Dockets: 2013-1066(IT)G
2013-1327(IT)G

BETWEEN:

DEVON CANADA CORPORATION,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals called for hearing on May 1 and 2, 2017, at Calgary, Alberta and on October 30 and 31, 2017 and November 1, 2017, at Toronto, Ontario. Submissions filed by the Appellant on August 14, 2017 and October 16, 2017 and by the Respondent on September 22, 2017.

By: The Honourable Justice Don R. Sommerfeldt

Appearances:

Counsel for the Appellant:	Al Meghji, Edward Rowe, Pooja Mihailovich, Joanne Vandale
Counsel for the Respondent:	Luther P. Chambers, Q.C., Patrick Vézina, Vincent Bourgeois

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JUDGMENT

These Appeals are allowed and the reassessment and the determination of a loss that are the subject of these Appeals are referred back to the Minister of National Revenue for reconsideration and reassessment or redetermination, as the case may be, in accordance with the attached Reasons, and, in particular, on the basis that the

Surrender Payments (as defined in the Reasons) were eligible capital expenditures (as defined in subsection 14(5) of the *Income Tax Act*, as it read in 2001).

Costs are awarded to the Appellant. The Parties shall have 30 days from the date of this Judgment to reach an agreement on costs, failing which the Appellant shall have a further 30 days to file written submissions on costs, and the Respondent shall have yet a further 30 days to file a written response. Any such submissions are to be limited to 10 pages in length. If the Parties do not advise the Court that they have reached an agreement and if no submissions are received within the foregoing time limits, costs shall be awarded to the Appellant in accordance with the Tariff.

Signed at Ottawa, Canada, this 20th day of August 2018.

"Don R. Sommerfeldt"

Sommerfeldt J.

Citation: 2018 TCC 170
Date: 20180820
Dockets: 2013-1066(IT)G
2013-1327(IT)G

BETWEEN:

DEVON CANADA CORPORATION,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Sommerfeldt J.

I. INTRODUCTION

[1] These Reasons pertain to two Appeals brought by Devon Canada Corporation ("Devon") in respect of:

a) a reassessment (the "Reassessment"), as set out in a Notice of Reassessment dated September 3, 2008, issued by the Canada Revenue Agency (the "CRA") on behalf of the Minister of National Revenue (the "Minister"), in respect of the taxation year of a predecessor, Numac Energy Inc. ("Numac"), that ended on February 11, 2001; and

b) a determination of a loss (the "Determination"), as set out in a Notice of Determination of a Loss dated July 31, 2008, issued by the CRA on behalf of the Minister, in respect of the taxation year of a predecessor, Anderson Exploration Limited ("Anderson"), that ended on October 14, 2001.

[2] In the context of two corporate takeovers, by Anderson of Numac on or about February 12, 2001 and by Devon Energy Corporation ("DEC") of Anderson on or about October 15, 2001, Numac and Anderson made payments (the "Surrender Payments") to various individuals who held options to acquire shares of the respective corporations.

[3] In computing its income for the taxation year ended on February 11, 2001, Numac deducted the Surrender Payments (the "Numac Surrender Payments") paid by it to its option holders who had elected to surrender their unexercised options to Numac in exchange for a cash payment calculated by reference to the difference between the takeover-bid price of a Numac share and the exercise price of the particular option. In computing its income for the taxation year ended on October 14, 2001, Anderson deducted the Surrender Payments (the "Anderson Surrender Payments") paid by it to its option holders who had elected to surrender their unexercised options to Anderson in exchange for a cash payment calculated by reference to the difference between the takeover-bid price of an Anderson share and the exercise price of the particular option.

II. ISSUES

[4] As set out in the pleadings, the issues in these Appeals were, in essence:

a) In computing Numac's income for the taxation year ended on February 11, 2001, was Numac entitled to deduct the Numac Surrender Payments pursuant to subsection 9(1) of the *Income Tax Act* (the "*ITA*"),[1] or was that deduction precluded by paragraph 18(1)(*a*) or (*b*) of the *ITA*?

b) If the Numac Surrender Payments were on account of capital, within the meaning of paragraph 18(1)(*b*) of the *ITA*, were they eligible capital expenditures, within the meaning of subsection 14(5) of the *ITA*, so as to be deductible in part pursuant to paragraph 20(1)(*b*) of the *ITA*, read in conjunction with subsection 111(5.2) of the *ITA*?

c) Were the Numac Surrender Payments deductible pursuant to subparagraph 20(1)(*e*)(i) of the *ITA*?

d) In computing Anderson's income for the taxation year ended on October 14, 2001, was Anderson entitled to deduct the Anderson Surrender Payments pursuant to subsection 9(1) of the *ITA* or was that deduction precluded by paragraph 18(1)(*a*) or (*b*) of the *ITA*?

e) If the Anderson Surrender Payments were on account of capital, within the meaning of paragraph 18(1)(*b*) of the *ITA*, were they eligible capital expenditures, within the meaning of subsection 14(5) of the *ITA*, so as to be

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[1] *Income Tax Act*, RSC 1985, c.1 (5th supplement), as amended.

deductible in part pursuant to paragraph 20(1)(*b*) of the *ITA*, read in conjunction with subsection 111(5.2) of the *ITA*?

f) Were the Anderson Surrender Payments deductible pursuant to subparagraph 20(1)(*e*)(i) of the *ITA*?

[5] By letter dated April 25, 2017, counsel for Devon advised the Court that Devon would no longer be advancing the arguments that it had previously made in respect of issues a) and d) above. In other words, Devon implicitly acknowledged that the Surrender Payments were not deductible under subsection 9(1) of the *ITA*.

III. FACTS

[6] The Parties filed a Statement of Agreed Facts – Partial (the "SAFP"),[2] a two-volume Joint Book of Documents (the "JBOD")[3] and a Supplementary Joint Book of Documents.[4] Unless otherwise indicated, the following facts are taken from the SAFP. A copy of the SAFP is attached as Appendix A to these Reasons.

A. Parties

[7] Devon was formed as the result of a number of amalgamations. Numac and Anderson were two of the corporations that participated in some of the amalgamations to form Devon.

[8] On or about February 12, 2001, Anderson (through a subsidiary) acquired all of the issued and outstanding shares of Numac by way of a takeover bid (the "Numac Acquisition"), described below.[5]

[9] Before February 12, 2001, Numac was a public corporation, the shares of which were listed and traded on the Toronto Stock Exchange (the "TSE") and the

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2 Exhibit AR-1.

3 Exhibit AR-2. The Parties also filed, as Exhibit AR-4, an Agreement Regarding the Joint Book of Documents (the "JBOD Agreement"), in which they agreed, among other things, that the JBOD Agreement did not restrict their rights to tender documents not addressed by the JBOD Agreement, or to introduce evidence to explain, or elaborate upon, any document entered as an exhibit pursuant to the JBOD Agreement.

4 Exhibit AR-3.

5 In these Reasons, the issued and outstanding shares of Numac are referred to interchangeably as the "Numac shares" or the "Numac common shares."

American Stock Exchange. After the Numac Acquisition, the Numac shares were delisted from trading on those stock exchanges.

[10] Numac, together with its subsidiaries, was engaged in the active business of exploring for, producing and selling natural gas and other hydrocarbons in Canada. Numac and its successors, including Devon, continued to carry on this business after the Numac Acquisition.

[11] On or about October 15, 2001, DEC (through a subsidiary) acquired all of the issued and outstanding shares of Anderson by way of a takeover bid (the "Anderson Acquisition"), described below.[6]

[12] Before October 15, 2001, Anderson was a public corporation, the shares of which were listed and traded on the TSE and the New York Stock Exchange. After the Anderson Acquisition, the Anderson shares were delisted from trading on those stock exchanges.

[13] Anderson, together with its subsidiaries, was engaged in the active business of exploring for, producing and selling natural gas and other hydrocarbons in Canada. Anderson and its successors, including Devon, continued to carry on this business after the Anderson Acquisition.

B. Stock Option Plans

(1) Numac Stock Option Plan

[14] Before the Numac Acquisition, Numac had an employee stock option plan (the "Numac SOP"), which had come into existence before 2001. The Numac SOP was to be administered by the Numac Board of Directors, or a special committee thereof, appointed from time to time. At all relevant times, the Numac SOP was administered by the Compensation Committee of the Board of Directors of Numac.

[15] The Numac SOP provided for share option agreements (the "Numac SOAs"), with attached terms and conditions, to be entered into between Numac and its directors, officers and key employees (the "Numac Optionees"), to grant them options to purchase common shares of Numac for an option price specified in the SOAs and described therein as the "exercise price." The Compensation

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[6] In these Reasons, the issued and outstanding shares of Anderson are referred to interchangeably as the "Anderson shares" or the "Anderson common shares."

Committee of the Board of Directors of Numac decided which of the Numac employees would receive options to acquire Numac shares in a given year.

[16] The Numac SOP provided that the Compensation Committee of Numac's Board of Directors could "in its sole discretion, determine the time during which options shall vest." Although the terms of the Numac SOAs varied, each SOA provided for vesting limitations, which had to be satisfied before the options could be exercised to acquire shares of Numac. Specifically, the vast majority of Numac SOAs provided that the options granted thereunder would vest in three equal parts (that is, one-third of the grant) on the first, second and third anniversaries of the date of grant. Upon satisfaction of those limitations, a Numac Optionee could exercise a vested option by paying to Numac the exercise price specified in the applicable SOA.

[17] The Numac SOP provided that the exercise price of an option was to be fixed by the Compensation Committee at the time the option was granted. The Numac SOP also provided that the exercise price could not be less than the closing price of the common shares of Numac on the stock exchange on which the shares were traded on the last trading day before the grant of the option.

[18] All of the Numac SOAs also provided that:

a) in the event of an amalgamation, arrangement, merger or other consolidation of Numac with another corporation (other than a wholly-owned subsidiary of Numac), the vesting of unvested options was accelerated such that the Numac Optionees had the right to exercise their options at that time; and

b) in the event of a formal bid being made to acquire more than 25% of the outstanding voting shares of Numac, and if Numac's Board of Directors recommended acceptance of the offer, the vesting of unvested options was accelerated and such options could be exercised for the sole purpose of tendering the shares to the bid.

[19] The terms and conditions of the Numac SOAs provided that the Board of Directors of Numac had the discretion to permit unexercised options to be surrendered to Numac for cash equal to the amount by which the fair market value of the shares at the time of the surrender exceeded the exercise price,[7] but the

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[7] It appears that the intent of the particular provision was as stated above; however, I think that the provision may have contained a typographical error. Section 17 of the terms and

Numac Optionees did not otherwise have the right to surrender and cash out their options. Before the Numac Acquisition, Numac's Board of Directors had not previously exercised the discretion to permit the Numac Optionees to surrender their options for cash.

[20] The Numac SOP and the Numac SOAs provided that the options were not assignable by the Numac Optionees. The Numac SOP also provided that, if a Numac Optionee ceased to be a director, officer or full-time employee of Numac, the option would terminate on the expiry of the period determined by the Compensation Committee of Numac's Board of Directors, which was to be no more than six months after that cessation. The terms and conditions of each Numac SOA further provided that, if a Numac Optionee's employment was terminated without cause within 60 days of an amalgamation, merger or other consolidation of Numac with any one or more corporations, any unexercised option would terminate and become null and void.

(2) Anderson Stock Option Plan

[21] Before the Anderson Acquisition, Anderson had an employee stock option plan (the "Anderson SOP"), which had come into existence on or about December 31, 1994. It was amended and restated as of February 10, 1999, and further amended and restated on February 13, 2001.

[22] The Anderson SOP provided that:

a) the Board of Directors of Anderson had the authority to:

i. grant to Anderson's officers, members of management and employees (the "Anderson Optionees") options to purchase a

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conditions of the Numac SOAs provided that the consideration to be paid to a Numac Optionee on the surrender of an unexercised option was "an amount equal to the excess, if any, of the aggregate fair market value of the Common Shares purchasable pursuant to the exercisable portion of the Option, on the date of the surrender, (as determined by the Board of Directors) *and* the aggregate Exercise Price with respect to such Common Shares pursuant to the Option." [*Emphasis added.*] See Exhibit AR-2, Tab 7, p. 164. In my view, in the excerpt quoted in this footnote, the word "*and*" should be replaced with "over" or a similar word. However, as already indicated, I am of the view that the intent of the provision is clear, such that I have interpreted the provision in the manner set out in paragraph 19 above.

number of Anderson's common shares designated by the Board of Directors at the exercise price specified in the option grant;

ii. fix the exercise price, which had to be equal to the closing price of the common shares on the TSE on the date of grant;

iii. designate the period during which those options could be exercised, with the caveat that such period would not exceed ten years from the date of option grant; and

iv. specify the vesting limitations that were required to be satisfied before the options could be exercised;

b) options granted under the plan were not assignable;

c) on the termination of an Anderson Optionee's employment with Anderson, unexercised options were terminated;

d) in the event of a takeover of Anderson, any options that had not vested would immediately vest, giving the Anderson Optionees the right to exercise their options at that time; and

e) in connection with the exercise of options, the Anderson Optionees could, at the sole option of the Board of Directors, be entitled to obtain a loan from Anderson on terms prescribed in the Anderson SOP.

[23] Options granted under the Anderson SOP were governed by stock option agreements (the "Anderson SOAs") between Anderson and the Anderson Optionees. The Anderson SOAs provided:

a) for a five-year expiry date of the particular option from the date of the grant of the option;

b) for a vesting limitation that had to be satisfied before the options could be exercised to acquire shares of Anderson; and

c) for the options to vest in three equal parts (that is, one-third of the grant) on the first, second and third anniversaries of the date of grant.

Upon satisfaction of those limitations, an Anderson Optionee could exercise a vested option by paying to Anderson the exercise price specified in the applicable Anderson SOA.

[24] Neither the Anderson SOP nor the relevant options granted pursuant to the Anderson SOAs gave the Anderson Optionees the right to unilaterally surrender their options in return for cash payments. However, the Board of Directors of Anderson had the discretion to permit vested unexercised options to be surrendered to Anderson for cash equal to the amount by which the fair market value of the shares at the time of their surrender exceeded the exercise price.[8] Before the Anderson Acquisition, the Board of Directors of Anderson had not previously exercised the discretion to permit the Anderson Optionees to surrender their unexercised options to Anderson for cash.

[25] The Anderson SOP was administered by the Board of Directors of Anderson, which had full and final discretion to interpret the provisions of the Anderson SOP and to prescribe, amend, rescind and waive rules and regulations to govern the administration and operation of the plan.

C. Numac Acquisition

(1) Anderson Acquires Numac

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[8] As best I can tell from my review of the Anderson SOP (as set out in Exhibit AR-2, Tab 19) and a specimen Anderson SOA (as set out in Exhibit AR-2, Tab 16), the only provision that could provide the Board of Directors of Anderson with the discretion to permit vested unexercised options to be surrendered to Anderson for cash was paragraph 18(a) of the Anderson SOP, which permitted an option to be granted after February 10, 1999 with an attached share appreciation right. See Exhibit AR-2, Tab 19, p. 384, ¶18(a). This view was confirmed by an answer given during the examination for discovery of Keith Raskob-Smith, who was Devon's senior adviser for tax, and who stated that "a share appreciation right was a separate right attached to the option which would allow the holder of the option to surrender the option in exchange for cash"; Notice of Intent to Read-In Evidence from the Examination for Discovery of Keith Raskob-Smith, Exhibit R-1, Tab 39, page 83 of the exhibit (page 133 of the transcript), lines 20-23. Assuming that counsel for the Crown quoted correctly, the 2000 annual report of Anderson apparently stated, "Share appreciation rights give the holder of the options the right to surrender his or her options for cancellation and receive a cash payment from the Company equal to the excess of the then current market price of the common shares over the exercise price of the options"; *ibid.*, Tab 40, page 85 of the exhibit (page 135 of the transcript), lines 12-17.

