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Tax Implications of Expropriation

Adam Scherer and Shane Rayman*

PRÉCIS

La justice et l'équité représentent des éléments fondamentaux de la législation et de la politique fiscale. Il est juste d'imposer les gens à l'égard des décisions qu'ils prennent relativement aux biens, dans la mesure où leurs décisions représentent des événements volontaires. On ne peut en dire autant de l'expropriation, qui n'est pas volontaire et qui ne touche pas la totalité des contribuables. Elle touche en effet une petite partie de la population et elle n'est habituellement pas demandée ni voulue. Le présent article porte sur les différentes questions qui se posent relativement à l'imposition du produit tiré d'une expropriation et sur la façon dont la Loi de l'impôt sur le revenu s'efforce d'aboutir à un traitement fiscal équitable pour les propriétaires expropriés.

ABSTRACT

Fairness and equity are cornerstones of tax legislation and policy. It is fair to tax people on income resulting from their decisions about property, because those decisions represent voluntary events. Such is not the case with the expropriation of property. For the property owner, expropriation is an involuntary event; it is not ordinarily requested or desired; and it generally affects only a small portion of the population. This article examines various issues relating to the taxation of proceeds from an expropriation and how the Income Tax Act endeavours to create a fair result for property owners whose property has been expropriated.

KEYWORDS: EXPROPRIATION ■ INVOLUNTARY CONVERSIONS ■ CAPITAL GAINS ■ DISPOSITIONS ■ ROLLOVERS ■ PROPERTY

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* Adam Scherer is of Soberman LLP, Toronto. Shane Rayman is of Rueter Scargall Bennett LLP, Toronto. The authors wish to thank Stacie Scherer, of Pass It On Communications, Toronto, for editorial assistance, and Dorete Astroff and Adam Rubinoff of Soberman LLP, for their insightful comments during the development of this article.

INTRODUCTION

The Income Tax Act[1] contains provisions intended to mitigate or eliminate the immediate tax burden created as a result of expropriation. Certain rules in the Act allow an expropriated owner to potentially defer the tax burden. This article describes the deferral mechanisms, including the underlying policy and the administration of these rules by the Canada Revenue Agency (CRA). It also explores how the courts have determined the appropriate tax treatment of awards of compensation resulting from expropriation—in particular, the basis for determining whether such compensation constitutes "income," "capital," or a "windfall." Finally, the article reviews the treatment of taxation in the determination of awards of compensation, and the circumstances in which an owner can recover the cost of tax advice required as a result of an expropriation.

The discussion that follows addresses various tax issues arising in the context of expropriation. One significant area of concern is the treatment of replacement

1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

property. Although other articles and papers have discussed this topic,[2] this article expands on the issues.

POLICY

Expropriations and other involuntary property dispositions are usually unforeseen, and they often create an unexpected burden for an expropriated property owner. The expropriated owner may have to immediately rebuild or replace his property in order to continue his business operations or support his lifestyle. He will likely also face administrative dealings with government agencies, insurance companies, lawyers, appraisers, and accountants to determine the settlement amount and timing. Without rules to the contrary, the owner may also be saddled with the immediate taxation of the compensation received for the property lost.

In fairness to taxpayers who must involuntarily dispose of property, Parliament passed legislation aimed at providing relief from the immediate tax event that might otherwise result. When this legislation was first introduced, then Minister of Finance John Turner spoke of the fairness and timing issues as follows:

> It has . . . come to my attention that the tax system does not apply fairly where property has been expropriated, lost or destroyed. Quite often a taxpayer may be faced with a significant tax liability long before a settlement date has been agreed upon and funds are available. This seems quite unfair, and I am introducing a relieving amendment which will ensure that under certain circumstances no tax is payable until the compensation has been finally determined.[3]

APPLICATION OF POLICY

When a taxpayer disposes of certain capital property,[4] such as land or a building, for cash or other proceeds in excess of its tax cost, a liability for tax may arise. This usually takes the form of a capital gain or, in the case of depreciable property,[5] recapture

2 See, for example, Adam Shapiro, "The Replacement Property Rules: A Bit More Than Before," Personal Tax Planning feature (2002) vol. 50, no. 6 *Canadian Tax Journal* 2141-66; and Edwin G. Kroft, "An Update on Selected Issues Relating to Dispositions and Exchanges of Property," in *Real Estate Transactions: Tax Planning for the Second Half of the 1990s*, 1995 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1996), 10:1-45. See also Larissa V. Tkachenko, "Expropriations: The Income Tax Aspects" (1985) vol. 33, no. 1 *Canadian Tax Journal* 1-35.

3 Canada, Department of Finance, 1974 Budget, Budget Speech, May 6, 1974, 25.

4 "Capital property" generally means property the disposition of which gives rise to a capital gain, and is defined in section 54 of the Act as follows:

> (a) any depreciable property of the taxpayer and
> (b) any property (other than depreciable property), any gain or loss from the disposition of which would, if the property were disposed of, be a capital gain or a capital loss, as the case may be, of the taxpayer.

5 "Depreciable property" is defined in subsection 13(21) as property in respect of which the taxpayer has been allowed to claim capital cost allowance.

of the capital cost allowance (CCA). Capital gains and recapture are generally taxable in the years in which they are realized.

In cases of involuntary dispositions, such as expropriations, the typical tax liability may be deferred. The Act sets out rules on deferring capital gains (section 44) or recapture (subsection 13(4)) resulting from the disposition of certain capital property.[6] It also provides a framework for determining the taxation year in which the taxpayer must report the disposition and pay any taxes arising from it.

The basic premise of these provisions is that if a taxpayer disposes of certain capital (depreciable) property and acquires a suitable replacement property within a specific period of time, she may defer the tax from the disposition of the original (or "former") property. The gain that would have been realized at the time of the disposition is now "rolled" into the purchase price of the replacement property. As a result of this rollover, some or all of the tax is deferred until the taxpayer disposes of the new (or replacement) property.

