesses and farm properties eligible to claim these exemptions.

The leading case interpreting these sections is *Sani Sport Inc.* v. *M.N.R.*[8], a decision of the Federal Court affirmed on appeal. The expropriated party in this case was awarded damages as recompense for losing its ability to generate profits. The Federal Court reviewed the definition of “disposition of property”, “proceeds of disposition”, and “property” in the ***Income Tax Act***. It noted that s. 54 of the ***Act*** defines “proceeds of disposition” as including compensation for property taken under statutory authority, and that s. 248(1) of the ***Act*** defines “property” as any kind whatever, including a “right of any kind”. Based upon this statutory interpretation, the Court concluded that the right to generate profits was a part of the “property” expropriated and, therefore, compensation for its loss was taxable as a capital gain.

On the other hand, very recently, a lower court has allowed that amounts awarded pursuant to a provision of a s. 30-type agreement for “damages as a result of the inability of the Appellant to relocate its business” are a non-taxable capital receipt.[9]

Court/Board treatment of tax issues to date

Unlike their personal injury cousins, there have been few expropriation cases in which either a Court or a Board have acknowledged tax consequences – and even fewer in which the tax implications have resulted in additional landowner compensation. One of only two exceptions that I am aware of is *City of Montreal* v. *Ilgwu Centre Inc.*[10] in which the Supreme Court of Canada agreed with the landowner that the loss of a property tax exemption was an important advantage to the owner and should be compensable.

The other is *The Queen in Right of Manitoba* v. *Hilger*[11], in which a Manitoba court considered the tax implications of expropriating a farmer’s land just shy of his planned retirement date. The court in that case took notice of previous cases in which Ontario’s and Alberta’s Land Compensation Boards denied compensation connected with the incidence of capital gains tax. However, it ruled for the landowner in any event.

Cases in which tax compensation has been denied include the following:

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[8] *Sani Sport Inc.* v. *M.N.R.* (1986), 87 DTC 5253 (F.C.T.D.), affirmed (1990) 90 DTC 6230 (F.C.A.).
[9] *Toronto Refiners & Smelters Limited* v. *The Queen* [2001] F.T.R. 36630.
[10] *City of Montreal* v. *Ilgwu Centre Inc.*(1971), 2 L.C.R. 26 (S.C.C.).
[11] *The Queen in Right of Manitoba* v. *Hilger* (1982), 25 L.C.R. 308 (Man. Q.B.).

In *Loukras* v. *The Queen*[12], an expropriated party argued that, as a result of an expropriation, he had been deprived of a rollover under the ***Income Tax Act*** and also a tax exemption for his principal residence. His position was that these tax consequences should be taken into account in the expropriation award. The court declined to entertain this notion, and did not mince words:

> "In my view, Parliament in enacting the *Expropriation Act*, never contemplated that liability for payment of tax on compensation awarded under the *Act* would be one of the matters which a Court must take into consideration in awarding the compensation. If it had been so contemplated it would have spelled out such an intention in clear and unmistakable language in the *Expropriation Act*. However, in point of fact the *Income Tax Act* in defining the words "proceeds of disposition" of property includes within that definition compensation for property taken under statutory authority."

In 1986, a Nova Scotia court rejected a claim for compensation for a "tax shield" lost because of reduced undepreciated capital cost categories resulting from an expropriation[13].

The claimant in *St. Mary's Cement Ltd.* v. *Ontario Hydro*[14] argued unsuccessfully that, like a personal injury award, his lump sum compensatory award should be grossed-up to respond to the tax impact. The Ontario Court of Appeal declined to consider it, entertaining "considerable doubt whether the gross-up principle falls within the contemplation of the specifically enumerated bases of compensation set forth in Ontario's Expropriations Act".

It is notable that all of these cases predate the Supreme Court ruling in *Dell Holdings Ltd.* v. *Toronto Area Transit Operating Authority*[15] in which the Court categorized expropriation legislation as remedial statutes to be given "broad and liberal interpretation consistent with their purpose to adequately compensate those whose lands are taken to serve the public interest".

Demonstrable Tax Impacts

I have described the several "heads of damage" compensable in expropriation proceedings. I have described the tax regime in which compensation received under those heads of damage is often characterized as a capital gain.

[12] *Loukras* v. *The Queen* (1974) 7 L.C.R. 240 (F.C.T.D.)
[13] *Gardiner Burton Agencies Ltd. v. Nova Scotia* (1986) 37 L.C.R. 18 (N.S.S.C.)
[14] *St. Mary's Cement Ltd.* v. *Ontario Hydro* (1989) 41 L.C.R. 161; 68 O.R. (2d) 727 (Ont. C.A.).
[15] *supra*, note 7.

The tax consequences of an expropriation, whether such tax is based on income or capital disposition, can and often does put an expropriated landowner “out of pocket”. The following are some illustrations of how this occurs.