[26] On or about January 17, 2001, Anderson and Numac entered into a Pre-Acquisition Agreement, pursuant to which:

a) Anderson expressed its intention to acquire all of Numac's outstanding common shares, including any Numac shares that could become outstanding pursuant to the exercise of outstanding options under the Numac SOP, in consideration for a cash payment of $8.00 for each Numac share;

b) Numac represented that all option entitlements held by the Numac Optionees under the Numac SOP would accelerate and vest as a result of Anderson making the offer to acquire all of Numac's outstanding shares, and that it would give immediate notice of the offer to all Numac Optionees;

c) the parties agreed that all options granted under the Numac SOP that were tendered to Numac for exercise, conditional on Anderson's takeover of Numac, would be deemed to have been exercised concurrently with the take-up of Numac shares by Anderson;

d) the parties agreed that, to the extent that the Numac Optionees did not exercise their options and tender the shares acquired to the Anderson offer, Numac was permitted to agree with the Numac Optionees that, in lieu of such persons exercising their options, Numac would pay to such Numac Optionees the difference between the purchase price for the Numac shares under the offer and the exercise price of their options, in exchange for the termination of their options;

e) Numac represented that all persons holding options were entitled to exercise their options and tender their Numac shares under Anderson's offer, and that Numac's Board of Directors would not, before the completion of the offer, grant additional options pursuant to the Numac SOP; and

f) Numac agreed to use commercially reasonable efforts to encourage and facilitate the Numac Optionees to either exercise their options and deposit all of the Numac shares issued in connection therewith under the offer, or to surrender all of their Numac options for cancellation.

[27] The closing price of the Numac common shares on the TSE on January 17, 2001 was $6.40 per share.

[28] By news release dated January 19, 2001, Anderson announced that it was mailing to Numac's shareholders its formal offer to purchase all of the issued and outstanding common shares of Numac for cash consideration of $8.00 per share.

[29] On January 19, 2001, Anderson Acquisition Corp ("Anderson Acquireco"), an indirect wholly-owned subsidiary of Anderson, on behalf of Anderson, offered to purchase all of the Numac common shares at a price of $8.00 in cash for each share. On January 23, 2001, Numac's Board of Directors issued to Numac shareholders a Directors' Circular pursuant to which the Board recommended acceptance of Anderson Acquireco's offer.

[30] By letter dated January 25, 2001, Numac advised the Numac Optionees that:

a) Anderson Acquireco's offer to purchase all of the outstanding Numac common shares had triggered the acceleration of the unvested options;

b) they could elect to receive a cash payment from Numac for the value of their options, determined as the difference between $8.00 per share and the applicable exercise price (less applicable withholding tax) (the "Numac Cash Election"), or they could exercise their options by paying the applicable exercise price and acquiring the shares, and then tender the shares to the offer (the "Numac Exercise Election"); and

c) if a Numac Optionee failed to act on either alternative, that Numac Optionee would be deemed to have made the Numac Cash Election.

[31] In the letter dated January 25, 2001, the Numac Optionees were also advised that:

a) in order to facilitate the realization by the Numac Optionees of the value of their options, Numac agreed to purchase the options of the Numac Optionees who chose the Numac Cash Election;

b) a Numac Cash Election would become effective only if and when Anderson Acquireco took up the common shares of Numac under its offer and, if it did not take up and pay for the Numac common shares, Numac's offer to purchase their options would be withdrawn,

the Numac Optionees would not receive any payment for their options, and the options that had accelerated would revert to their previous vesting arrangements in accordance with the terms of the Numac SOP; and

c) the Numac Exercise Election would be effective only if Numac was satisfied that Anderson Acquireco's offer would be completed and Numac deposited a letter of transmittal provided by the Numac Optionees together with their Numac Exercise Elections, whereupon the Numac Optionees would receive payment for their common shares of Numac by cheque at the price of $8.00 per share, and if Anderson Acquireco did not take up and pay for the Numac common shares under its offer, the options that had been accelerated would revert to their previous vesting arrangements in accordance with the terms of the Numac SOP, and the certified cheques, bank drafts or money orders delivered in satisfaction of the exercise price would be returned to them.

[32] Upon the closing of the Numac Acquisition on February 12, 2001, Numac shareholders tendered, and Anderson Acquireco acquired, 95,250,604, or approximately 98%, of the then outstanding Numac common shares, and the remaining 1,415,008 common shares that were not tendered were acquired through the compulsory share acquisition provisions in the Alberta *Business Corporations Act* (the "*ABCA*").[9]

[33] As a result of the acquisition of control of Numac by Anderson Acquireco on February 12, 2001, Numac's taxation year (the "Numac Taxation Year") that would otherwise have included that date was deemed to end on February 11, 2001.

(2) Numac Surrender Payments

[34] During the Numac Taxation Year, options to acquire 7,228,829 Numac common shares were surrendered by the Numac Optionees who had made the Numac Cash Election. After the Numac Acquisition, Numac made cash payments (defined above as the "Numac Surrender Payments") in the aggregate amount of $20,844,041 to the Numac Optionees who had made the Numac Cash Election.

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9 *Business Corporations Act*, RSA 2000, c. B-9, as amended.

[35] The Numac Surrender Payments made to the respective Numac Optionees were reported by Numac (or its successor) on the T4 slips issued to those optionees and were included in computing their employment income for the purposes of the *ITA*.

D. Other Facts Relevant to Numac

[36] On April 1, 2001, Anderson Acquireco amalgamated with Numac to form Numac Energy Inc. ("Numac Amalco").

[37] On September 1, 2003, Numac Amalco amalgamated with Devon Amalco[10] to form Devon Canada Corporation (defined above as "Devon"), the Appellant in these Appeals.

[38] In computing Numac's income under the *ITA* for the Numac Taxation Year, Numac Amalco (as successor to Numac) deducted the Numac Surrender Payments, relying on subsection 9(1) of the *ITA*. By means of the Reassessment, notice of which was dated September 3, 2008, the Minister reassessed Devon (as successor to Numac), to disallow the deduction of the Numac Surrender Payments. Devon (as successor to Numac) objected to the Reassessment by means of a Notice of Objection filed on November 27, 2008. The Minister confirmed the Reassessment by means of a Notice of Confirmation dated March 14, 2013.

[39] In its Notice of Appeal, Devon (as successor to Numac) claimed, in the alternative, that the Numac Surrender Payments were deductible as eligible capital expenditures at the time of the acquisition of control pursuant to subsection 111(5.2) and paragraph 20(1)(*b*) of the *ITA*, or as expenses under paragraph 20(1)(*e*) of the *ITA*.

E. Anderson Acquisition

(1) Devon Acquires Anderson

[40] On August 31, 2001, DEC, which was a US public company, and Anderson entered into a Pre-Acquisition Agreement, pursuant to which:

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[10] As explained in paragraph 49 below, the term "Devon Amalco" refers to the amalgamated corporation formed on October 18, 2001 by the amalgamation of DAC (as defined in paragraph 42) and Anderson. Also as noted below, on October 25, 2001 Devon Amalco changed its name to Devon Canada Corporation.

a) DEC expressed its intention to acquire, either itself or through a subsidiary corporation, all of Anderson's outstanding common shares, including any Anderson shares that could become outstanding pursuant to the exercise of outstanding options under the Anderson SOP, in consideration for a cash payment of $40.00 for each Anderson share;

b) Anderson represented that all option entitlements held by Anderson Optionees under the Anderson SOP would accelerate and vest as a result of DEC making the offer to acquire all of Anderson's outstanding shares, and that it would give immediate notice of the offer to all Anderson Optionees;

c) the parties agreed that all options granted under the Anderson SOP that were tendered to Anderson for exercise, conditional on DEC's takeover of Anderson, would be deemed to have been exercised concurrently with the take-up of Anderson shares by DEC;

d) the parties agreed that, to the extent that any Anderson Optionees did not exercise their options under DEC's offer, Anderson was permitted to agree with those Anderson Optionees that, in lieu of those Anderson Optionees exercising their options, Anderson would pay to those Anderson Optionees the difference between the purchase price for the Anderson shares under the offer and the exercise price of their options, in exchange for the termination of their options; and

e) Anderson represented, among other things, that all persons holding options were entitled to exercise their options and tender their Anderson shares under DEC's offer, and that Anderson's Board of Directors would not, prior to the completion of the offer, grant additional options pursuant to the Anderson SOP.

[41] The closing price of the Anderson common shares on the TSE on August 31, 2001 was $26.40 per share.

[42] On September 6, 2001, Devon Acquisition Corporation ("DAC"), a wholly-owned Canadian subsidiary of DEC, offered to purchase all of the Anderson common shares at a price of $40.00 in cash for each share. On September 6, 2001, Anderson's Board of Directors issued to Anderson's shareholders a Directors' Circular pursuant to which the Board recommended acceptance of DAC's offer.

[43] By memorandum dated September 25, 2001, Anderson advised the Anderson Optionees that:

a) the Anderson SOP provided for the acceleration of unvested options in order to provide the Anderson Optionees with the opportunity to tender to DAC's offer the Anderson shares issuable on the exercise of unvested options;

b) Anderson's Board of Directors had exercised its discretion under the Anderson SOP to permit the Anderson Optionees to elect either to receive a cheque for their options or to follow the traditional method requiring the optionees to exercise their options and to forward payments for the shares to Anderson by a certified cheque or bank draft;

c) the Anderson Optionees were required to complete an election form and to return it to a specified employee of Anderson;

d) if the Anderson Optionees desired to participate in the offer, they had two alternatives (both of which required the completion of the election form) for dealing with their vested and unvested options:

i. they could make an election (the "Anderson Cash Election") to surrender their options to Anderson in consideration for a cash payment equal to the value of their surrendered options, which was equal to $40 a share less the particular option exercise price, or

ii. they could make an election (the "Anderson Exercise Election") to exercise their options and tender the shares to DAC's offer.

[44] In the memorandum dated September 25, 2001, the Anderson Optionees were also advised that, if DAC did not take up and pay for the Anderson common shares under its offer:

a) the Anderson Cash Election would not take effect, Anderson's offer to purchase their options would be withdrawn, they would not receive any payment for their options, their options would continue to exist and would be subject to the terms of the Anderson SOP, and the

options that were accelerated would revert to their previous vesting arrangements; and

b) the Anderson Exercise Election would not take effect, the exercise of their options would be deemed not to have occurred, the certified cheques or bank drafts delivered by the Anderson Optionees to Anderson in payment of the exercise price would be returned to them, and the options that were accelerated would revert to their previous vesting arrangements.

[45] On the closing of the Anderson Acquisition on October 15, 2001, Anderson shareholders tendered, and DAC acquired, approximately 97% of the then outstanding Anderson common shares,[11] and the remaining 3% of the shares that were not tendered were acquired through the compulsory share acquisition provisions of the *Canada Business Corporations Act*.[12]

[46] As a result of the acquisition of control of Anderson by DAC, on October 15, 2001, Anderson's taxation year (the "Anderson Taxation Year") that otherwise would have included that date was deemed to end on October 14, 2001.

(2) Anderson Surrender Payments

[47] During the Anderson Taxation Year, options to acquire 3,291,445 Anderson common shares were surrendered by the Anderson Optionees who had made the Anderson Cash Election. After the Anderson Acquisition, Anderson made cash payments (defined above as the "Anderson Surrender Payments") in the aggregate amount of $59,842,894 to the Anderson Optionees who had made the Anderson Cash Election. By reason of an acquisition-of-control condition that was triggered in respect of the operating line of credit that Anderson had with a major financial institution, Anderson was no longer able to access that line of credit. As a result, DAC lent Anderson sufficient funds to take care of its immediate cash needs, including the cash Anderson needed to make the Anderson Surrender Payments.

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[11] Although paragraph 61 of the SAFP states that, on the closing, DAC acquired approximately 98% of the outstanding Anderson common shares, a document described as an undated "Overview of the former Anderson Corporate group and the new Devon Canada Corporate Structure" (Exhibit AR-2, Tab 26, p. 531), which was part of an Annual Information Form, states that, on October 15, 2001, DAC acquired 97% of the outstanding Anderson common shares.

[12] *Canada Business Corporations Act*, RSC 1985, c. C-44, as amended.

[48] The Anderson Surrender Payments made to the respective Anderson Optionees were reported by Anderson (or its successor) on the T4 slips issued to those optionees and were included in computing their employment income for the purposes of the *ITA*.

F. Other Facts Relevant to Anderson

[49] DAC and Anderson amalgamated on October 18, 2001 to form Devon Acquisition Corporation ("Devon Amalco"). On October 25, 2001, Devon Amalco continued under the *ABCA*[13] and changed its name to "Devon Canada Corporation."[14]

[50] As indicated above, on September 1, 2003, Devon Amalco and Numac Amalco amalgamated to form Devon Canada Corporation (defined above as "Devon"), the Appellant in these Appeals.[15]

[51] In computing Anderson's income under the *ITA* for the Anderson Taxation Year, Devon Amalco (as successor to Anderson), deducted the Anderson Surrender Payments, relying on subsection 9(1) of the *ITA*. On July 31, 2018, the Minister issued the Determination to Devon (as successor to Anderson) for the Anderson Taxation Year, to disallow the deduction of the Anderson Surrender Payments. Devon (as successor to Anderson) objected to the Determination by means of a Notice of Objection filed on October 28, 2008. The Minister confirmed the Determination by means of a Notice of Confirmation dated February 4, 2013.

[52] In its Notice of Appeal, Devon (as successor to Anderson) claimed, in the alternative, that the Anderson Surrender Payments were deductible as eligible capital expenditures at the time of the acquisition of control pursuant to subsection 111(5.2) and paragraph 20(1)(*b*) of the *ITA*, or as expenses under paragraph 20(1)(*e*) of the *ITA*.

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13 Exhibit AR-2, Tab 26, p. 531; Exhibit R-1, Tab 55.

14 Notwithstanding the change of name that occurred on October 25, 2001, I will continue to refer to the corporation formed by the amalgamation on October 18, 2001 as "Devon Amalco."

15 In certain portions of these Reasons, where the precise corporate identity of a particular member of the Devon corporate group is not critical, I will use the term "Devon" to refer to Devon, DAC or Devon Amalco, as the context may require.

IV. SUMMARY OF ORAL EVIDENCE

A. Fact Witnesses

(1) Brent Snyder

[53] Counsel for Devon called Brent Snyder and Michael Perlette as fact witnesses.

[54] Mr. Snyder is a professional geologist, who has worked in the oil and gas industry since 1983. After working as a geophysical technician for the first year and a half of his career, he took a position as a geologist with Texaco Canada Ltd. ("Texaco") where he worked from 1984 to 1989. After Imperial Oil Limited ("Imperial") acquired Texaco in 1989, Mr. Snyder worked as an exploration geologist for Esso Resources ("Esso") for approximately two years.[16]

[55] Mr. Snyder testified that there were certain advantages to working for a larger oil company, such as Texaco or Esso. In particular, they offered competitive salaries and usually had attractive benefit packages, including a defined benefit pension plan. As well, the larger oil companies generally provided better training. However, in the 1990s it was generally acknowledged that greater rewards could be found by working for one of the junior oil and gas companies, which tended to be nimble and entrepreneurial and had more attractive compensation packages, which included not only a competitive salary but also bonuses and stock options, which were significant motivators. It was Mr. Snyder's experience that, where any of his employers had a stock option plan, the employer posted its daily stock price on the computer screen of each employee in order to enhance the motivation. Mr. Snyder indicated that it was common in the 1990s for geoscientists to begin their careers with a large company and then move to a junior oil and gas company. In keeping with this trend, Mr. Snyder left Esso in 1991 and took a position with Murphy Oil Canada ("Murphy").

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[16] The names of Mr. Snyder's employers and the particulars of the transaction between Imperial Oil Limited and Texaco Canada Ltd. are taken from his resumé, which was entered as Exhibit A-1, and from his oral testimony. That resumé does not provide complete corporate names (i.e., the legal elements, such as "Ltd." or "Inc.," are not used in the resumé). Similarly, the legal elements of corporate names were not used in the oral testimony. The brief description of the Imperial–Texaco transaction set out above was based on the oral testimony and may not be precisely correct. Nothing in these Reasons or the decision in these Appeals turns on the precise names of Mr. Snyder's employers or the specific details of the Imperial–Texaco transaction.

[56] In the 1990s, Mr. Snyder worked for several independent oil and gas companies, specifically Murphy, Richland Petroleum (“Richland”) and Ulster Petroleum (“Ulster”). He stated that he was granted stock options at Richland and Ulster. Nothing was said one way or the other in respect of Murphy.

[57] In May 2000, Anderson acquired Ulster, whereupon Mr. Snyder became an employee of Anderson. His compensation package at Anderson included a salary, bonuses and stock options.

[58] Mr. Snyder stated that corporate acquisitions were not uncommon in the oil and gas industry in Alberta in the 1990s and early 2000s. In some acquisitions there was concern on the part of employees, particularly those employed by the target corporation, that they might lose their jobs as a result of the acquisition. That concern was less prevalent among the professionals, including geologists and other geoscientists, as they knew that their professional knowledge and credentials would be needed even after the acquisition.

[59] Mr. Snyder indicated that, in most of the corporate takeovers, the acquiror usually paid a premium above the market price to acquire the shares of the target. This was attractive for employees of the target who held options, as the higher price was reflected in the amounts paid to buy out the stock options. When Anderson purchased Ulster in 2000, Mr. Snyder realized a modest gain, as his Ulster stock options were cashed out.