While subsection 44(1) deals with the parameters of such rollovers, subsection 44(2) deals specifically with the timing issues, and subsection 44(5) outlines what constitutes a valid replacement property. Each subsection will be examined in greater detail below. The Act sets out parallel rules for the deferral of recapture in subsection 13(4).

For a rollover to occur, the following events must take place:[7]

1. the taxpayer becomes entitled to proceeds of disposition;
2. the taxpayer acquires capital property that is a replacement of the former property;
3. the taxpayer acquires the replacement property within a specified time period;
4. the taxpayer does not dispose of the replacement property before the date of disposition of the former property; and
5. the taxpayer makes a valid election.

The rules associated with each of these events are discussed below.

Entitlement to Proceeds of Disposition

There are many transactions or events that may cause a taxpayer to become entitled to proceeds of disposition. For the purposes of this discussion, proceeds of disposition may include

> (a) the sale price of property that has been sold,
> (b) compensation for property unlawfully taken,
> (c) compensation for property destroyed, and any amount payable under a policy of insurance in respect of loss or destruction of property,

6 Gains on "eligible capital property" may also be deferred pursuant to subsection 14(6).

7 Subsection 44(1).

> (d) compensation for property taken under statutory authority or the sale price of property sold to a person by whom notice of an intention to take it under statutory authority was given,
>
> (e) compensation for property injuriously affected, whether lawfully or unlawfully or under statutory authority or otherwise.[8]

Absent any rules to the contrary, when a taxpayer is considered to have received proceeds of disposition as a consequence of any of the events above, a tax liability may result.

Requirements for Expropriations or Involuntary Dispositions

The circumstances described in paragraphs (b), (c), and (d) of the definition above are commonly referred to as "involuntary dispositions."[9] Only proceeds from these types of dispositions qualify for the section 44 rollover.[10] Accordingly, proceeds of disposition that fall under paragraphs (a) and (e) (among others) are not eligible for the rollover.

Proceeds of disposition for expropriated property generally fall within the parameters of paragraph (d) above. Therefore, it is important to examine the elements of this definition: either compensation must be received for property that has been expropriated, or compensation must be received for property that has been sold to a person (the statutory authority) who provided notice of an intention to expropriate.

Because the second part of the definition requires notice of an intention to expropriate, an unsolicited sale of the property to the expropriating authority does not qualify for the rollover provisions. Nor do the rollover provisions apply if, after providing notice of intention to expropriate, the statutory authority notifies the owner that it has abandoned that intention, and there is a subsequent sale to the authority.[11] Similarly, the rollover provisions apply only when the transfer occurs between the expropriating authority and the taxpayer. If the taxpayer receives a notice of intention to expropriate but sells the property to a third party, the proceeds received are not eligible to be rolled into a replacement property, and therefore the taxes arising from them cannot be deferred.

After receiving a notice of intention to expropriate, the property owner may begin negotiating the sale to the expropriating authority. A notice of intention can include any of the following:

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8 Section 54, the definition of "proceeds of disposition." Note that this is a partial listing of the items included in the definition.

9 *Interpretation Bulletin* IT-259R4, "Exchange of Property," September 23, 2003, paragraph 1.

10 Paragraph 44(1)(a).

11 *Interpretation Bulletin* IT-271R, "Expropriations—Time and Proceeds of Disposition," May 16, 1980, paragraph 5. This bulletin was archived by the CRA in 2004.

- A formal notice of intention to expropriate (Notice of Application for Approval to Expropriate Land) given to the owner under the requirements of the applicable expropriation legislation.[12]
- Any notice provided or made available to the property owner by the expropriating authority, indicating its intention to expropriate if negotiations for the sale of the property are not fruitful, and describing the property involved. Examples include an information circular or letter published by the expropriating authority and sent to the owners of the property.[13]
- Verbal notice given to the owner by a representative of the expropriating authority.[14]

The courts have considered the principles underlying the notice requirement in order to determine whether a taxpayer qualifies for the replacement property provisions under the Act. An example is the decision in *Damka Lumber & Development Ltd. v. The Queen*.[15] In that case, the taxpayer disposed of property to the Urban Transit Authority of British Columbia, even though no formal notice of an intention to expropriate was ever provided. The taxpayer sold the property on the basis of verbal notifications and rumours of an impending expropriation. The court held that the replacement property rules did not apply because there was no evidence that the proceeds actually constituted "the sale price of property sold to a person by whom notice of intention to take it under statutory authority was given."[16]

Although the court referenced *Interpretation Bulletin* IT-271R,[17] it accepted the evidence of a policy specialist who stated that the intention of the rollover provisions was not just that a "verbal notice of expropriation" must be given by the expropriating authority, but that verbal notice must also be followed by a written notice of an intention to commence, or the actual commencement of, expropriation proceedings. In light of the court's finding in this case, it appears that verbal notification from an expropriating authority must be followed by written notice in order for the replacement property provisions in section 44 to apply.

Disposition of the Former Property

In cases of expropriation, or other involuntary dispositions, the principal problem for the taxpayer is one of timing. Although a taxpayer may have "disposed" of his property, he may not receive all or any part of the proceeds of disposition for a long

12 Ibid., at paragraph 4(a). In Ontario, giving this notice represents the formal initiation of the expropriation process in accordance with section 6 of the Expropriations Act, RSO 1990, c. E.26, as amended (herein referred to as "the Expropriations Act").

13 Ibid., at paragraph 4(b).

14 Ibid., at paragraph 4(c).

15 90 DTC 6101 (FCTD).