Scenario #1

Mr. and Mrs. K. are in their late 60’s. Both have farmed their entire lives and had no intention of leaving the farm for at least another 10 years. Theirs is a small quarter section farm and their annual taxable income is only $18,000.00. However, they have a small cow/calf operation of 30-35 head, chickens, ducks, fish, honeybees, an orchard, a wood lot and a garden, and are largely self-sufficient. When their entire farm is expropriated, Mr. and Mrs. K. reasonably decide not to start over, but rather to move to an acreage. Unfortunately, in their new location, they can no longer practise the same levels of animal husbandry and horticulture. Their costs of living rise significantly. Prior to the expropriation, the couple received a combined Old Age Security Pension and Income Supplement of $8,296.44 annually or $691.37 per month. Their Alberta Health Care premiums were subsidized to the annual tune of $816.00 or $68.00 per month. Like most farmers, Mr. and Mrs. K. were taxed on a cash basis. This meant that they were not taxed on the cows in their herd or on their stockpile of grain until sold. Mr. and Mrs. K.’s farm equipment had been depreciated to zero dollars. Notwithstanding that much of their equipment was old, Mr. and Mrs. K. were able to sell it at auction for $40,000.00. All of their cattle and stockpiles of grain were also sold in the year of the expropriation. The year prior to the expropriation the K’s paid tax of $1,154.00. (See Appendix #1)

Expropriation year income:

Equipment recapture -	$ 40,000.00
Cattle sold -	$ 42,000.00
Stockpiled grain sold -	$ 20,000.00
Normal Farm Income -	$ 18, 000.00
Total	$120,000.00

Expropriation year tax impact:

Additional income tax ($49,413.45 - $1,154)	$48,259.45
O.A.S. - clawed back	$ 8,296.44
A.H.C.- clawed back	$ 816.00
Total	$ 57,371.89 (See Appendix 1A)

<u>Scenario #2</u>

Mr. M. is an elderly single farmer who had no intention of moving from his half section farm for ten years. His land is located near the city and has significant development value. Appraisal evidence shows that if it had not been required for an interchange, the land would have been ripe for development in 5 to 10 years. Mr. M.'s land was forcibly acquired at a current market value of $2 million. The V-Day value of the land was $150,000.00. The principal residence portion was valued at $100,000.00. The net result is a capital gain of $1.75 million, resulting in tax payable of $281,681.39. (See Appendix 2). Because of his age, Mr. M. did not replace the land and was unable to take advantage of the replacement provisions in the ***Income Tax Act***. If left undisturbed, Mr. M. would have remained living on the property and sold all but the residence portion in 5 to 10 years. During that time period, had the expropriation not occurred, he would have owned an asset that was undoubtedly appreciating at a rate well in excess of banking investments.

<u>Impact:</u>

Loss of tax funds for 5 years:
$281,000 x (10% return – 3% inflation) x 5 years = $113,117.04 (See Appendix 2A)
Loss of tax funds for 10 years:
$281,000 x (10% return – 3% inflation) x 10 years = $271,769.53 (See Appendix 2B)

<u>Scenario #3</u>

ABC Corporation is a small wholesale business owned by Mr. and Mrs. S. As a result of the expropriation it is forced to cease operations. While a going concern, ABC averaged a net annual income of about $300,000. The directors always utilized bonuses to ensure that the taxable active income was below $200,000 so that the corporation paid only the 19.12% Canadian small business corporate tax rate. The evidence establishes that ABC will be unable to re-establish the old business, and that the time to locate and set up an acceptable alternative is likely to be 3 years. In the meantime, ABC will invest the expropriation proceeds in mutual funds that will also generate $200,000/year. The tax rate payable on such income is 24.62%.

Tax Impact:

Present value of 5.5% x $200,000 x 3 years or $31,419.00 (assumes 5% discount rate)

<u>Conclusion – It just makes sense</u>

Not every case will generate compensable tax consequences. In fact, it may be that very few will. However, the examples illustrated here are based, in part, on actual cases. The numbers have been simplified and sometimes amplified, but they are not farfetched.

Why have we not seen these kinds of tax impacts claimed or compensated for more often?

The rationale used to deny tax recovery or tax gross-up is usually based on one of two premises:

1. There exists no provision expressly set forth in the compensation legislation that provides rights to compensation for tax impact.

2. The damages are too speculative.

Turning to the first objection, we now have the benefit of the Supreme Court's ruling that expropriation legislation is to be purposively interpreted. Its compensation provisions are not to be limited by a strict reading of the words, but rather interpreted broadly, having in mind the ultimate goal of complete recompense to the landowner.

As for the speculation objection, two means to overcome it are:
(a) The landowner may seek an advance ruling from CCRA, or
(b) The Board or Court may leave open, like the issue of costs, the tax claim portion of the judgment pending final calculation and assessment of tax by CCRA.

Where neither of these solutions is practical, nevertheless, the speculative nature of the claim should not be a bar to tax recovery. As the Supreme Court of Canada said (in the personal injury context) in *Watkins* v. *Olafson*:

> "… difficulty of calculation is a weak basis for refusing to award a plaintiff damages to which he or she is, in principle, entitled."[16]

The purpose of this presentation was to demonstrate the lack of legal, philosophical or mechanical reason to deny this type of claim. The evidentiary impediments, while arguably significant, are not insurmountable. That tax has not been pursued as a compensation item more often is probably an indictment of the vigilance of those of us who act for landowners. I suggest we add it to our checklists.

[16] *Watkins* v. *Olafson, supra*, note 1, at p. 588