[60] Several themes were prominent in the testimony given by Mr. Snyder:

a) Stock options were a very common feature of the compensation packages offered by the junior oil and gas companies in Alberta in the 1990s.

b) Stock options were used by junior oil and gas companies to attract talent.

c) Corporate acquisitions or takeovers were not uncommon in the oil and gas industry in Alberta in the 1990s and early 2000s.

d) A corporate takeover typically resulted in the stock options of the target corporation being subject to accelerated vesting, and optionees possibly being offered cash payments for the surrender of their options.

[61] When the acquisition of Anderson by DEC was formally announced, there was “a bit of concern” among the employees of Anderson as to what would

become of them, "[b]ut it was different this time."[17] The reason for the difference was that, when DAC (DEC's acquiring subsidiary) acquired Anderson in October 2001, DEC's Canadian operating subsidiary, known as Northstar Energy Corp. ("Northstar"), had approximately 200 to 250 employees, while Anderson had approximately 700 to 800 employees. The employees of Anderson anticipated that DEC would need to retain them in order to manage and operate the assets of Anderson.

[62] However, DEC, which was based in Oklahoma City, was not then well known in Calgary. Therefore, some of the employees of Anderson were not certain that they wanted to remain with Anderson after the acquisition. At that time, many of the oil and gas companies in Calgary were competing for employees, so the employees of Anderson were confident that they could readily find employment elsewhere if they decided not to stay with Anderson.[18]

[63] To address the concern that employees of Anderson might decide to go elsewhere, Larry Nichols, the president and chief executive officer of DEC, the parent of DAC, came to Calgary to meet with all of Anderson's employees. He told them that they (as well as Anderson's assets) were one of the reasons for which DAC had bought Anderson. In addition, he assured them that DEC would let the former employees of Anderson "continue to run the show" in Canada.[19]

[64] When Anderson acquired Ulster in May 2000 and Mr. Snyder became an employee of Anderson, he was granted 24,000 Anderson stock options. A year later, in May 2001, one-third of those options vested. Mr. Snyder exercised the vested options, acquired 8,000 shares of Anderson and sold those into the market. At approximately the same time, he was granted an additional 24,000 options by Anderson.

[65] When Devon made its takeover bid for Anderson in October 2001, Mr. Snyder could have exercised his 40,000 options and then sold the shares into the offer. However, exercising his options would have required a cash outlay in excess of $1,000,000. Therefore, it was much more attractive for him to accept the cash surrender alternative made available by Anderson.[20]

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17 *Transcript*, May 1, 2017, p. 76, lines 21-23.
18 *Ibid.*, p. 76, line 18 to p. 77, line 17.
19 *Ibid.*, p. 77, line 18 to p. 78, line 3.
20 *Ibid.*, p. 78, line 4 to p. 80, line 13.

(2) Michael D. Perlette

[66] At the time of the hearing, Michael Perlette, a petroleum engineer, had worked in the oil and gas industry for approximately 33 years. When he testified, he was the manager of business development and corporate planning for Devon, a position that he had held since 2012.

[67] After obtaining a bachelor of science degree in petroleum engineering, Mr. Perlette was employed as an engineer by Amoco Canada ("Amoco"),[21] which was a large integrated oil and gas company. In January 1998, he moved to Canadian 88 Energy ("Canadian 88"), a junior oil and gas producer. By moving from Amoco to Canadian 88, Mr. Perlette avoided the possibility of receiving an international assignment, and, instead, was able to remain in Alberta. He had less security and more risk at Canadian 88, but he also had higher compensation, particularly as he was able to participate in Canadian 88's stock option plan. He regularly received and exercised stock options, which permitted him to do well financially. In 2000, Mr. Perlette left Canadian 88 and moved to Northstar, which, by then, had been acquired by DEC.[22] At Northstar he worked on acquisitions and divestitures. He was compensated by salary, a savings plan, a bonus and participation in Devon's stock option plan. As DEC's stock prices were steadily increasing throughout the early 2000s, Mr. Perlette benefitted from his participation in the stock option plan.

[68] As Mr. Perlette worked in Devon's acquisitions and divestitures group, he participated in the process of evaluating Anderson when Devon was contemplating whether to make a takeover bid. Mr. Perlette stated that in mid-2001 there was a decline in the price of natural gas, which led to a decline in the trading price of the shares of Anderson. The acquisition team at Devon recognized the value of Anderson's position in the Western Canadian Sedimentary Basin, particularly its natural gas reserves and undeveloped properties. Devon perceived that there was an opportunity to make a takeover bid for Anderson, as Devon realized that the

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[21] The names of Mr. Perlette's employers are taken from his resumé, which was entered as Exhibit A-2, and from his oral testimony. That resumé does not provide complete corporate names (i.e., the legal elements, such as "Ltd." or "Inc.," are not used in the resumé).

[22] While testifying, Mr. Perlette used the term "Devon" to refer to the current Devon Canada Corporation (i.e., the Appellant) and to its various predecessor corporations, including the corporation that had acquired Northstar in 1998. As Mr. Perlette used the term "Devon" indiscriminately in his testimony, I will generally do so also in summarizing that testimony.

value of Anderson was greater than that attributed to it by the marketplace. Devon was also interested in the assets in northeast British Columbia which were owned by Numac, which had recently been acquired by Anderson. Ultimately, those assets were retained, operated and worked first by Anderson and then by Devon.

[69] In addition, Devon also recognized the value attributable to Anderson's employees, who had a good reputation and who were very nimble. Northstar had direct experience working with Anderson on joint properties, primarily in the foothills, where the Northstar employees and their Anderson counterparts were working well together. Devon/Northstar saw Anderson "as a company with quality people running a quality business."[23] When Devon decided to acquire Anderson, the former wanted not only the hard assets of the latter, but it also "wanted what the company was, and that was the people, the management, the ability to run as a company."[24]

[70] Mr. Perlette suggested that sometimes markets tend to overreact, which may create an opportunity to acquire a quality viable business at a time when the market might feel otherwise.[25] More specifically, at a time when the Anderson shares were trading at approximately $26 per share, Devon formed the view that the shares were actually worth $40 per share, which was the price offered in its takeover bid.

[71] Mr. Perlette stated that the Anderson Optionees whose options were in the money were cashed out. The Anderson executives who were retained by Devon were granted Devon stock options.

B. Expert Witness

[72] Scott Munn testified as an expert witness. Mr. Munn has more than 20 years of experience as an executive compensation consultant. Mr. Munn obtained a Bachelor of Arts degree in economics from the University of Western Ontario in 1990,[26] a Master of Business Administration degree from the Schulich School of Business at York University in 1996, and a Chartered Financial Analyst designation in 2001. He worked at Mercer (Canada) Ltd. from 1996 to 2008. Since 2008 he has been a partner at Hugessen Consulting.

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[23] *Transcript*, May 2, 2017, p. 23, lines 22-23.

[24] *Ibid.*, p. 29, line 28 to p. 30, line 2.

[25] *Ibid.*, p. 46, lines 1-4.

[26] Since 2012, the University of Western Ontario has also been known as "Western University."

[73] Counsel for the Crown acknowledged that Mr. Munn was qualified to provide an expert opinion for the purposes set out in his report.

[74] There was no dispute, and I find, that Mr. Munn was qualified to provide an expert opinion concerning executive and non-executive compensation and compensation practices among companies in the Canadian oil and gas sector. In particular, he was asked to provide his opinion on typical compensation practices among small and medium-sized upstream oil and gas companies in the period from the 1990s to 2001.

[75] Mr. Munn's opinion is summarized and paraphrased as follows:[27]

a) In Mr. Munn's opinion, typical compensation practices in the oil and gas industry during the relevant time period of the early 1990s to the mid-2000s included the following:

   i. Grants under long-term incentive programs ("LTIP"), particularly in the form of stock options, were an essential part of attracting the key talent required to maintain high-performing operations, especially for small/mid-cap exploration and production companies.

   ii. Stock options were part of the regular, ongoing costs incurred in the normal course of business to compensate employees for their service.

   iii. On the date of a grant, stock options were given to employees to complement cash compensation and other entitlements (e.g., pension, saving plans, etc.) and were in respect of then current service.[28]

   iv. At the time of a change of control, the "in the money" value of a stock option was a contractual right of the employee in respect of past service, and any payment received to compensate for the "in the money" value of the option was in respect of that past service.[29]

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27 Exhibit A-3, vol. I, p. 6, ¶2.5.1.

28 See also Exhibit A-3, vol. I, p. 12, ¶3.6.1; and *Transcript*, May 2, 2017, p. 88, lines 2-20.

29 See also Exhibit A-3, vol. I, p. 14, ¶3.8.6; and *Transcript*, May 2, 2017, p. 94, lines 7-23. It seems to me that the word "for" on the third line of paragraph 3.8.6 on page 14 of volume I of Exhibit A-3 was intended to be "from"; see *Transcript*, May 2, 2017, p. 94, line 22.

b) Based on Mr. Munn's review of the agreements, resolutions, correspondence and other documents provided to him in respect of the Numac and Anderson SOPs, it is his opinion that each of the above factors applied to:

   i. the stock options granted by Numac to its employees and surrendered to Numac in connection with the acquisition by Anderson; and

   ii. the stock options granted by Anderson to its employees and surrendered to Anderson in connection with the acquisition by DAC.[30]

[76] One of the documents reviewed by Mr. Munn was a copy of the minutes of a meeting of the Board of Directors of Numac held on September 17, 1993. Although the meeting predated the taxation years in issue, the minutes of the meeting illustrate the competitive nature of the employment market in the oil and gas industry in Alberta in the 1990s. The following is an excerpt from those minutes in respect of Numac's "inaugural share option proposal"[31]:

> Mr. McKeough [a director of Numac and chairman of the Compensation Committee] advised that the Compensation Committee had a considerable amount of discussion and debate on the issue of share options and indicated that their preferred course of action would be for a full compensation program to be in place with all relevant information available before options would be granted. Mr. McKeough and the Compensation Committee recognized the need, however, to move ahead with the options, given that the market was very competitive and given that staff attrition rates within the Corporation had increased significantly over the last year.[32]

[77] In the "Analysis" portion of his report and in his testimony, Mr. Munn made a few additional points, some of which are summarized and paraphrased below:

a) From the early 1990s to the early 2000s, stock options were the dominant and most prevalent form of long-term incentive in the Canadian oil and gas sector, particularly among small and mid-cap publicly traded companies.[33]

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30 Exhibit A-3, vol. I, p. 6; ¶2.5.2. See also *Transcript*, May 2, 2017, p. 95, line 18 to p. 96, line 28.

31 Exhibit AR-2, Tab 1, p. 5.; and Exhibit A-3, vol. II, Tab 2, p. 5 (the same document is reproduced in both exhibits).

32 *Ibid.*, p. 6.

33 Exhibit A-3, vol. I, p. 7, ¶3.1.1; and *Transcript*, May 2, 2017, p. 69, line 25 to p. 70, line 4.

b) During the same period, granting long-term incentives in the form of stock options (rather than a mix of incentives) and accelerating the vesting of all the options when an employer/issuer experienced a change of control were mainstream compensation practices and were part of the competitive pay environment.[34]

c) From 1994 to 2001 in Alberta, particularly Calgary, the unemployment rate fell, making it difficult for employers in the oil and gas sector to attract and retain employees, which led to aggressive compensation programs, particularly the use of stock option plans with a vesting schedule.[35]

[78] During cross-examination, Mr. Munn and counsel for the Crown engaged in an exchange concerning the value of a stock option on the date of grant, in the context of Mr. Munn's opinion, as summarized in clause 75(a)iii above, to the effect that, on the date of a grant, stock options were given to employees to complement cash compensation and other entitlements and were in respect of current service.[36] Counsel for the Crown suggested that, if the market value of an optioned share were to drop below the option's exercise price, the option would not have any value.[37] Mr. Munn acknowledged that, when a stock option is granted, if the exercise price is equal to the then market value (i.e., if the option is issued "at the money"), there is no imbedded value at that point in time. However, he said, in receiving the option, there is a significant opportunity, which is valuable. Even though it is very difficult to put a value on the opportunity, it is worth something and employees are willing to accept that as a form of compensation, even though there is a risk that the market value of the optioned share may decrease.[38] Mr. Munn suggested that the concept might be described as contingent value.[39]

[79] At the hearing, the Crown did not call any fact witnesses or expert witnesses. The Crown read into evidence numerous answers given by an officer of, or counsel for, Devon during the examination for discovery.

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34 Exhibit A-3, vol. I, p. 7, ¶3.1.2; and *Transcript*, May 2, 2017, p. 70, lines 5-9; and p. 71, line 16 to p. 72, line 2.

35 Exhibit A-3, vol. I, p. 10, ¶3.4; and *Transcript*, May 2, 2017, p. 81, line 2 to p. 83, line 24.

36 *Transcript*, May 2, 2017, p. 107, line 19 to p. 114, line 10.

37 *Ibid.*, p. 107, line 19 to p. 108, line 23.

38 *Ibid.*, p. 108, line 24 to p. 109, line 12; and p. 110, lines 10-19.

39 *Ibid.*, p. 113, line 10.

V. ANALYSIS

[80] It is the position of Devon that the Surrender Payments were eligible capital expenditures, as defined in subsection 14(5) of the *ITA*, and were deductible in part pursuant to paragraph 20(1)(*b*) and subsection 111(5.2) of the *ITA*, as those provisions read in 2001. Alternatively, Devon submitted that the Surrender Payments were deductible under paragraph 20(1)(*e*) of the *ITA*.

A. Eligible Capital Expenditure

[81] To assist in resolving the issues pertaining to Devon's submission that the Surrender Payments were eligible capital expenditures, it is helpful to consider the historical context for the introduction in 1972 of the provisions that became section 14 of the *ITA*. The editors of the *Canada Tax Service* describe this context as follows:

> Under the pre-1972 Act there were a number of types of expenditures for which no deduction was available notwithstanding that they had been incurred for the purpose of earning income from a business. The expenditures were capital in nature, having been made to produce an advantage to the business of enduring benefit, and thus were not deductible as an item of expense in the year incurred. Yet, the taxpayer was not allowed to deduct the cost over a number of years by way of depreciation, because the expenditures were not made to acquire an asset described in the Income Tax Regulations in respect of which capital cost allowance was granted. Such expenditures (commonly referred to as "nothings") were often made to acquire assets of an intangible nature: eg, goodwill, customer lists, franchises for an unlimited period, etc. Other capital expenditures might not have related to any particular asset or perhaps were made in connection with an asset which the taxpayer did not own.
>
> For taxation years after 1971 and before 2017, former section 14 and paragraph 20(1)(b) together ensure that a portion of the cost of assets and expenditures within this category of "nothings" was recognized as a business expense deductible over a period of time.[40]

No longer relying on its original position that the Surrender Payments were deductible in their entirety, Devon now asserts that 75% of the Surrender Payments were deductible as eligible capital expenditures under paragraph 20(i)(*b*) and subsection 111(5.2) of the *ITA*. On the other hand, the effect of the Reassessment and the Determination issued by the CRA was, in a

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[40] Chris Falk *et al*. (editors), *Canada Tax Service* (Toronto: Thomson Reuters Canada Ltd., 2017), vol. 3, p.14-124 to 14-125 (dated 2017-03-24).

sense, to treat the Surrender Payments as "nothings" in respect of which no tax recognition was available.

[82] Given that section 14 of the *ITA* was repealed effective as of January 1, 2017, it is helpful to reproduce the definition of "eligible capital expenditure" in subsection 14(5) of the *ITA*, as it read in 2001:

> "eligible capital expenditure" of a taxpayer in respect of a business means the portion of any outlay or expense made or incurred by the taxpayer, as a result of a transaction occurring after 1971, on account of capital for the purpose of gaining or producing income from the business, other than any such outlay or expense
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> (*a*) in respect of which any amount is or would be, but for any provision of this Act limiting the quantum of any deduction, deductible (otherwise than under paragraph 20(1)(*b*)) in computing the taxpayer's income from the business, or in respect of which any amount is, by virtue of any provision of this Act other than paragraph 18(1)(*b*), not deductible in computing that income,
>
> (*b*) made or incurred for the purpose of gaining or producing income that is exempt income, or
>
> (*c*) that is the cost of, or any part of the cost of,
>
> (i) tangible property of the taxpayer,
>
> (ii) intangible property that is depreciable property of the taxpayer,
>
> (iii) property in respect of which any deduction (otherwise than under paragraph 20(1)(*b*)) is permitted in computing the taxpayer's income from the business or would be so permitted if the taxpayer's income from the business were sufficient for the purpose, or
>
> (iv) an interest in, or right to acquire, any property described in any of subparagraphs (i) to (iii),
>
> but, for greater certainty and without restricting the generality of the foregoing, does not include any portion of
>
> (*d*) any amount paid or payable to any creditor of the taxpayer as, on account or in lieu of payment of any debt or as or on account of the redemption, cancellation or purchase of any bond or debenture,

> (*e*) where the taxpayer is a corporation, any amount paid or payable to a person as a shareholder of the corporation, or
>
> (*f*) any amount that is the cost of, or any part of the cost of,
>
> (i) an interest in a trust,
>
> (ii) an interest in a partnership,
>
> (iii) a share, bond, debenture, mortgage, hypothecary claim, note, bill or other similar property, or
>
> (iv) an interest in, or right to acquire, any property described in any of subparagraphs (i) to (iii)[.]