16 Ibid., at 6104.

17 Supra note 11.

time (sometimes even years) after the disposition.[18] For this reason, there are rules for identifying the year in which a disposition is considered to take place—that is, the year in which the former property owner must account for the proceeds for tax purposes.

In the majority of expropriations, an expropriated owner receives "without prejudice" advances or interim payments of compensation from the expropriating authority before the final amount of compensation is determined.[19] These advance payments generally need not be taken into income for tax purposes until the full amount of the compensation is determined.[20]

On the basis of the Supreme Court of Canada decision in *Minister of National Revenue v. Benaby Realties Ltd.*,[21] a disposition of a capital property does not take place until the final determination of compensation is made. This decision sets a parameter for recognizing the timing of a disposition and avoids the prejudice to a taxpayer of having to pay tax on compensation before it is determined with finality. At times, it may also provide an incentive for taxpayers to extend the negotiation or litigation process, thereby delaying the recognition of and consequential taxation on the proceeds of compensation.

In the context of expropriations or other involuntary dispositions, the taxpayer must acquire a replacement property before the end of the second taxation year following the year in which the disposition is deemed to occur.[22] Otherwise, she cannot reap the benefits of the rollover provisions.[23]

Subsection 44(2) of the Act governs when the two-year period starts. Under this provision, involuntary dispositions are deemed to occur at the earliest of the following events:

1. the day the taxpayer has agreed to an amount as full compensation for the property taken or sold;[24]

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18 See J.G. Ware, "Involuntary Dispositions and the 1974 Budget," in *Report of Proceedings of the Twenty-Sixth Tax Conference*, 1974 Conference Report (Toronto: Canadian Tax Foundation, 1975), 542-54.

19 See, for example, the Expropriations Act, supra note 12, section 25(1).

20 Paragraph 44(2)(a) of the Act, and IT-271R, supra note 11, at paragraph 18.

21 [1968] SCR 12.

22 Draft amendments to the Act propose to change this period to the later of the end of the second taxation year following the final determination and 24 months after the end of the year in which the final determination took place. See Bill C-10, An Act To Amend the Income Tax Act, Including Amendments in Relation to Foreign Investment Entities and Non-Resident Trusts, and To Provide for the Bijural Expression of the Provisions of That Act, as passed by the House of Commons on October 29, 2007. The amendment is applicable to dispositions that occur in taxation years ending on or after December 20, 2000.

23 Paragraph 44(1)(c).

24 Paragraph 44(2)(a).

2. where a claim, suit, appeal, or other proceeding has gone before any tribunals or courts, the day on which the taxpayer's compensation for the property is finally determined by the tribunal or court;[25]
3. where a claim referred to in 2 above has not gone before a tribunal or court within two years of the loss, destruction, or taking of the property, the day that is two years following the day of the loss, destruction, or taking;[26]
4. the day on which the taxpayer dies or ceases to be a resident of Canada;[27] and
5. where the taxpayer is a corporation, other than certain subsidiary corporations, the time immediately before it is wound up.[28]

A taxpayer is deemed to own the property continuously until the date of disposition is determined.[29] Accordingly, the taxpayer can continue to claim CCA in respect of the property, provided that the taxpayer continues to use the property to earn business income.[30]

The decision in *Loukras v. MNR*[31] illustrates the timeline for the application of subsection 44(2). In *Loukras*, the following events had taken place:

- In March 1972, a notice of intention was registered by the government of Canada to expropriate the appellant's portion of a 100-acre farm in Pickering, Ontario.
- On April 24, 1973, a formal offer was made to the appellant for the property.
- On August 15, 1973, the appellant commenced an action in the Federal Court claiming compensation in respect of the expropriation of the property.
- The appellant received amounts, on various dates in 1973 and 1974, without prejudice to his right to appeal the quantum of the compensation.
- A judgment was signed on September 20, 1974.
- On October 17, 1974, the appellant filed a notice of appeal to the Federal Court of Appeal.
- On February 19, 1976, the appellant dropped the appeal.

The Tax Court of Canada held that partial advance payments arising from the expropriation were not taxable, pursuant to subsection 44(2), until the full amount

25 Paragraph 44(2)(b).

26 Paragraph 44(2)(c). It appears that a claim is considered to go before a tribunal or court when the jurisdiction of the tribunal or court is invoked. Under the Expropriations Act, the jurisdiction of the Ontario Municipal Board is invoked when a notice of arbitration for the determination of compensation by the board is served. See section 26(b) of the Expropriations Act, supra note 12, and *Marshall v. Ontario (MoT)* (2005), 87 LCR 177, at 179 (OMB).

27 Paragraph 44(2)(d) of the Act.

28 Paragraph 44(2)(e).

29 Subsection 44(2).

30 Paragraph 20(1)(a).

31 90 DTC 1557 (TCC).

of the compensation had been fully determined by the court before which the claim was brought. That date was determined to be September 20, 1974. A discontinued appeal did not affect the year of taxability. Had the appeal proceeded, and had the Federal Court of Appeal awarded a different amount of compensation than that contained in the initial judgment, the effective date would likely have been the date on which the appellate decision was rendered.

Replacement Property Requirements

Subsection 44(5) outlines what constitutes a replacement property.[32] A particular capital property qualifies as a replacement property for the taxpayer's former property if it meets all of the following conditions:

- It is reasonable to conclude that the new property was acquired by the taxpayer to replace her former property.[33]
- The new property was acquired by the taxpayer and the use of the property by the taxpayer (or a related person) is the same as or similar to the use of the former property.[34]
- Where the taxpayer (or a related person) used the former property for the purpose of gaining or producing income from a business, the taxpayer (or a related person) acquired the new property for the same purpose in the same or a similar business.[35]
- Where the former property was a taxable Canadian property of the taxpayer, the new property is also a taxable Canadian property of the taxpayer.[36]
- Where the former property was a taxable Canadian property of the taxpayer that was not treaty-protected, the new property is also a taxable Canadian property that is not treaty-protected.[37]

The CRA provides some guidance on its administrative interpretation of the replacement property rules in *Interpretation Bulletin* IT-259R4,[38] as discussed above.

Property Acquired To Replace the Former Property

With respect to the requirement that the new property was acquired to replace the former property (paragraph 44(5)(a)), IT-259R4 states, in part:

32 The parallel provision outlining the conditions necessary for the deferral of recapture is contained in subsection 13(4.1).

33 Paragraph 44(5)(a).

34 Paragraph 44(5)(a.1). "Related persons" is defined in subsection 251(2).

35 Paragraph 44(5)(b).

36 Paragraph 44(5)(c). "Taxable Canadian property" is defined in subsection 248(1).

37 Paragraph 44(5)(d). "Treaty-protected property" is defined in subsection 248(1).

38 Supra note 9.

> [T]here must be some correlation or direct substitution, that is, a causal relationship between the disposition of a former property and the acquisition of the new property or properties. Where it cannot readily be determined whether one property is actually being replaced by another, the newly acquired property will not be considered a replacement property for the former property. . . . Generally, the geographical location of the "replacement property" is not determinative when considering whether one property is a replacement for another.[39]

Same or Similar Use

IT259-R4 also provides guidance for determining whether the new property can be considered to have the same or a similar use as the former property (paragraph 44(5)(a.1)). To meet the requirements, the former property must have been "used." Thus, land that has never been used by the taxpayer (or a related person) cannot qualify as a former property. Land or any other capital property that is used for non-income-earning purposes (such as a personal-use cottage) can qualify as a replacement property provided that it replaces a property that was used by the taxpayer (or a related person) for the same or a similar purpose. Land that is acquired for the purpose of resale cannot qualify under paragraph 44(5)(a.1) because it is not considered to be a capital property for the purposes of section 44.[40]

The "use test" was adjudicated in *Depaoli et al. v. The Queen*,[41] where the taxpayers (Depaoli) owned 33.47 acres of vacant, unsevered land in Milton, Ontario. The property was expropriated, and Depaoli purchased two new properties in Caledon, Ontario. Each of the new properties consisted of approximately 10 acres of vacant, unsevered land.

Depaoli argued that he had purchased the former property with the intention to eventually build a house and operate a farm upon his retirement. Every year throughout his ownership of the property, he had arranged for local farmers to cultivate the land and plant and harvest crops. After the expropriation of the former property, Depaoli entered into the same farming arrangements for the two new properties. The court ruled that this arrangement passed the same or similar use test, and therefore the new properties were considered replacement properties.

IT-259R4 also notes that although a replacement property generally bears the same physical description as the former property (for example, land replaced by land or a building replaced by a building), there may be cases where a different type of property serves the same (or a similar) function or is applied to the same (or a similar) use as the former property.[42]

39 Ibid., at paragraph 15.

40 Ibid., at paragraph 16(a).

41 96 DTC 1820 (TCC); aff'd. 99 DTC 5727 (FCA).

42 IT-259R4, supra note 9, at paragraph 16(b).

Gaining or Producing Income from a Business

With respect to the requirement in paragraph 44(5)(b), where a taxpayer (or a related person) used the former property for the purpose of gaining or producing income from a business and the new property is used for the same purpose in the same or a similar business, the CRA will consider the new property to be a replacement property if it generally bears the same physical description as the former property. IT-259R4 provides the example of a business that replaces a warehouse with a manufacturing building. In the CRA's view, the manufacturing building qualifies as a replacement property "because both properties are buildings and the two uses are 'similar' in that they are both part of the overall process of providing products from the same or a similar business to the consumer."[43]

However, the same or similar use test is not outweighed by the same or similar business test. For example, a corporate automobile cannot replace a corporate building, even if they are both used in the same business. IT-259R4 also notes that a property normally cannot be a replacement property when it is acquired for the same or a similar use but also serves substantial other uses at the same time. An insignificant secondary use will not disqualify the new property.[44]

The CRA interprets the same or similar business test in a reasonably broad manner. It will consider two businesses to be similar if they both fall into one of the following categories, listed in IT-259R4:

(a) merchandising—retailing and wholesaling;
(b) farming;
(c) fishing;
(d) forestry and forest products;
(e) extractive industries, including refining;
(f) financial services;
(g) communications;
(h) transportation;
(i) construction, including subcontracting; and
(j) manufacturing and processing.[45]

Acquisition of the Replacement Property

The CRA states that for the replacement property provisions to apply in cases of expropriation, the property must be acquired after the taxpayer receives a notice of intention to expropriate the property under statutory authority and before the end of the two-year period after the disposition of the former property is considered to have taken place (see the discussion above).[46]

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43 Ibid., at paragraph 17.

44 Ibid.

45 Ibid., at paragraph 18.

46 Ibid., at paragraph 2(b).

A taxpayer can acquire a replacement property either before or after he disposes of his former property. Given the length of time that can elapse between a notice of intention and the actual disposition, it is common for a taxpayer to purchase a replacement property before he disposes of the former property. In order to qualify for the deferral rules, the taxpayer must be mindful not to dispose of the replacement property before the disposition of the former property; for the replacement provisions to apply, he must own the replacement property at the time he receives the proceeds for the former property.[47]

When the taxpayer does not acquire a replacement property until a subsequent year, he must report any recaptured CCA or taxable capital gains from the disposition on his income tax return. Once he acquires the replacement property, he may request a reassessment of his income tax return for the year of the disposition of the former property. In this way, he may generate a refund of the taxes he paid on the proceeds of disposition.[48] In order to alleviate the financial burden that may follow, the CRA may accept security in lieu of payment of taxes owing, until the final taxes are determined or the time for acquiring a replacement property lapses.[49]

Elections

Rules for a Valid Rollover Election

The replacement property and deferral rules do not apply automatically; a taxpayer must elect to use the rollover provisions.[50] The timing and nature of the election varies, depending on the circumstances of the disposition and the acquisition of replacement property.