The above definition sets out a number of criteria that must be satisfied for an outlay or expense to constitute an eligible capital expenditure. Those criteria will be discussed below.

(1) In Respect of a Business

[83] The opening words of the definition of "eligible capital expenditure" indicate that the particular outlay or expense must be in respect of a business.[41] An indirect link between the outlay or expense and the business is sufficient to satisfy this requirement.[42]

[84] After Numac was acquired by Anderson on February 12, 2001, Numac continued to carry on the business which it had been carrying on before the Numac Acquisition.[43] After the amalgamation of Numac and Anderson Acquireco on April 1, 2001, Numac Amalco continued to carry on the business previously carried on by Numac.[44] In carrying on that business, Numac and its successors continued to use most of the assets owned by Numac before the Numac Acquisition, and Numac

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41 See *Potash Corporation of Saskatchewan Inc. v The Queen*, 2011 TCC 213, ¶106 & 110.

42 *Ibid.*, ¶109-110 & 112. In *Nowegijick v The Queen*, [1983] 1 SCR 29, the Supreme Court of Canada stated that "The words "in respect of" are … words of the widest possible scope…. The phrase "in respect of" is probably the widest of any expression intended to convey some connection between two related subject matters."

43 See paragraph 10 above.

44 See paragraphs 10 and 36 above.

and its successors continued to employ most of the employees who had been employed by Numac before the Numac Acquisition.[45]

[85] After Anderson was acquired by DAC on October 15, 2001, Anderson continued to carry on the business which it had been carrying on before the Anderson Acquisition.[46] After Anderson and DAC amalgamated on October 18, 2001, Devon Amalco continued to carry on the business that had been carried on by Anderson before the Anderson Acquisition.[47] In carrying on that business, Anderson and its successors continued to use most of the assets which had been used by Anderson before the Anderson Acquisition and continued to employ most of the employees who had been employed by Anderson before the Anderson Acquisition.[48]

[86] The Surrender Payments were made to employees who had been granted their options while working in the businesses of their respective employers and who, for the most part, continued to work in those businesses after the respective acquisitions. Accordingly, I am of the view that the Surrender Payments were made by Numac and Anderson in respect of their businesses.

(2) On Account of Capital

[87] As indicated in the above statutory definition, to constitute an eligible capital expenditure, an outlay or expense must be made or incurred on account of capital.

[88] Devon initially took the position that the Surrender Payments were made on income account and were deductible pursuant to the ordinary rules applicable for the purpose of computing profit in accordance with section 9 of *ITA*. However, before the commencement of the hearing, and again in his opening statement, counsel for Devon advised the Court that, by reason of the decisions of the Federal Court of Appeal in *Kaiser Petroleum* and *Imperial Tobacco*, Devon was no longer pursuing that argument. Those two cases had held that similar cash payments made

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45 See paragraph 68 above and subparagraphs 98(e) and (f) below.
46 See paragraph 13 above.
47 See paragraphs 13 and 49 above.
48 See paragraphs 61, 63 and 68 above and subparagraphs 98(e) and (f) below.

as consideration for the surrender of the particular stock options in question were outlays of capital.[49]

[89] In a memorandum dated October 31, 2012 from "HQ – Appeals Branch" of CRA's Tax & Charities Appeals Directorate to the Chief of Appeals of the Calgary North Tax Services Office, it was stated that "both the taxpayer [i.e., Devon] and CRA agree that the cash payments were capital in nature."[50]

[90] In the Further Amended Replies filed by the Crown on April 24, 2017, at a time when Devon had not yet conceded that the Surrender Payments were not deductible under subsection 9(1) of the *ITA*, the Crown submitted "that if the cash surrender payments were made for the purpose of gaining or producing income from [Numac's or Anderson's, as the case may be] business, within the meaning of paragraph 18(1)(a) of the *Act*, they were payments or outlays on account of capital whose deduction was prohibited by paragraph 18(1)(b) of the *Act*, in that they were made for the purpose of the reorganization or reshaping of [Numac's or Anderson's, as the case may be] capital structure."[51] As well, in his opening statement, counsel for the Crown, in acknowledging Devon's concession concerning the subsection 9(1) issue, seemed to acknowledge that the Surrender Payments were on capital account.[52]

[91] Accordingly, for the purposes of these Appeals, I find that the Surrender Payments were outlays or expenses made or incurred by Numac and Anderson on account of capital.

(3) Purpose of Gaining or Producing Income

[92] Another criterion that must be met in order for an outlay or expense to constitute an eligible capital expenditure in respect of a business is that the outlay or expense must have been made or incurred by a taxpayer for the purpose of gaining or producing income from the business (which I will, for the sake of brevity, call the "income-gaining purpose"). The statutory definition of "eligible capital expenditure" does not require that the income-gaining purpose be the only

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49 *The Queen v Kaiser Petroleum Ltd.*, [1990] 2 CTC 439; 90 DTC 6603 (FCA), ¶22; and *Imperial Tobacco Canada Limited*, 2011 FCA 308, ¶31-32. See also *Canada Forgings Limited v The Queen*, [1983] CTC 94, 83 DTC 5110 (FCTD).

50 Exhibit AR-2, Tab 56, p. 867.

51 Further Amended Reply in the Numac Appeal, ¶14; and Further Amended Reply in the Anderson Appeal, ¶13.

52 *Transcript*, May 1, 2017, p. 28, lines 11-14; see also lines 23-28.

purpose, or even the primary purpose, of the outlay or expense. It will suffice if the income-gaining purpose is one of the purposes of the outlay or expense.

[93] Before reviewing the evidence concerning the purposes of the Surrender Payments, I will review a few legal principles that may be applicable here.

[94] In the *B.C. Electric Railway* case, Justice Abbott stated the following in the context of then paragraph 12(1)(*a*) [now 18(1)(*a*)] of the *ITA*:

> 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 Section 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.[53]

The significance of the above statement is that it confirms that a capital outlay may have an income-gaining purpose.

[95] The facts of the *Kaiser Petroleum* case bear some similarity to the facts of these Appeals. In that case, Ashland Oil Canada Ltd. ("Ashland"), shortly before being taken over by Kaiser Resources Ltd., made a sizable payment to various employees who held options entitling them to purchase shares of Ashland. The Federal Court of Appeal concluded that the payment made by Ashland to its employees for the surrender of their options was made on capital account, rather than income account. The question of whether the payment may have been an eligible capital expenditure was not before the Court. The Crown argued that Ashland's purpose in terminating the particular stock option agreement at the time of the takeover was not to compensate its employees, but rather was to restructure Ashland's capital. In determining that the payment made by Ashland to its employees was an outlay of capital, the Court made the following comments (among others):

> 19. … [Ashland], in buying out rights under the plan, parted with an asset (the purchase price) and effected a sterilization of future issues of shares. The

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[53] *British Columbia Electric Railway Company Limited v MNR*, [1958] SCR 133, [1958] CTC 21, 58 DTC 1022 (SCC), ¶36-37. See also *Shoppers Drug Mart Limited v The Queen*, 2007 TCC 636, ¶21, fn. 1.

> 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, … it does not follow that the payment, from the point of view of [Ashland], had the character of an operating expenditure. What is important is not the purpose pursued by [Ashland] but what it did and how it did it….
>
> 21. … 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 [Ashland'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 out in the *B.P. Australia Ltd.* case....[54]

While the Federal Court of Appeal in *Kaiser Petroleum* did not consider whether the particular payment was an eligible capital expenditure, the Court did indicate that, in applicable circumstances, a payment made by a corporation, in the context of a takeover, to eliminate stock options held by its employees, may have a compensation-related purpose, even though the payment also reshaped the capital structure of the corporation.

[96] There are also similarities between the facts of the *Imperial Tobacco* case and the facts of these Appeals. In that case, Imasco Limited ("Imasco") had previously issued stock options to its employees. Subsequently, and shortly after British American Tobacco p.l.c. ("BAT") had approached Imasco to discuss a proposed "going-private" transaction, Imasco's board of directors passed a resolution to amend Imasco's employees stock option plan so as to give option holders the right to surrender their options for a cash payment equal to the amount by which the fair market value of the particular optioned shares exceeded their exercise price. After the amendment was enacted, Imasco's board passed a resolution to accelerate the vesting of the options, and BAT and Imasco proceeded to implement the going-private transaction. Consequently, many of Imasco's employees surrendered their options for cash, and Imasco, in computing its income, deducted the aggregate of the cash surrender payments. The Crown took the position that paragraph 18(1)(*b*) of the *ITA* precluded the deduction of those payments, as they were made in the context of a reorganization of Imasco's capital. Imasco argued that the cash surrender payments were best characterized as

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54 *Kaiser Petroleum*, *supra* note 49, ¶19 & 21.

employee compensation, such that they should be deductible as ordinary business expenses for the purpose of computing profit, as required by section 9 of the *ITA*. The Federal Court of Appeal concluded that the cash surrender payments were outlays on account of capital, and thus were not deductible in computing profit for the purpose of section 9 of the *ITA*, notwithstanding that the stock option plan had been entered into to provide a form of employee compensation.[55] For the purpose of these Appeals, the following comment by the Federal Court of Appeal is relevant:

> It is reasonable to infer … that this amendment [to permit option holders to surrender their options for cash] was one of the steps taken by Imasco to facilitate the going private transaction. Imasco contended that the amendment was made to ensure that option holders were treated fairly if the going private transaction was completed. That is also consistent with the documentary evidence. I see no conflict between the objective of facilitating the going private transaction and the objective of treating option holders fairly.[56]

The above statement suggests to me that, even though the cash surrender payments in *Imperial Tobacco* facilitated the going-private transaction and were outlays on account of capital, they were also made for the purpose of treating option holders fairly, which was an employee-compensation-related purpose. This implies that the cash surrender payments in that case were made for the purpose of gaining or producing income, even though they were on account of capital and were made for the additional purpose of facilitating the going-private transaction.

[97] In *ONEnergy Inc.*, the corporate taxpayer had been carrying on a telecommunications business unsuccessfully. In the course of winding up its business, it sold its assets, providing an opportunity for its directors to cause the corporation to use some of the sale proceeds to make payments to themselves and to certain other executives, shareholders, employees and personal holding companies (collectively, the "Former Executives") to cancel options and share appreciation rights that they held and to pay bonuses to themselves. Subsequently, the shareholders of the corporation caused the corporation to sue the Former Executives to recover what the shareholders considered to be overpaid remuneration. In the subsequent tax litigation (which dealt with GST), the issue was whether the civil litigation costs incurred by the corporation in pursuing its claim against the Former Executives were incurred in the course of a commercial

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55 *Imperial Tobacco*, *supra* note 49, ¶29-32.

56 *Ibid.*, ¶9.

activity. In describing the litigation brought by the corporation against the Former Executives, the Federal Court of Appeal stated:

> The disputed amounts were paid to the Former Executives for their cancelled options and SARs and as a bonus. The options and SARs would have been part of the compensation or remuneration payable to the Former Executives and the bonus would also be remuneration paid to these persons. Although the legal basis for the claim against the Former Executives may be a breach of fiduciary duty, the result of that breach (if established) would be an overpayment of remuneration. Therefore, in my view, the litigation should be characterized as a claim for overpaid remuneration.[57]

The above statement indicates that the options were part of the compensation or remuneration package made available to the Former Executives, possibly implying that, if income tax were to have been in issue, one of the purposes of the payment for the cancellation of the options would have been to gain or produce income.

[98] Returning to the facts of these Appeals, the evidence of Mr. Snyder, Mr. Perlette and Mr. Munn established that:

a) The Numac SOP and the Anderson SOP were important features of the compensation packages offered by Numac and Anderson respectively.

b) The SOPs were used by Numac and Anderson to attract and retain talent.

c) When options were granted to employees of Numac and Anderson, the employees viewed the options as part of their compensation for their current service, notwithstanding that they had not yet exercised the options.

d) When Numac was taken over by Anderson, and when Anderson was taken over by Devon, the employees of Numac and Anderson respectively expected that there would be accelerated vesting in respect of their options and that the "in the money" value of those options would constitute compensation for their service for the period between the grants of the particular options and the respective takeovers.

e) The business carried on by Numac when it was taken over by Anderson, and the business carried on by Anderson by when it was taken over by Devon,

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[57] *ONEnergy Inc. v The Queen*, 2018 FCA 54, ¶17.

continued to be carried on by the respective amalgamated corporations resulting from those takeovers.

f) The assets owned by Numac when it was taken over by Anderson, and the assets owned by Anderson when it was taken over by Devon, continued to be owned and operated by the respective amalgamated corporations that resulted from the takeovers.

[99] Based on the legal principles established in *B.C. Electric*, *Kaiser Petroleum*, *Imperial Tobacco* and *ONEnergy*, as summarized in paragraphs 94 to 97 above, and having regard to the evidentiary findings summarized in the preceding paragraph, it is my view that the Surrender Payments were made or incurred by Numac and Anderson respectively in respect of their businesses for the purpose of gaining or producing income from those businesses. The Surrender Payments may have been made, as well, for other purposes, such as facilitating the takeovers or revising the capital structure of the corporations, but those other purposes do not negate that one of the purposes of the Surrender Payments was to gain or produce income from the respective businesses of Numac and Anderson.

(4) Exceptions

[100] As indicated in the statutory definition of "eligible capital expenditure" quoted in paragraph 82 above, that definition excepts an outlay or expense described in paragraph (a), (b) or (c) of the definition. None of those three exceptions is relevant to these Appeals.

(5) Exclusions

(a) Cost of Right to Acquire Certain Property

[101] After itemizing the three exceptions referenced above, the statutory definition of "eligible capital expenditure" goes on to state that, "for greater certainty and without restricting the generality of" the preceding portion of the definition, the term does not include any portion of any amount described in paragraph (d), (e) or (f) of the definition.[58] Paragraphs (d) and (e) are not applicable here. However, paragraph (f) might possibly be applicable. The relevant portion of the text of paragraph (f) reads as follows:

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[58] See *Rio Tinto Alcan Inc. v The Queen*, 2016 TCC 172, ¶206; *aff'd*, 2018 FCA 124.

> (f) any amount that is the cost of, or any part of the cost of, …
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> (iii) a share … or other similar property, or
>
> (iv) an interest in, or right to acquire, any property described in any of subparagraphs (i) to (iii)[.]

As a stock option is a right to acquire one or more shares, it is the position of the Crown that the Surrender Payments were the cost of rights to acquire shares.[59] Devon takes the position that Numac and Anderson did not acquire the options held by their respective employees, such that the Surrender Payments were not the cost of the options.[60]

(b) *Meaning of "Cost"*

[102] Although paragraph (f) of the definition of "eligible capital expenditure" excludes an amount that is the cost of a share or a right to acquire a share, the word "cost" is not defined in the *ITA*,[61] either for the purpose of the statute as a whole or for the purpose of former section 14 specifically.

(i) Text

[103] The key word in the text of paragraph (f) of the definition of "eligible capital expenditure" is "cost." Several cases have considered the meaning of the word "cost." In *Stirling*, the Federal Court of Appeal stated:

> As we understand it, the word "cost" in those sections means the price that the taxpayer gave up *in order to get the asset*; it does not include any expense that he may have incurred in order to put himself in a position to pay that price or to keep the property afterwards.[62] [*Emphasis added.*]

In commenting on the decision of the Federal Court of Appeal in *Stirling*, Justice McNair stated the following in *Bodrug Estate*:

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59 Respondent's Written Submissions ("Crown's Submissions"), filed September 22, 2017, p. 22-24; ¶64-70.