There are three situations that determine how an election is made:

1. If the disposition and replacement take place in the same taxation year, the taxpayer's calculation of the recaptured CCA and capital gains on the income tax return for that year constitutes an election.[51]
2. Where a property is not replaced until a subsequent year, the election must take the form of a letter attached to the income tax return for the year in which the replacement property is acquired. The letter should include a description of both the former and the replacement properties, a request for an adjustment to the recapture of CCA and taxable capital gains previously reported, and a calculation of the revised recapture and taxable capital gains.[52]
3. Similarly, where the replacement property is acquired in a taxation year prior to the disposition of the former property, the election must take the form of

47 Subsection 44(1).

48 IT-259R4, supra note 9, at paragraph 3.

49 Ibid.

50 Subsections 44(1) and 13(4).

51 IT-259R4, supra note 9, at paragraph 7(a).

52 Ibid., at paragraph 7(b).

a letter attached to the income tax return for the year of acquisition of the replacement property, and the letter should include a description of both the former and the replacement properties.

If the taxpayer elects to roll over the proceeds and defer the capital gains on a depreciable property, an election is automatically applied to the corresponding recapture as well (and vice versa).[53] This ensures that the capital cost of the replacement property is consistent for the purposes of both the CCA and capital gains provisions of the Act.

The election is an essential component of the replacement property deferral. The CRA will accept late-filed elections in certain circumstances.[54] The CRA's guidelines for accepting late, amended, or revoked elections are outlined in *Information Circular* 07-1.[55] In 2004, the legislation was amended to add a 10-year limitation period for applications made after 2004.[56] If the taxpayer late-files the replacement property election, it will still be accepted, provided that it is filed with the income tax return for the year in which the former property is disposed of.[57]

Elections for Capital Losses

Because the rollover provisions are elective, a taxpayer can choose not to apply them when she incurs other capital or non-capital losses that would not otherwise be absorbed. In certain circumstances, not using the rollover provisions can be beneficial, since the taxpayer can recognize the losses immediately.

DETERMINING TAXATION

Once a taxpayer receives compensation for a property that has been expropriated, the next step is to determine how that compensation is to be treated for tax purposes—in the current year if the proceeds cannot be rolled over, or in a later year if they can.

A taxpayer may receive various components of compensation when his property is expropriated. In Ontario (and other provinces with similar legislation), various heads of compensation are itemized.[58] The Expropriations Act divides compensation into the following heads of damages:

- market value for the land acquired;[59]
- injurious affection to the remaining lands;[60]

53 Subsection 44(4).

54 Subsection 220(3.2) and regulation 600.

55 *Information Circular* 07-1, "Taxpayer Relief Provisions," May 31, 2007, paragraphs 45-63.

56 Paragraph 220(3.2)(b).

57 IT-259R4, supra note 9, at paragraph 7(c).

58 Expropriations Act, supra note 12, section 13(2).

59 Ibid., section 13(2)(a).

60 Ibid., section 13(2)(c).

- disturbance damages, including business losses, relocation expenses, and other areas of compensation to make the owner whole;[61]
- special difficulties in relocating;[62]
- interest on compensation outstanding, including additional interest when appropriate;[63] and
- reimbursement of reasonable legal, appraisal, and other costs incurred by the owner in the determination of compensation.[64]

In some cases, the quantification of market value and injurious affection is blended using the before and after approach.[65]

How the compensation is characterized can have important consequences for income tax purposes. Each category has a varying degree of taxability. On the basis of income tax postulations, an award from expropriation can fall under one or more of the following categories:

- a receipt on account of income (which is ordinarily taxed as income);
- a receipt resulting from the disposition of capital property (which is ordinarily taxed as a capital gain);[66]
- a non-taxable receipt;
- an eligible capital amount, or goodwill (which is taxed similarly to capital gains);[67] and
- reimbursement of expenses (which is presumed to have no tax effect).

It is not uncommon for awards of compensation from expropriation to fall into multiple categories. Often, there is no clear answer as to which category a particular receipt falls into. Individual results vary according to the facts and circumstances of the particular case. Consequently, it is important to examine jurisprudence in this area for guidance on the taxability of a particular receipt.

Income Versus Capital

The first step in establishing the tax treatment of a particular receipt is to determine whether the property to which the receipt relates is a capital asset or held on account of income. A property is considered to be held on account of income if it is held for

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61 Ibid., sections 13(2)(b) and 19.

62 Ibid., section 13(2)(d).

63 Ibid., sections 33(1) and 33(4).

64 Ibid., section 32(1).

65 Ibid., section 14(3).

66 The tax treatment of capital gains is governed by section 39 of the Act. Currently (September 2008), 50 percent of the net gain is included in income.

67 The tax treatment of the disposition of goodwill and other eligible capital amounts is governed by section 14 of the Act. Currently, the disposition of goodwill is effectively taxed at the same rate as capital gains—that is, 50 percent of the net proceeds is included in income.

the purpose of resale and the taxpayer can be considered to be "in the business" of selling it (or, put differently, if the taxpayer acquired the property as an adventure in the nature of trade). When a taxpayer disposes of property held on account of income and realizes a gain, the gain is not treated as capital, but taxed as ordinary income.

The same applies in the case of expropriated property: a capital gain does not apply if the property was held for resale. It is the underlying use of the property that determines the tax treatment, not the manner of its disposition. The Federal Court of Appeal supported this notion in *Bellingham v. The Queen*.[68] It held that since the taxpayer's property was acquired as an adventure in the nature of trade, any profit on the disposition was taxable on account of income, whether the property was disposed of by sale or by expropriation. The judge stated that nowhere does the Act deem a disposition by way of expropriation to be eligible for treatment as a capital property.[69] Given that the taxpayer in *Bellingham* admitted that the property was acquired in the course of an adventure in the nature of trade, and filed her return reporting the proceeds as derived therefrom, the proceeds of disposition were taxable as income and not treated as a capital gain.

Business Losses and Other Related Expenses

Usually, compensation for business losses and other related expenses is treated on account of income. If the award is a reimbursement for current expenses, it is likely taxable as income, but presumably offset when the actual expenditure takes place. In the case of an expropriation, a business loss is intended to replace taxable income that would have been enjoyed but for the expropriation. Generally, the compensation would be taxed on account of income; however, in certain instances, courts have come to a different conclusion. Specifically, where the business losses could be interpreted as "permanent," they appear to have been treated as capital. Examples of this characterization occur in the decisions in *Sani Sport Inc. v. The Queen*[70] and *Farrell et al. v. MNR*.[71]

In *Sani Sport*, the taxpayer owned and operated a sport centre in Quebec. The company intended to use part of its land to build a tennis court. However, Hydro Quebec expropriated part of that land and settled for a payment of $350,000, which included $286,000 for permanent business losses. The court ruled that the indemnity paid on the expropriation was a whole amount that could not be split into various headings.[72] Because the compensation was considered a unitary sum, the full amount was treated as capital.

68 96 DTC 6075 (FCA).

69 Ibid., at 6078.

70 90 DTC 6230 (FCA).

71 85 DTC 706 (TCC).

72 Quebec does not have legislation similar to Ontario's Expropriations Act, which breaks down compensation into distinct heads of damages.

In *Farrell*, the taxpayer owned a parcel of land for which he entered into gravel removal contracts. Ontario Hydro expropriated the land and compensated the owner for "granular deposits" on the basis of the revenue that he expected to derive from the sale of gravel. The court ruled that the payment for the business loss was to be treated as a capital gain. Tremblay J, writing for the court, stated that determining compensation on the basis of anticipated revenues was merely a yardstick in calculating the value of the property, and did not change the capital nature of the receipt.[73]

Interest

Ordinary Interest

Ordinary interest paid on an award is not included in the definition of "proceeds of disposition" and is taxed separately.[74] The rationale for this treatment can be found in the comments of Weston J in *The Queen v. Elliott*, where the Federal Court Trial Division, on an appeal from the Tax Court of Canada, concluded that the interest on compensation arose not from the disposition of property, but from a delay in the payment of a capital sum.[75] Accordingly, the interest element of an expropriation award should properly be characterized as "interest" and taxed as such.

It should also be noted that the portion of proceeds from an expropriation that is considered to be interest cannot be rolled into a new property, and the tax, if applicable, cannot be deferred to a later date.

Additional Interest

Additional interest—interest that exceeds a statutorily prescribed rate[76]—is treated differently than ordinary interest. The *Bellingham* decision noted this distinction. In that decision, the taxpayer received expropriation proceeds as follows:

- $377,015 as compensation for the property lost;
- $181,319 as ordinary interest; and
- $114,272 as "additional interest."

The amounts awarded for property lost and ordinary interest were treated as business and interest income, respectively. However, the Federal Court of Appeal held that additional interest does not constitute compensation for lands previously taken, nor does it compensate for the loss or use of money; rather, in the court's view, the additional interest was tantamount to an award of punitive damages.[77]

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73 *Farrell*, supra note 71, at 717.

74 Paragraph 12(1)(c). See *Wideman v. MNR*, 83 DTC 531 (TCC); *The Queen v. Shaw*, 93 DTC 5121 (FCA); *The Queen v. Elliott*, 96 DTC 6189 (FCTD); and *Bellingham*, supra note 68.

75 *Elliott*, supra note 74, at 15.

76 In Ontario, "additional interest" refers to interest in excess of 6 percent per annum, awarded pursuant to section 33(4) of the Expropriations Act.

77 Supra note 68, at 6083.

The court concluded:

> [T]he source of the additional interest award is not the expropriating authority. That body is merely the payor. The true source of the award is the *Expropriation Act* which dictates as a matter of public policy, that expropriating authorities are obligated to pay a penal sum in circumstances where their behaviour falls below a prescribed standard.[78]

The award did not flow from an agreement between the two parties, and there was no element of bargain or exchange. Since additional interest (like other forms of exemplary damages) is meant to punish the wrongdoer and not compensate the victim, the court concluded that the award was a non-taxable windfall.[79]

Eligible Capital Property[80]

Eligible capital property of a business is broadly described as intangible capital property, such as goodwill and other "nothings."[81] Goodwill is the value of a business as a going concern that exceeds the stand-alone value of the assets of the business. Goodwill may include any of the following:

(i) reputation,
(ii) services of employees,
(iii) favourable commercial contracts,
(iv) trademarks or trade names,
(v) favourable financial relationships,
(vi) management performance record, and
(vii) non-competition provisions.[82]

A common instance of the disposition of goodwill occurs when a business is sold. Normally, the sale of the goodwill is a disposition of eligible capital property and taxed similarly to a capital gain.[83] In *The Queen v. Toronto Refiners and Smelters Limited*,[84] this issue was examined with different results.

Toronto Refiners and Smelters ("TRS") carried on a business of lead refining. When its property was expropriated by the city of Toronto ("the city"), the company was unable to relocate. TRS ceased carrying on business and disposed of all its business assets to the expropriating authority. The city paid a total of $12 million in

78 Ibid., at 6082.

79 Ibid.

80 Replacement property rules applicable to eligible capital property are found in section 14 of the Act.

81 *Interpretation Bulletin* IT-386R, "Eligible Capital Amounts," October 30, 1992, paragraph 1.