60 Memorandum of Fact and Law of Devon Canada Corporation ("Devon's Memorandum"), filed August 14, 2017, p. 38, ¶121.

61 Vern Krishna, *The Taxation of Capital Gains* (Toronto: Butterworths, 1983), p. 95; D. Keith McNair, *The Meaning of Cost in Canadian Income Tax* (Toronto: Canadian Tax Foundation, 1982), p. 1; and D.J. Sherbaniuk, "Foreword" to McNair, *op. cit.*, p. iii.

62 *The Queen v Stirling*, [1985] 1 CTC 275 at 276, 85 DTC 5199 at 5200 (FCA); leave to appeal to SCC dismissed, [1985] 1 SCR xiii.

> I have no problem with the submission of counsel for the plaintiffs that the cost of an asset is not restricted to the actual purchase price paid therefor. It seems clear that the cost of property may include brokerage fees, legal fees, commissions and other expenses *incurred in connection with the acquisition of the property*. In my view the decision in *Stirling* does not necessarily restrict such an extended definition of the term "cost". However, I am of the opinion that it is clear authority for the proposition that the cost of an asset for the purposes of capital gains computation is *limited to the costs of acquisition of that asset* or, as Pratte, J. put it, "the price that the taxpayer gave up *in order to get the asset.*"[63] [*Emphasis added.*]

In *Canada Trustco*, the Supreme Court of Canada stated:

> Textually, the CCA [i.e., capital cost allowance] provisions use "cost" in the well-established sense of the amount paid *to acquire the assets*. Contextually, other provisions of the Act support this interpretation. Finally, the purpose of the CCA provisions of the Act, as applied to sale-leaseback transactions, was, as found by the Tax Court judge, to permit deduction of CCA based on the cost of the *assets acquired*.[64] [*Emphasis added*.]

A close reading of the three excerpts quoted above makes it clear that, textually, the word "cost" contemplates an acquisition of an asset or other property.

[104] Before continuing the analysis of the meaning of "cost," I would like to make a few more comments about the *Bodrug Estate* case. In that case, Mr. Bodrug owned the control block of shares in the capital of Canadian Hidrogas Resources Ltd. ("Hidrogas"). When Hidrogas entered into an employment agreement with a Mr. Cohen, Mr. Bodrug granted to NIR Oil Ltd. ("NIR"), a corporation owned by Mr. Cohen, an option to purchase 340,000 of the Hidrogas shares owned by Mr. Bodrug at a price of $0.65 per share. Later, after the employment agreement had been terminated by Mr. Cohen and after NIR had exercised the option in part, so as to acquire 30,000 of the Hidrogas shares owned by Mr. Bodrug, Mr. Bodrug purported to cancel the option agreement in respect of the remaining 310,000 Hidrogas shares. NIR commenced legal proceedings against Mr. Bodrug, seeking specific performance of the option agreement. The parties settled that litigation on the basis that Mr. Bodrug would pay NIR the amount of $1,320,000 in consideration for NIR releasing and surrendering all its rights under the option agreement. As well, as part of the settlement, Mr. Cohen and NIR agreed to sell to Mr. Bodrug their previously acquired shares of Hidrogas for $7

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63 *E.W. Bodrug Estate v The Queen*, [1990] 2 CTC 324 at 332, 90 DTC 6521 at 6526, ¶11 (FCTD); *aff'd*, [1991] 2 CTC 347, 91 DTC 5621 (FCAD).

64 *The Queen v Canada Trustco Mortgage Company*, 2005 SCC 54, ¶74.

per share, the approximate price at which Hidrogas shares were then trading on the Toronto Stock Exchange. Unbeknown to NIR and Mr. Cohen, when they signed the settlement agreement, Mr. Bodrug was aware of an impending takeover bid with respect to the shares of Hidrogas, at a price of $15.50 per share. NIR and Mr. Cohen subsequently sued Mr. Bodrug again, and were ultimately awarded damages pursuant to the Alberta insider–trading legislation. Subsequently, in computing the capital gain that arose by reason of the deemed disposition of the Hidrogas shares at the time of Mr. Bodrug's death, his estate added the amount of the damages to the ACB to Mr. Bodrug of his Hidrogas shares. The only issue before the Federal Court – Trial Division and the Federal Court – Appeal Division was whether the amount of the damages formed part of the ACB to Mr. Bodrug of his Hidrogas shares at the time of his death. The case did not deal with the treatment of the $1,320,000 that had been paid by Mr. Bodrug to NIR pursuant to the settlement agreement. However, based on comments contained in the reasons given by the trial judge, it appears that, in assessing the estate, the CRA had added the amount of $1,320,000 to the ACB to Mr. Bodrug of his Hidrogas shares (which included the shares that he had acquired from Mr. Cohen and NIR).

[105] I do not think that the *Bodrug Estate* case is authority for the proposition that, in these Appeals, the Surrender Payments were the cost of an interest in, or right to acquire, the shares that were the subject of the Numac SOAs and the Anderson SOAs. First, the issue of whether the $1,320,000 paid by Mr. Bodrug for the release and surrender of NIR's rights under the option should be added to the ACB to him of his Hidrogas shares (including those acquired from Mr. Cohen and NIR) was not before the Court, but was merely mentioned by the trial judge as being the treatment given to that amount by the CRA. Second, the option granted by Mr. Bodrug to NIR related to shares that had previously been issued by Hidrogas to, and were still owned by, Mr. Bodrug. In the present Appeals, the stock options were granted by Numac and Anderson respectively (i.e., the employers and the potential share issuers), and related to treasury shares that had not yet been issued. Third, the *Bodrug Estate* case said nothing about whether the option originally granted by Mr. Bodrug to NIR was, pursuant to the settlement agreement, acquired by Mr. Bodrug, and, if so, whether the $1,320,000 formed part of the cost to Mr. Bodrug of the option (as distinct from the previously issued shares that were the subject of the option). Thus, the facts of the *Bodrug Estate* case are distinguishable from the facts of these Appeals.

(ii) Context

[106] The context of the ITA supports the proposition that the word "cost" contemplates an acquisition of property. For instance, section 54 of the *ITA* defines the term "adjusted cost base" ("ACB"). For property other than depreciable property, the ACB to a taxpayer of a property at any time is the cost to the taxpayer of the property adjusted, as of that time, in accordance with section 53 of the *ITA*. Thus, that definition contemplates that a taxpayer, after incurring a cost to acquire a property, may hold that property and might, while holding the property, participate in various transactions that could result in adjustments to the original cost. The definition of the term "cost amount" in subsection 248(1) of the *ITA* contains various provisions for various types of property. Paragraph (*d.1*) of the definition indicates that the cost amount to a taxpayer of a loan or lending asset at any time is the amortized cost of the property to the taxpayer at that time, and paragraph (f) of the definition states that, in any case not covered by the preceding statutory provisions, the cost amount to a taxpayer of a property at any time is the cost to the taxpayer of the property as determined for the purpose of computing the taxpayer's income, except to the extent that that cost has been deducted in computing the taxpayer's income for any taxation year ending before that time. Hence, both of those provisions use the word "cost" in a context contemplating that a particular property may be acquired and held for a period of time by a taxpayer. Furthermore, as indicated in the above quotation from *Canada Trustco*, contextually, various provisions of the *ITA* support the interpretation that the word "cost" means the amount paid to acquire an asset.[65]

(iii) Purpose

[107] I will discuss my understanding of the purpose of paragraph (f) of the definition of "eligible capital expenditure" in paragraph 124 below, after first discussing certain characteristics of the options, the legal nature of the transactions in which the Surrender Payments were made and the impact of the doctrine of merger in respect of those transactions.

(c) Non-Assignability and Non-Transferability of Options

[108] It is the position of Devon that no options or shares were acquired by Numac or Anderson in exchange for the Surrender Payments, such that the Surrender Payments cannot be considered to comprise any part of the cost of acquiring options or shares.[66] As support for this proposition, Devon noted that the options

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65 *Ibid.*, ¶74. See paragraph 103 above.

66 Devon's Memorandum, *supra* note 60, p. 38, ¶121.

were generally not assignable or transferable.[67] In this regard, the Numac SOP provided that each option was personal to the optionee and was not assignable.[68] As well, the various SOAs between Numac and the employees to whom options were granted provided that the options were not assignable by the employee.[69]

[109] While the Numac options were not assignable or transferable, the Numac SOAs conferred on the directors of Numac the discretion to permit an unexercised option to be surrendered to Numac upon payment of an amount (payable in cash, Numac common shares or a combination thereof) equal to the fair market value of the Numac shares that would be issued if the option were to be exercised less the amount of the applicable exercise price.[70] Therefore, it seems that the non-assignability and non-transferability of the options did not preclude those options from being surrendered by their holders to Numac.

[110] Turning to the Anderson options, the Anderson SOP provided that "No right or interest … in or under the Plan … is assignable or transferable … except by bequeath [*sic*] or the laws of descent and distribution."[71] As will be discussed below, the Pre-Acquisition Agreement pertaining to the Anderson Acquisition and a memorandum sent to the Anderson Optionees contemplated the surrender of their options. Thus, as in the case of the options granted by Numac, it appears that the non-assignability and non-transferability of the options granted by Anderson did not preclude those latter options from being surrendered by their holders to Anderson.

(d) *Termination, Surrender or Purchase of Options*

[111] The legal nature of the transactions involving the options and the Surrender Payments is not precisely clear. As indicated in paragraphs 34 and 47 above, the Parties have agreed, in the SAFP, that the various options were surrendered by the Numac Optionees and the Anderson Optionees respectively. However, as explained below, the documents describing those transactions do not use consistent terminology.

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67 *Ibid.*, p. 38, ¶122.

68 Exhibit AR-2, Tab 3, p. 112, ¶8; see also Exhibit AR-2, Tab 1, p. 33, ¶8.

69 Exhibit AR-2, Tab 7, p. 163, ¶11, and p. 178, ¶11. See also Exhibit AR-2, Tab 7, p. 168, ¶6.1, which related to options granted under a predecessor of the Numac SOP and which provided that those options were not to be transferred other than by will or the laws of descent and distribution applicable in Canada.

70 Exhibit AR-2, Tab 7, p. 164, ¶17, and p. 179, ¶17.

71 Exhibit AR-2, Tab 19, p. 381, ¶10(a).

[112] Subsection 2.4 of the Pre-Acquisition Agreement between Anderson and Numac, dated as of January 17, 2001, contained the following provision :

> 2.4 Outstanding Stock Options
>
> (a) Subject to the receipt of any necessary regulatory approvals, persons holding Numac Options who may do so under Securities Laws and in accordance with the Stock Option Plan shall be entitled to exercise all of their Numac Options and tender all Numac Shares issued in connection therewith under the Offer…. It is agreed by Anderson that all Numac Options which have been tendered to Numac for exercise, conditional on Anderson taking up Numac Shares under the Offer ("Conditional Option Exercise"), shall be deemed to have been exercised concurrently with the take-up of Numac Shares by Anderson. Furthermore, Anderson shall accept as validly tendered under the Offer as of the Take-up Date all Numac Shares which are to be issued pursuant to the Conditional Option Exercise, provided that the holders of such options indicate that such shares are tendered pursuant to the Offer and provided that such holder agrees to *surrender* their remaining unexercised Numac Options to Numac *for cancellation* for no consideration effective immediately after the Take-up Date.
>
> (b) Numac and Anderson agree that to the extent holders of Numac Options do not exercise them and tender the Numac Shares they receive upon such exercise, Numac may agree with all remaining holders of Numac Options that, in lieu of such persons exercising their Numac Options, Numac will pay to such persons the difference between the exercise price of their Numac Options and the purchase price for the Numac Shares under the Offer immediately after the Expiry Time of the Offer in exchange for the *termination* of their Numac Options and provided that such holder agrees to *surrender* their remaining unexercised options to Numac *for cancellation* for no consideration effective immediately after the Take-up Date.
>
> (c) Numac agrees to use commercially reasonable efforts to encourage and facilitate all persons holding Numac Options to either exercise all of their Numac Options and deposit (and not withdraw) all of the Numac Shares issued in connection therewith under the Offer or *surrender* all of their Numac Options *for cancellation* and *terminate their rights to exercise* such Numac Options prior to the Expiry Time.[72] [*Emphasis added.*]

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[72] Exhibit AR-2, Tab 8, p. 192, ¶2.4 (a)-(c).

For the most part, the above provision uses the term "Numac Options"; however, the last clause of paragragh 2.4(b) contemplates the holders agreeing "to surrender their remaining unexercised options to Numac for cancellation for no consideration." It is not clear whether the word "options" in the phrase just quoted was intended to refer to the options described elsewhere by the term "Numac Options" or was intended to refer to some other options that did not come within the definition of the term "Numac Options". Presumably the latter meaning was intended, given that paragraph 2.4(b) contemplated that any options coming within the definition of the term "Numac Options" would have been terminated upon receipt of the applicable Numac Surrender Payments. In any event, the concluding portion of paragraph 2.4(c) indicates that any Numac Options that were surrendered in exchange for a Numac Surrender Payment would have been cancelled and the right to exercise those Numac Options would have been terminated. Interestingly, paragraph 2.4(b) speaks of terminating the Numac Options themselves, whereas paragraph 2.4(c) speaks of terminating the rights to exercise the Numac Options.

[113] Further uncertainty arises by reason of a letter sent by Numac on or about January 25, 2001 to each of the Numac Optionees, to explain two alternative elections described as the "Cash Election" and the "Option Exercise Election" respectively. The letter explained that each Numac Optionee could elect to receive a cash payment (i.e., a Numac Surrender Payment) or could elect to exercise his or her options and tender the resultant Numac shares to the offer by Anderson. The letter went on to state the following about the Cash Election:

> In order to facilitate the realization by you of the value of your Options, Numac agrees to *purchase*, effective only if and at the time Anderson takes up Numac Shares under the Anderson Offer, all of the Options held by you for a cash price equal to $8.00 per Numac Share subject to an Option less the option exercise price in respect thereof.
>
> By signing this letter and upon payment of the requisite amount by Numac, all *rights* under all of your Options will be *terminated* and you hereby agree to release Numac from any and all claims you may have had in respect of the Options….
>
> In the event Anderson does not take up and pay for any Numac Shares under the Anderson Offer, the offer to *purchase* your Options will be withdrawn and you will not receive any payment for your Options and those Options which have been

> accelerated will revert to their previous vesting arrangements in accordance with the terms of the Stock Option Plan.[73] [*Emphasis added.*]

It is interesting that the above letter speaks of Numac purchasing the options of a holder who makes the Cash Election (see the first and third paragraphs quoted above), but also speaks of all rights under the options being terminated (see the second paragraph quoted above). There may be an internal inconsistency in those provisions, unless the concepts of "purchase" and "termination" are synonymous in this context, or unless one includes the other. Furthermore, the concept of Numac purchasing the options appears to be inconsistent with subsection 2.4 of the Pre-Acquisition Agreement, unless the word "surrender" in the Pre-Acquisition Agreement is synonymous with the word "purchase," as it is used in the letter of January 25, 2001, or unless one of those words includes the other.

[114] Turning to the treatment accorded to the options in respect of which the Anderson Surrender Payments were paid, a set of recommendations made by Anderson's Compensation Committee, as a result of a meeting on August 29, 2001, recommended that, for any option holders who did not exercise their options and tender the resultant shares to the offer by Devon, Anderson should "pay to such persons the excess, if any, between the purchase price for the Shares under the Transaction less the exercise price of their stock options in exchange for the *termination* of all of their stock options…."[74] [*Emphasis added.*]

[115] Subsection 2.4 of the Pre-Acquisition Agreement, dated as of August 31, 2001, between Devon and Anderson, which was similar, but not identical, to subsection 2.4 of the Pre-Acquisition Agreement between Anderson and Numac, read as follows:

> 2.4 Outstanding Stock Options
>
> (a) Subject to the receipt of any necessary regulatory approvals, persons holding options pursuant to the Stock Option Plan who may do so under Securities Laws and in accordance with the Stock Option Plan shall be entitled to exercise all of their options and tender all Anderson Shares issued in connection therewith under the Offer…. It is agreed by Devon that all Anderson Options which have been tendered to Anderson for exercise, conditional on Devon taking up Anderson Shares under the Offer ("Conditional Option Exercise"), shall be deemed to have been exercised concurrently with the take-up of Anderson Shares by Devon. Furthermore,

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[73] Exhibit AR-2, Tab 13, p. 321-322.

[74] Exhibit AR-2, Tab 20, p. 389, ¶3(b).

> Devon shall accept as validly tendered under the Offer as of the Take-up Date all Anderson Shares which are to be issued pursuant to the Conditional Option Exercise, provided that the holders of such options indicate that such shares are tendered pursuant to the Offer and provided that such holder agrees to *surrender* their remaining unexercised options to Anderson *for cancellation* for no consideration effective immediately after the Take-up Date.
>
> (b) Anderson and Devon agree that to the extent holders of Anderson Options do not exercise such Anderson Options and tender the Anderson Shares they receive upon such exercise, Anderson may agree with all remaining holders of Anderson Options that, in lieu of such persons exercising their Anderson Options, Anderson will pay to such persons the difference between the exercise price of their Anderson Options and the purchase price for the Anderson Shares under the Offer immediately after the Expiry Time of the Offer in exchange for the *termination* of their Anderson Options and provided that such holders agree to *surrender* their remaining unexercised options to Anderson *for cancellation* for no consideration effective immediately after the Take-up Date.[75] [*Emphasis added.*]

The Devon-Anderson Pre-Acquisition Agreement does not contain a provision corresponding to paragraph 2.4(c) of the Anderson-Numac Pre-Acquisition Agreement. However, there is still an element of uncertainty as to whether Anderson options were to be terminated or surrendered for cancellation (assuming that those are different, and not equivalent, transactions).

[116] Two memoranda sent by Anderson to the Anderson Optionees, on or about September 25, 2001, do not clarify the nature of the transactions involving the Anderson options and the Anderson Surrender Payments. The first memorandum is a short cover memo, advising that the Anderson Board of Directors had exercised its discretion so as to enable option holders to "elect to receive a cheque for [their] options…."[76] The second memorandum sets out a description of the two alternatives available to option holders, whereby they could elect to receive a cash payment (i.e., an Anderson Surrender Payment) or to exercise their options and tender the resultant shares to Devon. In describing the first alternative, the memorandum states:

> Alternative #1 (Cash Election) – you may elect to *surrender* your Options and receive a cash payment from Anderson for the value of the Options….

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75 Exhibit AR-2, Tab 22, p. 417, ¶2.4(a)-(b).

76 Exhibit AR-2, Tab 25, p. 525.

> In choosing this alternative, Anderson agrees to *purchase* … all of the Options held by you for a cash price equal to $40.00 per Anderson Share subject to an Option, less the Option exercise price in respect thereof. Upon receipt by [a named officer of Anderson] of your executed … Election Form … and upon payment to you of the requisite amount by Anderson, you will have agreed that all *rights* in connection with your participation in the Option Plan and your Options will be *terminated*….
>
> … Anderson has to withhold tax on any such cash payment made to you on the *surrender* of your Options to Anderson.
>
> Anderson intends to withhold tax at the rate required by Canada Customs and Revenue Agency on the cash payment made to you on the *surrender* of your Options….
>
> In the event Devon does not take-up and pay for any Anderson Shares under the Offer, the election will not take effect, the offer to *purchase* your Options in accordance with this alternative will be withdrawn, you will not receive any payment for your Options and your Options will continue to exist and will be subject to the terms of the Option Plan under which they were granted on their original terms.[77] [*Emphasis added.*]

Again, there is confusion by use of the word "purchase" in some places, the word "surrender" in other places and the words "rights … terminated" in another place.

[117] If the various transactions pertaining to the options and the corresponding Surrender Payments merely resulted in a termination of the contractual rights represented by the options, it is my view that those rights simply came to an end, without anything having been acquired by Numac or Anderson. On the other hand, if the options were surrendered by the holder or were purchased by the grantor (which entails a sale by the holder), it becomes necessary to consider the impact of the doctrine of merger.

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[77] Exhibit AR-2, Tab 25, p. 527-528.

(e) *Doctrine of Merger*

[118] In considering the legal consequences of a transaction in which the holder of an option purportedly surrenders or sells that option to the issuer thereof, one must also consider the doctrine of merger, which has various meanings, depending on the context. The meaning that is relevant to these Appeals is explained in *Black's Law Dictionary* as follows:

> merger…. [meaning no.] 9. The merger of rights and duties in the same person, resulting in the extinction of obligations; esp., the blending of the rights of a creditor and debtor, resulting in the extinguishment of the creditor's right to collect the debt.[78]

[119] In a chapter entitled "Discharge by Operation of Law," *Anson's Law of Contract* states that there are several rules of law which, operating upon certain sets of circumstances, will bring about the discharge of a contract. One such situation is the merger of rights and liabilities in the same person, the rationale being that "it is not possible to contract with oneself";[79] or as another textbook has stated, "a [person] cannot maintain an action against [itself]."[80]

(i) Jurisprudence

[120] A few comments concerning the timing of a merger of rights and liabilities were expressed by the Tax Review Board in the *Anderson* (*subnom. Huestis*) case, in which four employees had been issued stock options by their employer. While the options were still outstanding, the employer sold its assets to another corporation (which had been a minority shareholder of the employer). As well, the shareholders of the employer passed a resolution approving the winding-up of the employer. The employer and each of the four employees (i.e., the option holders) entered into an agreement pursuant to which the employees were given the right to acquire shares of the acquiror corporation in consideration, and as compensation, for the cancellation of the options that had been issued by the employer. The Tax

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78 Bryan A. Garner (editor), *Black's Law Dictionary*, 10th ed. (St. Paul: Thomson Reuters, 2014), p. 1139.

79 Jack Beatson *et al.* (editors), *Anson's Law of Contract*, 29th ed. (Oxford: Oxford University Press, 2010), p. 527-528.

80 H.G. Beale *et al.* (editors), *Chitty on Contracts*, 32nd ed. (London: Sweet & Maxwell, 2015), vol. I, p. 1778, ¶25-004.

Review Board held that the employees had transferred or otherwise disposed of their rights under the stock option agreements and that the value of the right to receive shares of the acquiror corporation was to be included in computing the income of the employees pursuant to the predecessor of paragraph 7(1)(*b*) of the *ITA*. The Tax Review Board stated the following:

> 9. … The most effective and, for the respondent [i.e., the Minister of National Revenue], the most troublesome basis of the appellants' [i.e., the taxpayers'] appeals, in my opinion, is that they did not dispose of their option rights to purchase Bethex [i.e., the employer] shares to a specific person. They claim that they gave up those rights in consideration for a certain compensation, that compensation representing the damages for the premature cancellation of their option rights.
>
> 10. Counsel for the appellants has contended that such cancellation of rights is not what the Act means by "transferred or otherwise disposed of" under the section described above. The word "disposition" means, in his opinion, the transfer of an asset to another person in whose hands it will continue to exist, and that no such disposition took place in this case.
>
> 11. It appears to me that this interpretation of the facts and of the applicable relevant statutory provisions does not hold ground. It happens many times that an asset, tangible or intangible, is disposed of to a person but does not thereafter continue to exist. The words "to a person" have in this case the meaning of "for the benefit of", "at the direction of", or "for the account of" that person. The fact that a certain compensation is paid in consideration of such disposition shows that the person to whom that disposition was made, and who paid for it, attributed a value to it and wished to acquire it. Other examples of the disposition to another person of an asset which at the moment of transfer ceases to exist are, for instance, the disposition of an easement to the owner of a property on which the easement rests. The right of easement dissolves automatically. The same is true where the disposition of an account receivable goes to a person in whose hands it will be extinguished in compensation for a liability of the assignee to the debtor of that receivable; or consider the case wherein spoiled or poisonous merchandise is returned to the vendor for destruction. In all such cases a disposition takes place *to* − meaning "for the account of" or "for the benefit of" a person, even though there is no continuing existence of the disposed asset in the hands of the person to whom it is disposed.[81] [*Underlined emphasis added; italicized emphasis in original.*]

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[81] *Anderson et al. v Minister of National Revenue*, [1974] CTC 2135, 74 DTC 1103 (TRB), ¶9-11; *rev'd*, *subnom*, *Huestis et al. v The Queen*, [1975] CTC 85, 75 DTC 5042 (FCTD); *aff'd*, [1975] CTC 560, 75 DTC 5393 (FCAD); *aff'd*, [1976] CTC 792, 77 DTC 5044 (SCC).

Subsequently, in overturning the decision of the Tax Review Board, the Federal Court – Trial Division held that, when the shareholders' resolution approved the winding-up of the employer, the employer committed an anticipatory breach of the stock option contracts with its employees, such that those contracts were discharged (and terminated) before the employees entered into the settlement agreement, with the result that the options ceased to exist by reason of the termination of the underlying agreements, rather than by reason of the doctrine of merger. Nevertheless, I am of the view that the Tax Review Board expressed a sound principle when it commented about a property ceasing to exist, in the context of a merger of rights and liabilities, at the moment of transfer, such that there is no continuing existence of the particular property in the hands of the person to whom it was disposed.

[121] The doctrine of merger and the consequences of its application were explained by the Supreme Court of Canada in *Cie Immobilière BCN Ltée*, which dealt with a situation in which a taxpayer, which was the lessee of a parcel of land in Montreal, acquired the lessor's rights under the same lease. In determining that the taxpayer was not eligible for capital cost allowance in respect of the lease in subsequent taxation years, the Supreme Court stated:

> 42. I now come to deal with the rights of the respondent as lessee of the piece of land under the first lease. These rights were classified as a leasehold interest in Class 13 of Schedule B to the *Income Tax Regulations*. This leasehold interest *automatically terminated* when the lease under which it was created came to an end upon respondent acquiring the lessor's rights under the same lease. One cannot *at the same time* be lessor and lessee of the same property.
>
> 43. The narrow point is whether the leasehold interest which terminated in such circumstances should be regarded as having been "disposed of" for the purposes of Regulation 1100(2).
>
> 44. As already indicated, the verb "to dispose of", in its first meaning, encompasses the idea of destruction; one of the meanings of the verb "to destroy" is "to put an end to, to do away with" (*Shorter Oxford English Dictionary*, see Destroy). The extinction of a right through merger is but one method of "destroying" that right, that is of putting an end to its existence. In *Re Leven*, [1954] 3 All ER 81, it was said that the word "disposition" taken by itself and used in its most extended meaning was "wide enough to include the act of extinguishment".

> 45. The acquisition by respondent of the lessor's rights under the first lease brought about the *automatic termination* of the leasehold interest; such interest was extinguished, it was destroyed.[82] [*Emphasis added*.]

Given that, as noted by the Supreme Court of Canada, one cannot at the same time be both lessor and lessee of a particular property, there never was a time at which the above taxpayer was both lessor and lessee. By reason of the doctrine of merger, those two interests were automatically terminated or extinguished concurrently with the implementation of the transaction in which the taxpayer acquired the lessor's rights under the lease.

[122] In *Greiner*, the Federal Court – Appeal Division considered whether two holders of stock options were taxable under paragraph 7(1)(*b*) of the *ITA* in respect of payments which they received when they surrendered those options to their employer, which was the corporation that had issued the options. Paragraph 7(1)(*b*) applies where the particular employee (i.e., the stock option holder) "has transferred or otherwise disposed of rights under the [stock option] agreement…." In determining that the two option holders in question had disposed of their respective rights when they entered into the surrender agreements, the Court stated:

> Those words ["otherwise disposed of"] appear to me to be sufficiently broad as to include an amount received as consideration for the surrender of rights that are thereby extinguished, in contrast with an amount received as consideration for rights that are "transferred" and, as such, that remain in existence.[83] [*Footnote omitted.*]

Griener confirms that, when a stock option is surrendered to the issuing corporation, the rights represented by that option are extinguished.

[123] Based on *Griener* and *Anderson* (*subnom. Huestis*), when the holder of a stock option surrenders or sells the option to the grantor thereof, the option is extinguished at the moment of surrender or sale. Just as a person cannot at the same time be both lessor and lessee of the same property (see the *BCN* case

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82 *The Queen v Cie Immobilière BCN Limitée*, [1979] 1 SCR 865, [1979] CTC 71, 79 DTC 5068 (SCC), ¶42-45. See also *RCI Environnement Inc. v The Queen*, 2007 TCC 647, ¶69-70. In *The Armour Group Limited v The Queen*, 2018 FCA 134, the Federal Court of Appeal considered a transaction in which the parties had endeavoured to avoid a merger of a leasehold interest with the fee simple title. The Court disposed of the appeal without needing to determine whether there had been such a merger.

83 *Greiner et al. v The Queen*, [1984] CTC 92, 84 DTC 6073 (FCAD), ¶13.

above), a corporation cannot at the same time be both the grantor and the holder of the same stock option.

(ii) Purpose of paragraph (f)

[124] In my view, the underlying rationale for paragraph (f) of the definition of "eligible capital expenditure" is that, if a taxpayer incurs an outlay or expense that is the cost of a property enumerated in that paragraph (such as an interest in a trust or a partnership, or a share, bond, debenture or similar property, or a right to acquire any of the enumerated properties), the cost of acquiring the property will be recognized when the taxpayer subsequently disposes of the property. In other words, the purpose of paragraph (f) is to preclude a taxpayer from making or incurring an eligible capital expenditure when acquiring an enumerated property, where the cost of the property may be recognized on a subsequent disposition of the property. In the case of an option that is surrendered or sold by the holder to the grantor, such that the respective interests of the holder and the grantor merge, resulting in the extinguishment of the option at the moment of the surrender or sale, the grantor is not left with any property that may be subsequently disposed of, such that there is no means whereby the amount paid by the grantor in respect of the surrender or sale may be recognized as the cost of the option. In such a situation, it would not be appropriate to adopt an interpretation of paragraph (f) that precludes the grantor from obtaining any recognition of the amount paid in respect of the surrender or sale of the option.[84]

[125] In *Johns-Manville*,[85] which was decided after *Stubart*[86] and before *Canada Trustco*,[87] the Supreme Court of Canada stated:

> … if the interpretation of a taxation statute is unclear, and one reasonable interpretation leads to a deduction to the credit of a taxpayer and the other leaves the taxpayer with no relief from clearly *bona fide* expenditures in the course of his business activities, the general rules of interpretation of taxing statutes would direct the tribunal to the former interpretation.[88]

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84 See *Potash Corporation*, *supra* note 41, ¶112.

85 *Johns-Manville Canada Inc. v The Queen*, [1985] 2 SCR 46 (SCC).

86 *Stubart Investments Ltd. v The Queen*, [1984] 1 SCR 536 (SCC).

87 *Canada Trustco*, *supra* note 64.

88 *Johns-Manville Canada*, *supra* note 85, at p. 67. In that case, Justice Estey also referred to a "residual principle" or "basic concept in tax law that where the taxing statute is not explicit, reasonable uncertainty or factual ambiguity resulting from lack of explicitness in the statute should be resolved in favour of the taxpayer": *ibid.*, p. 72.

The above statement was quoted in the most recent edition, published in 2017, of *Principles of Canadian Income Tax Law*.[89]

[126] The interpretation of the word "cost" reached in these Reasons, using the above textual, contextual and purposive analysis, leads to a result similar to the result that would be obtained if the above principle in *Johns-Manville* were to be applied.

(iii) Summary

[127] To summarize, if the proper construction of the two Pre-Acquisition Agreements and the related letter (in the case of Numac) or memorandum (in the case of Anderson) is that the Numac Optionees and the Anderson Optionees surrendered or sold their respective options to Numac or Anderson, those options were automatically extinguished at the moment of the surrender or sale transaction. Hence, Numac and Anderson did not acquire those options. In my view, the payments made by Numac and Anderson for the surrender or sale of the options were not the type of amount contemplated by subparagraph (f)(iv) of the statutory definition of "eligible capital expenditure." In other words, the Surrender Payments (in addition to forming part of the employment remuneration paid to the Numac Optionees and the Anderson Optionees)[90] were consideration for the termination, cancellation or extinguishment of the options, but were not the cost of the options.

[128] Thus, the Surrender Payments were incurred by Numac and Anderson in respect of their businesses, on account of capital, for the purpose of gaining or producing income from those businesses, and did not come within any of the exceptions or exclusions set out in the statutory definition of "eligible capital expenditure." Accordingly, the Surrender Payments were eligible capital expenditures.

B. Financing Expense

[129] Devon submits that, if the Surrender Payments were not eligible capital expenditures, so as to be deductible in part under paragraph 20(1)(*b*) of the *ITA*, the Surrender Payments were deductible, over a five-year period, pursuant to

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89 Jinyan Li, Joanne Magee and J. Scott Wilkie, *Principles of Canadian Income Tax Law*, 9th ed. (Toronto: Thomson Reuters Canada Ltd., 2017), section 9.2(a), p. 265-266.