82 Ibid., at paragraph 2(b).

83 Subsection 14(1).

84 2003 DTC 5001 (FCA).

compensation to TRS, broken down as follows: $2.9 million for the land, $100,000 for the building, and $9 million because the business could not relocate.[85]

TRS treated the $9 million as damages, a non-taxable receipt. However, on reassessment, the minister determined that the $9 million represented proceeds from the sale of goodwill—not compensation for damages—and therefore constituted proceeds from the disposition of eligible capital property. As a result, TRS was liable for tax on those proceeds similar to the tax on a capital gain.

The Federal Court of Appeal rejected the minister's assessment and decided in favour of TRS. The court found that the $9 million award was based on section 19(2) of the Expropriations Act (Ontario), which outlines compensation for the destruction of the goodwill of a business that is terminated as a result of an expropriation and cannot relocate.[86] The court took the view that because the city acquired the land for civic, and not business, purposes, it did not pay the $9 million to purchase the goodwill of the business.[87] Rather, that payment amounted to damages to compensate TRS for the cessation of its operations. Therefore, the $9 million was not a deductible expenditure by the purchaser. The court then applied a "mirror image" test based on subsection 14(1): if the $9 million was not an eligible capital expenditure for the purchaser, it could not be an eligible capital receipt for the seller.[88]

In light of these interpretations, the $9 million was treated as damages—a non-taxable windfall for TRS.

In what may well be a response to this decision, the Act was amended by the second 2006 budget implementation bill.[89] This amendment varied the description of "E" in the definition of "cumulative eligible capital" in subsection 14(5) to override the previous mirror image test. This in effect changed the implications of receiving compensation for loss of goodwill as a non-taxable receipt.

OTHER ISSUES

Non-Residents

This article focuses on issues of concern to Canadian residents who dispose of property involuntarily. In cases where the owner is a non-resident, other complications arise. If taxable Canadian property is disposed of, the non-resident will likely have to pay Canadian tax and file a Canadian income tax return.[90] The non-resident must apply for a certificate from the minister in respect of the disposition of the property within 10 days of the date of disposal, whether or not she incurs a tax liability on the disposition.[91] In addition, 25 percent of the gross proceeds from the disposition of

85 Ibid., at paragraph 3.

86 Ibid., at paragraph 13.

87 Ibid., at paragraph 23.

88 Ibid., at paragraph 20.

89 Budget Implementation Act, 2006, No. 2, SC 2007, c. 2, section 3(6).

90 Paragraphs 2(3)(c), 150(1)(a), and 150(1.1)(b) of the Act.

91 Subsection 116(3).

a capital property will be withheld (50 percent for depreciable property),[92] unless the non-resident applies to the minister for a reduction in a timely manner.[93]

Part XIII withholding tax may also apply on interest payments received by a non-resident taxpayer. The rate for this withholding is 25 percent unless it is reduced through an income tax treaty with the particular country.[94]

Principal Residence

If the expropriated property, or a portion of it, is considered to be the taxpayer's principal residence, he may be able to elect to treat the proceeds, or the portion of the proceeds relating to the principal residence, as tax-free, if certain conditions are met.[95]

Easements

Generally, when a property owner grants an easement or a public right of way, she is disposing of a portion of her property. She must allocate a reasonable portion of the adjusted cost base of the whole property to the disposition.[96]

In the CRA's view, if no more than 20 percent of the total area is expropriated, or an easement is granted, and the amount of the compensation received is not more than 20 percent of the amount of the adjusted cost base of the property, then the adjusted cost base can be calculated as being equal to the compensation received.[97] Consequently, no tax will be payable.

Professional Fees

In the course of negotiating a settlement, a taxpayer can incur substantial legal, accounting, appraisal, and other expert fees. The rules for the tax treatment and deductibility of these fees parallel those that apply to the underlying compensation. Reimbursement of all or a portion of these fees by the expropriating authority also affects their tax treatment and deductibility; under normal circumstances, fees recovered from an authority offset the expenditure.

Fees relating to items that are income receipts are ordinarily deductible. Professional fees relating to capital elements are generally not deductible; instead, they are treated as an outlay or expense for the purpose of disposing of a property. As such, they are taken into account, so that any capital gain, loss, recapture, terminal loss, or business investment loss must be adjusted as well.[98]

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92 Subsection 116(5).

93 Subsection 116(5.2).

94 Paragraph 212(1)(b).

95 Paragraph 40(2)(b). For a detailed discussion of the principal residence exemption, see *Interpretation Bulletin* IT-120R6, "Principal Residence," July 17, 2003.

96 *Interpretation Bulletin* IT-264R, "Part Dispositions," December 29, 1980, paragraph 2.

97 Ibid.

98 *Interpretation Bulletin* IT-99R5 (Consolidated), "Legal and Accounting Fees," paragraph 14.

Professional fees relating to a tax-free item of compensation are generally not deductible either on account of income or on account of capital.

Voluntary Dispositions

The Act also contains provisions for rolling over proceeds into a replacement property when a voluntary disposition occurs in the context of expropriation. For example, a taxpayer may sell his property to a third party while the property is subject to a formal expropriation, or the threat of one. In these circumstances, the disposition will not fall within paragraph 44(1)(a), but it may qualify for a rollover under other provisions of section 44.