90 As noted in paragraphs 35 and 48 above, Numac and Anderson reported their respective Surrender Payments on the T4 slips issued to the Numac Optionees and the Anderson Optionees respectively.

subparagraph 20(1)(*e*)(i) of the *ITA*. In the context of these Appeals, the amount, if any, that is so deductible is statutorily described as follows:

> (*e*) such part of an amount (other than an excluded amount) that is not otherwise deductible in computing the income of the taxpayer and that is an expense incurred in the year or a preceding taxation year
>
> (i) in the course of an issuance or sale of units of the taxpayer where the taxpayer is a unit trust, of interests in a partnership or syndicate by the partnership or syndicate, as the case may be, or of shares of the capital stock of the taxpayer …
>
> (including a commission, fee, or other amount paid or payable for or on account of services rendered by a person as a salesperson, agent or dealer in securities in the course of the issuance, sale or borrowing) …
>
> and for the purposes of this paragraph,
>
> (iv.1) "excluded amount" means
>
> (A) an amount paid or payable as or on account of the principal amount of a debt obligation or interest in respect of a debt obligation,
>
> (B) an amount that is contingent or dependent on the use of, or production from, property, or
>
> (C) an amount that is computed by reference to revenue, profit, cash flow, commodity price or any other similar criterion or by reference to dividends paid or payable to shareholders of any class of shares of the capital stock of a corporation….

[130] Thus, to be deductible under subparagraph 20(1)(*e*)(i) of the *ITA*, the Surrender Payments must satisfy two conditions:

a) the Surrender Payments must not have been excluded amounts; and

b) as neither Numac nor Anderson issued any shares in conjunction with the takeovers, the Surrender Payments must have been incurred in the course of a sale of shares of the capital stock of Numac or Anderson, as the case may be.

(1) <u>Excluded Amount</u>

[131] Paragraph 20(1)(*e*) of the *ITA* states that there is no deduction for an amount that comes within the definition of the term "excluded amount," which is defined in subparagraph 20(1)(*e*)(iv.1) of the *ITA*. The term "excluded amount" is defined as meaning, in simplified generalized terms:

a) principal or interest in respect of a debt obligation,

b) an amount that is contingent or dependent on the use of, or production from, property, or

c) an amount that is computed by reference to revenue, profit, cash flow, commodity price, any other similar criteria, or dividends.

As the Surrender Payments do not come within the above definition, they are not excluded amounts. Therefore, the statutory exclusion of such amounts is not applicable here.

(2) Expense in the Course of a Sale of Shares

[132] According to Devon, the Crown is of the view that the Surrender Payments are inextricably linked to the sale of the shares of Numac and Anderson by their shareholders to Anderson and DAC respectively. Therefore, as Devon submits, it must necessarily follow that the Surrender Payments were, for the purposes of subparagraph 20(1)(*e*)(i) of the *ITA*, incurred in the course of a sale of the shares of Numac and Anderson.[91] The Crown takes the position that subparagraph 20(1)(*e*)(i) of the *ITA* should be confined to transactions undertaken by a corporation to raise capital,[92] and should be limited to expenses (such as underwriting commissions, sellers' fees, legal and accounting fees, registrars' and transfer agents' fees, printing expenses and filing fees) that relate to the issuance of securities or that are incidental to the sale of shares or other securities.[93] As well,

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91 Devon's Memorandum, *supra* note 60, p. 40, ¶129-132.

92 Crown's Submissions, *supra* note 59, p. 26, ¶75. The Crown referred to a statement made by the Minister of Finance during a debate on June 29, 1955 concerning the predecessor of the current statutory provision. The Minister of Finance confirmed that the proposed provision was intended to allow a deduction for "[i]tems such as professional fees, printing costs, registration fees and the various minutiae of complying with the legal and accounting provisions surrounding the raising of capital"; see *House of Commons Debates*, 22nd Parl, 2nd Sess, No. 5 (29 June 1955), p. 5438.

93 Crown's Submissions, *supra* note 59, p. 27-28, ¶80-82. See also Department of Finance Canada, *Tax Reform 1987*, June 18, 1987, p. 119-120.

the Crown relies on the CRA's *Interpretation Bulletin IT-341R3*, which states that paragraph 20(1)(*e*) of the *ITA* allows a deduction in respect of certain expenses incurred in the course of "an issuance or sale of … shares in the capital stock of a corporation by the corporation."[94]

[133] Counsel for Devon referred me to the *International Colin Energy* case,[95] which considered the deductibility of a payment made by a corporate taxpayer to a financial adviser, which was assisting the taxpayer, with the intention of improving the ability of the taxpayer to earn income by combining its resources with that of another entity by various means, including a merger, an acquisition by another entity (i.e., a sale of the taxpayer's issued shares), a sale of assets, a new issue of common shares, a rights offering and a large private placement. Ultimately, the advisor assisted the taxpayer in negotiating and implementing a transaction with another corporation (the "acquiror") in the same industry, pursuant to which the shareholders of the taxpayer exchanged their shares of the taxpayer for shares of the acquiror, after which the former shareholders of the taxpayer held approximately 32% of the shares of the acquiror and the taxpayer continued to exist as a subsidiary of the acquiror. The taxpayer paid a fee to the financial advisor for its services, and, in computing its income, the taxpayer deducted the fee. The CRA denied the deduction of the fee on the premise that the fee had not been incurred for the purpose of gaining or producing income from the taxpayer's business, and therefore, by reason of paragraph 18(1)(*a*) of the *ITA*, the fee was not deductible. Associate Chief Justice Bowman (as he then was) found that the evidence supported the taxpayer's argument that the services performed by the financial advisor were intended to improve the taxpayer's income, with the result that the fee was deductible. In brief comments at the end of his reasons, Associate Chief Justice Bowman mentioned an alternative argument that had also been advanced by the taxpayer, to the effect that the fee was deductible under paragraph 20(1)(*e*) of the *ITA*. He made the following comments in respect of that issue:

> 57. Was the expense "in the course of an issuance or sale ... of shares of the capital stock of the taxpayer?"
>
> 58. The word "issuance" implies an issuance by the corporation of its own treasury stock. That is not of course what happened here. Here the sale was not by the corporation but by its shareholders. It may well be that even if the payment here is caught by paragraphs 18(1)(*a*) and (*b*) it falls broadly within the purpose of

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94 Canada Revenue Agency, *Information Bulletin IT-341R3*, November 29, 1995, ¶2.

95 *International Colin Energy Corporation v The Queen*, [2003] 1 CTC 2406, 2002 DTC 2185 (TCC).

> paragraph 20(1)(*e*). The question is however whether "in the course of the sale ... of the shares of the capital stock of the taxpayer ..." is to be restricted to a sale by the corporation of its own shares.
>
> 59. There are respectable arguments on either side. It is arguable that "sale" by its juxtaposition with "issuance" means a sale by the company of its own shares and not a sale by shareholders of their shares. It is equally arguable that "issuance" by itself is quite broad enough to cover a sale by a company of its own shares and that there was no need to add the word sale if all that was meant was a sale by the company. Therefore "sale" must imply something else and the only thing it can refer to is a sale by the shareholders in the course of a corporate transaction of the type involved here where the interests of the corporation are affected. I find the argument attractive not only because it makes sense commercially but because the more restrictive interpretation requires reading into the statute words that are not there. In light, however, of my conclusion on the principal argument advanced in the case I express no concluded view on the point.[96]

[134] Given that Associate Chief Justice Bowman:

a) explained that he was only making brief mention of an alternative argument raised by the taxpayer in the event that it was unsuccessful in respect of its main argument,

b) acknowledged that there are respectable arguments on either side of the question of whether subparagraph 20(1)(*e*)(i) of the *ITA* is to be confined to a sale by a corporation of its own shares, or may extend to a sale of its shares by its shareholders, and

c) specifically stated that he was not expressing a concluded view in respect of that issue,

I do not consider *International Colin Energy* as being determinative of the issue in the context of these Appeals.

[135] As discussed above, Devon's main argument is that the Surrender Payments were deductible in part as eligible capital expenditures. Devon's submission that the Surrender Payments were deductible under paragraph 20(1)(*e*) of the *ITA* is an alternative argument. Having found in Devon's favour in respect of its main argument, and being well aware that, in *International Colin Energy*, Associate

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96 *Ibid.*, ¶57-59.

Chief Justice Bowman chose to express no concluded view in respect of the interpretation to be given to paragraph 20(1)(*e*) of the *ITA*, and not considering myself as having any greater insight into this issue than he did, I too will conclude these Reasons without making a decision in respect of the alternative argument.

VI. CONCLUSION

[136] For the reasons set out above, these Appeals are allowed, and the Reassessment and the Determination are referred back to the Minister for reconsideration and reassessment or redetermination, as the case may be, on the basis that the Surrender Payments were eligible capital expenditures.

[137] Costs are awarded to Devon. The Parties shall have 30 days from the date of this Judgment to reach an agreement on costs, failing which Devon shall have a further 30 days to file written submissions on costs, and the Crown shall have yet a further 30 days to file a written response. Any such submissions are to be limited to 10 pages in length. If the Parties do not advise the Court that they have reached an agreement and if no submissions are received within the foregoing time limits, costs shall be awarded to Devon in accordance with the Tariff.

Signed at Ottawa, Canada, this 20th day of August 2018.

"Don R. Sommerfeldt"

Sommerfeldt J.

APPENDIX A

2013-1327(IT)G; 2013-1066(IT)G

TAX COURT OF CANADA

BETWEEN:

DEVON CANADA CORPORATION

Appellant

- and -

HER MAJESTY THE QUEEN

Respondent

STATEMENT OF AGREED FACTS - PARTIAL

The parties to this proceeding admit, for the purposes of this proceeding only, the truth of the facts, and the truth and authenticity of the documents, referred to in this Statement of Agreed Facts – Partial, and agree that their admission shall have the same effect as if the facts and documents had been proved formally and accepted by the Court as true.

The parties each reserve the right to adduce additional evidence which is relevant and probative of any issue before the Court and which is not inconsistent with the facts and documents admitted in this Statement.

TABLE OF CONTENTS

PARTIES

1. The Appellant, Devon Canada Corporation ("**Devon**"), is an indirect wholly-owned subsidiary of Devon Energy Corporation ("**DEC**"), a U.S. public company.

2. Devon was formed as the result of a number of amalgamations. Two of the companies that amalgamated with Devon are Numac Energy Inc. ("**Numac**") and Anderson Exploration Limited ("**Anderson**").

3. On or about February 12, 2001, Anderson acquired all of the issued and outstanding shares of Numac by way of a takeover bid (the "**Numac Acquisition**"), described in detail below.

4. Prior to February 12, 2001, Numac was a public company, the shares of which were listed and traded on the Toronto and American Stock Exchanges.

5. Because of Numac Acquisition, the Numac shares were delisted from trading on the Toronto and American Stock Exchanges.

6. Numac, together with its subsidiaries, was engaged in the active business of exploring for, producing and selling natural gas and other hydrocarbons in Canada.

7. Numac and its successors, including Devon, continued to carry on this business after the Numac Acquisition.

8. On or about October 15, 2001, Devon acquired all of the issued and outstanding shares of Anderson by way of a takeover bid (the "**Anderson Acquisition**"), described in detail below.

9. Prior to October 15, 2001, Anderson was a public company, the shares of which were listed and traded on the Toronto and New York Stock Exchanges.

10. Because of the Anderson Acquisition, the Anderson shares were delisted from trading on the Toronto and New York Stock Exchanges.

11. Anderson, together with its subsidiaries, was engaged in the active business of exploring for, producing and selling natural gas and other hydrocarbons in Canada.

12. Anderson and its successors, including Devon, continued to carry on this business after the Anderson Acquisition.

STOCK OPTION PLANS

Numac Stock Option Plan

13. Prior to the Numac Acquisition, Numac had an employee stock option plan (the "**Numac SOP**") that came into existence prior to 2001.

14. The Numac SOP provided that it would be administered by the Numac Board of Directors, or a special committee thereof, appointed from time to time. At all relevant times, the Numac SOP was administered by the Compensation Committee of the Board of Directors of Numac.

15. The Numac SOP provided for share option agreements ("**SOAs**") to be entered into between Numac and directors, officers and key employees of Numac (the "**Numac Optionees**") to grant them options to purchase common shares of Numac for an "option price" specified in the SOAs and described therein as the "exercise price".

16. Attached to, and forming part of, each SOA was a document entitled "Share Option Agreement Terms and Conditions".

17. The Compensation Committee of the Board of Directors of Numac decided which of the Numac employees would receive options to acquire Numac shares in a given year.

18. The Numac SOP provided that the Compensation Committee of Numac's Board of Directors "may in its sole discretion, determine the time during which options shall vest."

19. Although the terms of the Numac SOAs varied, each SOA provided for vesting limitations, which had to be satisfied before the options could be exercised for shares of Numac.

20. Specifically, the vast majority of Numac SOAs provided that the options granted thereunder would vest in equal parts (that is, 1/3 of the grant) on the 1st, 2nd and 3rd anniversaries of the date of grant. Upon satisfaction of these limitations, the Numac Optionees could exercise the vested options by paying the exercise price specified in the applicable SOA to Numac.

21. Paragraph 7 of the Numac SOP provided that the exercise price of an option was fixed by the Compensation Committee at the time the option was granted. The Numac SOP further provided that the exercise price could not be less than the closing price of the common shares on the stock exchange on which the shares were traded on the last trading day before the grant of the option.

22. All of the Numac SOAs also provided the following:

(a) in the event of an amalgamation, arrangement, merger or other consolidation of Numac with another corporation (other than a wholly-owned subsidiary of Numac), the vesting of unvested options was accelerated such that the Numac Optionees had the right to exercise their options at that time; and

(b) in the event of a formal bid being made to acquire more than 25% of the outstanding voting shares of Numac, and if Numac's Board of Directors recommended acceptance of the offer, the vesting of unvested options was accelerated and such options could be exercised for the sole purpose of tendering the shares to the bid.

23. The Terms and Conditions of the Numac SOAs provided that the Board of Directors of Numac had the discretion to permit unexercised options to be surrendered to Numac for cash equal to the excess of the fair market value of the shares at the time of the surrender over the exercise price, but the Numac Optionees did not otherwise have the right to surrender and cash out their options.

24. Prior to the Numac Acquisition, Numac's Board of Directors had not previously exercised the discretion to permit the Numac Optionees to surrender their options for cash.

25. Both the Numac SOP and SOAs provided that the options were not assignable by the optionee.

26. The Numac SOP also provided that if a Numac Optionee was no longer a director or officer or full-time employee of Numac, the option would terminate on the expiry of the period determined by the Compensation Committee of Numac's Board of Directors, which would be no more than six months following that event.

27. The Terms and Conditions of the Numac SOAs further provided that if a Numac Optionee's employment was terminated without cause within 60 days of the amalgamation, merger or other consolidation of Numac with any one or more corporation, any unexercised option would terminate, and become null and void.

Anderson Stock Option Plan

28. Prior to the Anderson Acquisition, Anderson had an employee stock option plan (the "**Anderson SOP**") that came into existence on or about December 31, 1994. It was amended and restated as at February 10, 1999, and further amended and restated on February 13, 2001.

29. The Anderson SOP provided, among other things:

(a) the Board of Directors of Anderson with the authority to:

(i) grant to Anderson's officers, members of management, and employees of Anderson (the "**Anderson Optionees**") options to purchase a number of Anderson's common shares designated by the Board of Directors at the exercise price specified in the option grant;

(ii) fix the exercise price, which had to be equal to the closing price of the common shares on the Toronto Stock Exchange on the date of grant;

(iii) designate the period such options could be exercised, with the caveat that such period would not exceed ten years from the date of option grant; and

(iv) specify the vesting limitations that were required to be satisfied before the options could be exercised;

(b) options granted under the plan were not assignable;

(c) upon the termination of an Anderson Optionee's employment with Anderson, unexercised options were terminated;

(d) in the event of a takeover of Anderson, any options which had not vested would immediately vest, giving the Anderson Optionees the right to exercise their options at that time; and

(e) in connection with the exercise of options, the Anderson Optionees could, at the sole option of the Board of Directors, be entitled to obtain a loan from Anderson on terms prescribed in the Anderson SOP.

30. Share purchase options granted under the Anderson SOP were governed by Anderson Stock Option Agreements ("**Anderson SOAs**") between Anderson and Anderson Optionees. The Anderson SOAs provided, among other things:

(a) for a five year expiry date of the option from the date of the grant of the option;

(b) for vesting limitation which had to be satisfied before the options could be exercised for shares of Anderson; and

(c) that the options granted thereunder would vest in equal parts (that is, 1/3 of the grant) on the 1st, 2nd and 3rd anniversaries of the date of grant.

31. Upon satisfaction of these limitations, the Anderson Optionees could exercise the vested options by paying to Anderson the exercise price specified in the applicable Anderson SOA.

32. Neither the Anderson SOP, nor the relevant options granted pursuant to the Anderson SOAs, gave the Anderson Optionees the right to unilaterally surrender their options in return for cash payments.

33. Under the Anderson SOP, the Board of Directors of Anderson had the discretion to permit vested unexercised options to be surrendered to Anderson for cash equal to the excess of the fair market value of the shares at the time of their surrender over the exercise price.

34. Prior to the Anderson Acquisition, the Board of Directors had not previously exercised the discretion to permit the Anderson Optionees to surrender their unexercised options to Anderson for cash.

35. The Anderson SOP was administered by the Board of Directors, which had full and final discretion to interpret the provisions of the Anderson SOP and to prescribe, amend, rescind and waive rules and regulations to govern the administration and operation of the plan.

NUMAC ACQUISITION

Anderson Acquires Numac

36. On or about January 17, 2001, Anderson and Numac entered into a Pre-Acquisition Agreement, pursuant to which, among other things:

(a) Anderson expressed its intention to acquire all of Numac's outstanding common shares, including any Numac shares that could become outstanding pursuant to the exercise of outstanding options under the Numac SOP, in consideration for a cash payment of $8.00 for each Numac share;

(b) Numac represented that all option entitlements held by Numac Optionees under the Numac SOP would accelerate and vest as a result of Anderson making the offer to acquire all of Numac's outstanding shares, and that it would give immediate notice of the offer to all Numac Optionees;

(c) it was agreed that all Numac options granted under the Numac SOP which were tendered to Numac for exercise, conditional on Anderson's takeover of Numac, would be deemed to have been exercised concurrently with the take-up of Numac shares by Anderson;

(d) it was agreed that, to the extent that Numac Optionees did not exercise their options and tender the shares acquired to the Anderson offer, Numac was permitted to agree with the Numac Optionees that, in lieu of such persons exercising their options, Numac would pay to such Numac Optionees the difference between the exercise price of their options and the purchase price for the Numac shares under the offer in exchange for the termination of their options;

(e) Numac represented, among other things, that all persons holding Numac options were entitled to exercise their options and tender their Numac shares under Anderson's offer, and that Numac's Board of Directors would not, prior to the completion of the offer, grant additional Numac options pursuant to the Numac SOP; and

(f) Numac agreed to use commercially reasonable efforts to encourage and facilitate Numac Optionees to either exercise their options and deposit all of the Numac shares issued in connection therewith under the offer, or to surrender all of their Numac options for cancellation.

37. The closing price of Numac's common shares on the Toronto Stock Exchange on January 17, 2001 was $6.40 a share.

38. By News Release dated January 19, 2001, Anderson announced that it was mailing to Numac's shareholders its formal offer to purchase all of the issued and outstanding common shares of Numac for cash consideration of $8.00 per share.

39. On January 19, 2001, Anderson Acquisition Corp. ("**Anderson Acquireco**"), an indirect wholly-owned subsidiary of Anderson, on behalf of Anderson, offered to purchase all of the Numac common shares on the basis of $8.00 in cash for each share.

40. On January 23, 2001, Numac's Board of Directors issued a Directors' Circular pursuant to which the Board recommended acceptance of Anderson's offer to the holders of Numac common shares.

41. By memorandum dated January 25, 2001, Numac informed the Numac Optionees that:

(a) Anderson Acquireco's offer to purchase all of the outstanding Numac common shares had triggered the acceleration of the unvested options;

(b) they could elect to receive a cash payment from Numac for the value of their options, determined as the difference between $8.00 per share and the applicable exercise price (less applicable withholding tax) (the "**Numac Cash Election**"), or they could exercise their options by paying the applicable exercise price and acquiring the shares, and tender the shares to the offer (the "**Numac Exercise Election**"); and

(c) in the event that a Numac Optionee failed to act on either alternative, such Optionee would be deemed to have made the Numac Cash Election.

42. In the memorandum dated January 25, 2001, the Numac Optionees were also advised that:

(a) in order to facilitate the realization by the Numac Optionees of the value of their Options, Numac agreed to purchase the options of the Numac Optionees who chose the Numac Cash Election;

(b) a Numac Cash Election would become effective only if and at the time Anderson Acquireco took up the common shares of Numac under its offer and, in the event that it did not take up and pay for the Numac common shares, Numac's offer to purchase their options would be withdrawn, the Numac Optionees would not receive any payment for their options, and the options that had accelerated would revert to their previous vesting arrangements in accordance with the terms of the Numac SOP; and

(c) the Numac Exercise Election would be effective only if Numac was satisfied that Anderson Acquireco's offer would be completed and Numac deposited the Letter of Transmittal provided by Numac Optionees together with their Numac Exercise Elections, whereupon the Numac Optionees would receive payment for their common shares of Numac by cheque at the price of $8.00 per share and that, if Anderson did not take up and pay for the Numac common shares under its offer,

the options that had been accelerated would revert to their previous vesting arrangements in accordance with the terms of the Numac SOP, and the certified cheques, bank drafts or money orders delivered in satisfaction of the exercise price would be returned to them.

43. Upon the closing of the Numac Acquisition Transaction on February 12, 2001, Anderson Acquireco acquired 95,250,604, or approximately 98%, of the then outstanding Numac common shares which were tendered to Anderson's offer, and the remaining 1,415,008 common shares that were not tendered were acquired through the compulsory share acquisition provisions in the *Business Corporation Act* (Alberta).

44. As a result of the acquisition of control of Numac by Anderson Acquireco on February 12, 2001, Numac's taxation year ended on February 11, 2001 (the "**Numac Taxation Year**").

Numac Cash Surrender Payments

45. During the Numac Taxation Year, 7,228,829 Numac common shares were surrendered by the Numac Optionees who elected to receive cash payments in consideration for the surrender of their options granted under the Numac SOP.

46. Following the Numac Acquisition, Numac made cash payments in the aggregate amount of $20,844,041 to Numac Optionees who elected to receive cash in consideration for the surrender of their options granted under the Numac SOP (the "**Numac Cash Surrender Payments**").

47. The Numac Cash Surrender Payments made to Numac Optionees were included in computing their employment income under the *Income Tax Act* (Canada) (the "**Act**") and were reported on their T4 slips.

OTHER FACTS RELEVANT TO NUMAC

48. On April 1, 2001, Anderson Acquireco amalgamated with Numac to form Numac Energy Inc. ("**Numac Amalco**").

49. On September 1, 2003, Numac Amalco amalgamated with Devon to form Devon Canada Corporation, the Appellant in this appeal.

50. In computing Numac's income under the Act for the Numac Taxation Year, Numac deducted the Numac Cash Surrender Payments, relying on subsection 9(1) of the Act.

51. By way of a reassessment, notice of which was dated September 3, 2008 (the "**Reassessment**"), the Minister of National Revenue ("**Minister**") reassessed Devon, as successor to Numac, to disallow the deduction of the Numac Cash Surrender Payments.

52. Devon, as successor to Numac, objected to the Reassessment by way of a Notice of Objection filed on November 27, 2008.

53. The Minister confirmed the Reassessment by way of a Notice of Confirmation dated March 14, 2013.

54. In its Notice of Appeal, Devon, as successor to Numac, claimed, in the alternative, that the Numac Cash Surrender Payments were deductible as eligible capital expenditures at the time of the acquisition of control pursuant to subsection 111(5.2) and paragraph 20(1)(b), or as expenses under paragraph 20(1)(e).

ANDERSON ACQUISITION

Devon Acquires Anderson

55. On August 31, 2001, DEC and Anderson entered into a Pre-Acquisition Agreement, pursuant to which:

(a) DEC expressed its intention to acquire, either itself or through any subsidiary corporation, all of Anderson's outstanding common shares, including any Anderson shares that could become outstanding pursuant to the exercise of outstanding options under the Anderson SOP, in consideration for a cash payment of $40.00 for each Anderson share;

(b) Anderson represented that all option entitlements held by Anderson Optionees under the Anderson SOP would accelerate and vest as a result of DEC making the offer to acquire all of Anderson's outstanding shares, and that it would give immediate notice of the offer to all Anderson Optionees;

(c) it was agreed that all Anderson options granted under the Anderson SOP that were tendered to Anderson for exercise, conditional on DEC's takeover of Anderson, would be deemed to have been exercised concurrently with the take up of Anderson shares by DEC;

(d) it was agreed that, to the extent Anderson Optionees did not exercise their options under DEC's offer, Anderson was permitted to agree with the Anderson Optionees that, in lieu of such persons exercising their options, Anderson would pay to such Anderson Employees the difference between the exercise price of their options and the purchase price for the Anderson Shares under the offer in exchange for the termination of their options; and

(e) Anderson represented, among other things, that all persons holding Anderson Options were entitled to exercise their options and tender their Anderson shares under Anderson's offer, and that Anderson's Board of Directors would not, prior to the completion of the offer, grant additional Anderson options pursuant to the Anderson SOP.

56. The closing price of Anderson's common shares on the Toronto Stock Exchange on August 31, 2001 was $26.40 a share.

57. On September 6, 2001, Devon Acquisition Corporation ("**DAC**"), a wholly-owned Canadian subsidiary of DEC, offered to purchase all of the Anderson common shares on the basis of $40.00 in cash for each share.

58. On September 6, 2001, Anderson's Board of Directors issued a Directors' Circular pursuant to which the Board recommended acceptance of DAC's offer to the holders of the Anderson common shares.

59. By memorandum dated September 25, 2001, Anderson advised the Anderson Optionees that:

(a) the Anderson SOP provided for the acceleration of unvested options in order to provide Anderson Optionees with the opportunity to tender Anderson shares issuable on the exercise of unvested options to DAC's offer;

(b) the Anderson Board of Directors had exercised its discretion under the Anderson SOP to permit the Anderson Optionees to elect either to receive a cheque for their options or to follow the traditional method requiring the optionees to exercise their options and to forward payments for the shares to Anderson by a certified cheque or bank draft;

(c) the optionees were required to complete Schedule A to a separate "Stock Option Memorandum" and to return it to a specified employee of Anderson;

(d) the Anderson Optionees had two alternatives for dealing with their vested and unvested options in the event they wished to participate in the offer. Both alternatives required the completion of Schedule "A" to the memorandum;

(e) the two alternatives were: (i) the "**Anderson Cash Election**", which allowed Anderson Optionees to surrender their options to Anderson in consideration for the receipt of a cash payment for the value of their surrendered options, and (ii) the "**Anderson Exercise Election**", under which Anderson Optionees could exercise their options and tender the shares to DAC's offer; and

(f) the value of the options in the event of the Anderson Cash Election was equal to $40.00 a share, less the option exercise price.

60. In the memorandum dated September 25, 2001, the Anderson Optionees were also advised that, in the event DAC did not take up and pay for the Anderson common shares under its offer:

(a) the Anderson Cash Election would not take effect, Anderson's offer to purchase their options would be withdrawn, they would not receive any payment for their

options, their options would continue to exist and would be subject to the terms of the Anderson SOP, and the options which were accelerated would revert to their previous vesting arrangements; and

(b) the Anderson Exercise Election would not take effect, the exercise of their options would be deemed not to have occurred, the Anderson Optionees' payment of the exercise price to Anderson would be returned to them, and the options which were accelerated would revert to their previous vesting arrangements.

61. Upon the closing of the Anderson Acquisition Transaction on October 15, 2001, DAC acquired approximately 98% of the then outstanding Anderson common shares by tender to Devon's offer, and the remaining 3% of the remaining common shares that were not tendered were acquired through the compulsory share acquisition provisions of the *Canada Business Corporations Act*.

62. As a result of the acquisition of control of Anderson by Devon, on October 15, 2001, Anderson's taxation year ended on October 14, 2001 (the "**Anderson Taxation Year**").

Anderson Cash Surrender Payments

63. During the Anderson Taxation Year, 3,291,445 Anderson common shares were surrendered by the Anderson Optionees who elected to receive cash payments in consideration for the surrender of their options granted under the Anderson SOP.

64. Following the Anderson Acquisition, Anderson made cash payments in the aggregate amount of $59,842,894 to Anderson Optionees who elected to receive cash in consideration for the surrender of their options granted under the Anderson SOP (the "**Anderson Cash Surrender Payments**").

65 Due to DAC's acquisition of control of Anderson, due to a condition of the operating line of credit Anderson had with a major financial institution, Anderson was no longer able to access that operating line of credit. As a result, DAC lent Anderson sufficient funds to take care of its immediate cash needs, including the cash Anderson needed to

fund the payments to its Anderson Optionees to surrender their stock options under the Anderson SOP.

65. The Anderson Cash Surrender Payments made to Anderson Optionees were included in computing their employment income under the Act and were reported on their T4 slips.

OTHER FACTS RELEVANT TO ANDERSON

66. DAC and Anderson amalgamated on October 18, 2001 to form Devon Acquisition Corporation, the Appellant in this appeal.

67. On October 25, 2001, Devon Acquisition Corporation changed its name to Devon Canada Corporation.

68. In computing its income under the Act for the Anderson Taxation Year, Devon as successor to Anderson, deducted the Anderson Cash Surrender Payments, relying on subsection 9(1) of the Act.

69. The Minister issued a Notice of Determination of a Loss dated July 31, 2008 (the "**Determination**") to Devon as successor to Anderson for the Anderson Taxation Year, disallowing the deduction of the Anderson Cash Surrender Payments.

70. Devon, as successor to Anderson, objected to the Determination by way of a Notice of Objection filed on October 28, 2008.

71. The Minister confirmed the Determination by way of a Notice of Confirmation dated February 4, 2013.

72. In its Notice of Appeal, Devon, as successor to Anderson, claimed, in the alternative, that the Anderson Cash Surrender Payments were deductible as eligible capital expenditures at the time of the acquisition of control pursuant to subsection 111(5.2) and paragraph 20(1)(b), or as expenses under paragraph 20(1)(e).

The parties agree that this Statement does not preclude either party from calling evidence to supplement the agreed facts and documents, it being accepted that such evidence may not contradict them.

DATED at the City of Toronto, in the Province of Ontario, this day of April, 2017.

Osler, Hoskin & Harcourt LLP

for: **Al Meghji, Edward Rowe**
Pooja Mihailovich, Joanne Vandale

Osler, Hoskin & Harcourt LLP
P.O. Box 50
First Canadian Place
Toronto, ON M5X 1B8

Tel: (416) 862-5677
Fax: (416) 862-6666

Counsel for the Appellant

DATED at the City of Ottawa, in the Province of Ontario, this 19th day of April, 2017.

Attorney General of Canada

per

L.P. Chambers
Vincent Bourgeois

Tax Law Services Section
Department of Justice Canada
Tax Law Services Section
99 Bank Street, 11th Floor
Ottawa, ON K1A 0H8

Tel: (613) 670-6449/6552
Fax: (613) 941-2293

Counsel for the Respondent

CITATION:	2018 TCC 170
COURT FILE NOS.:	2013-1066(IT)G, 2013-1327(IT)G
STYLE OF CAUSE:	DEVON CANADA CORPORATION AND HER MAJESTY THE QUEEN
PLACE OF HEARING:	Calgary, Alberta and Toronto, Ontario
DATE OF HEARING:	May 1 and 2, 2017, October 30 and 31, 2017 and November 1, 2017
DATE OF FILING SUBMISSIONS:	Appellant: August 14, 2017 Respondent: September 22, 2017 Appellant: October 16, 2017
REASONS FOR JUDGMENT BY:	The Honourable Justice Don R. Sommerfeldt
DATE OF JUDGMENT:	August 20, 2018

APPEARANCES:

Counsel for the Appellant:	Al Meghji, Edward Rowe, Pooja Mihailovich, Joanne Vandale
Counsel for the Respondent:	Luther P. Chambers, Q.C.,[97] Patrick Vézina, Vincent Bourgeois

[97] Mr. Chambers appeared on behalf of the Crown when the evidence was submitted to the Court on May 1 & 2, 2017, in Calgary. Regrettably, Mr. Chambers passed away on September 25, 2017, approximately five weeks before the oral submissions commenced on October 30, 2017, in Toronto. The Court would like to take this opportunity to recognize the long and distinguished career of Mr. Chambers, who worked for the Department of Justice for more than 50 years. It is my understanding that this was the last case in which Mr. Chambers appeared in the Tax Court of Canada before his death.

COUNSEL OF RECORD:

For the Appellant:

Name:	Pooja Mihailovich, Al Meghji, Patrick Marley, Andrew Boyd
Firm:	Osler, Hoskin & Harcourt LLP

For the Respondent:

Nathalie G. Drouin
Deputy Attorney General of Canada
Ottawa, Canada