There are two significant differences in the rules that apply to a voluntary disposition as compared with those for an involuntary disposition:

1. The property disposed of must be a "former business property" of the taxpayer.[99] A former business property is a capital property that the taxpayer used primarily for the purpose of gaining business income. It must be a real property, and the definition generally does not include a rental property.
2. In order to be eligible for the deferral, the taxpayer must acquire the replacement property before the end of the first (rather than the second) taxation year that follows the year of disposition.[100]

TREATMENT OF TAXATION IN DETERMINING COMPENSATION

Awards of compensation for business losses are normally based on the income stream of a business that is terminated or adversely affected by an expropriation. Under the income capitalization approach to valuation, the income stream of a property is often a component of the determination of market value as well. For these purposes, the determination of compensation under Ontario's Expropriations Act must be based on an income stream (or projected income stream) that is, or would normally be, subject to taxation. The effect of taxation may also be considered when a decision maker must determine the sum of compensation that is required to make an expropriated owner truly whole.

The Ontario Divisional Court dealt with the treatment of taxation of an income stream forming the foundation of a business loss claim in the decision of *City Parking Ltd. v. City of Toronto*.[101] In that decision, the claimant had a leasehold interest in a parking lot and advanced a claim for a business loss based on the loss of income in the remaining years of the lease. The Land Compensation Board, in determining the business loss, set compensation on the basis of the after-tax income stream of the parking lot.

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99 Paragraph 44(1)(b), and the definition of "former business property" in subsection 248(1). See also *Interpretation Bulletin* IT-491, "Former Business Property," September 3, 1982.

100 Paragraph 44(1)(d).

101 (1980), 20 LCR 159 (Ont. Div. Ct.).

The claimant appealed the decision, submitting that the board's consideration of taxation amounted to double taxation. This occurred because taxation reduced the income stream upon which the determination of compensation was based, and the award of compensation would also be taxed as income.[102]

Cory J (later a justice of the Supreme Court of Canada), writing for the Divisional Court, distinguished this matter from earlier decisions concerning taxation in expropriation awards, which were based on the "value to owner approach" as opposed to the modern approach under the Expropriations Act.[103] He then found that the Land Compensation Board's consideration of the after-tax income stream was in error and amounted to a double penalty, and possibly double taxation. In providing his reasons for this decision, Cory J stated:

> The compensation does no more than replace those profits and is therefore income in the hands of the company. If the estimated tax is deducted from the compensation award and such net amount paid to the company, it still must pay tax on the sum received and is thus subject to a double penalty, if not double taxation. No matter where the onus may lie to establish that income tax would be payable in this case, it would appear that the evidence is very clear that the company would be taxable upon the compensation received and will indeed pay tax on the amount received.[104]

The Divisional Court held that the effect of taxation on an income stream ought not to be considered when the ultimate proceeds of compensation are taxable in a like manner. As noted in the passage above, a decision maker requires evidence of the ultimate taxation of compensation in order to support a conclusion of double penalty.

The decision of the British Columbia Court of Appeal in *British Columbia v. MacMillan Bloedel Ltd.*[105] distinguished the *City Parking* decision. *MacMillan Bloedel* involved a similar issue, but in this case, the Expropriation Compensation Board did not have before it evidence that the deduction of income tax would subject the expropriated owner to an income tax penalty. Accordingly, the Court of Appeal permitted the deduction of tax from the income stream of the property in the determination of compensation.[106] Thus, in situations where portions of awards for compensation are not subject to income tax,[107] the basis for the court's holding in *City Parking* may be brought into question.

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102 Ibid., at 160.

103 See, for example, *Florence Realty Company Limited et al. v. The Queen*, [1968] SCR 42. In this decision, the Supreme Court of Canada determined that it is appropriate to deduct income tax from the income stream forming the value to an owner of an asset. In support of this holding, Spence J stated (ibid., at 52) that a prudent owner would calculate the benefit from the expropriated asset on the basis of its after-tax contribution to profit.

104 Supra note 103, at 163.

105 (1995), 56 LCR 81 (BCCA).

106 Ibid., at paragraphs 52-53.

107 See, for example, *Toronto Refiners and Smelters Limited*, supra note 84.

Despite such distinctions, the Ontario Municipal Board has recently accepted that "it was settled in law for more than 20 years that income tax is not to be deducted from awards made under the *Expropriations Act*."[108] It therefore appears that, under the Ontario Expropriations Act and in other jurisdictions that have similar legislation, no deduction in respect of income taxes is to be made in the determination of an award of compensation when the award itself is subject to taxation.

Compensation awarded following an expropriation is not to be increased in order to reimburse the owner for taxes that the owner must pay on the award of compensation.[109] It appears that the policy basis for this treatment is that the Act is presumed to treat expropriated owners fairly in instances where they receive compensation for capital property.

REIMBURSEMENT FOR TAX ADVICE

One of the fundamental policies of compensation under Ontario's Expropriations Act is to ensure that an expropriated owner is left whole and is not prejudiced as a result of the public need to acquire the owner's property.[110] The Expropriations Act endeavours to achieve this goal by providing compensation for all elements of the loss arising from an expropriation.[111]

Certain claims have been advanced where owners seek the recovery of their costs for tax advice pursuant to section 32 of the Expropriations Act. Section 32 addresses the recovery of reasonable legal, appraisal, and other costs from the expropriating authority incurred by the owner "for the determination of compensation." Accordingly, in instances where recovery was sought pursuant to section 32 and the costs incurred were not for the determination of compensation, expropriated owners have been unsuccessful in recovering the cost of an accountant's advice on tax matters, or costs for the preparation of tax filings necessitated by the expropriation.[112] In the event that tax advice is required principally for the purpose of advancing a claim for compensation, the cost of the advice may be recoverable pursuant to section 32 of the Expropriations Act.

An owner's costs for tax advice or the preparation of tax documents appear to be recoverable in cases where the owner is forced to incur out-of-pocket expenses for tax advice as a result of an expropriation. This recovery would be made pursuant to section 13(2)(b) of the Expropriations Act (disturbance damages) and section 18(1)

108 *Gadzala v. Toronto (City)* (2004), 84 LCR 176, at 238 (OMB); aff'd. in part (2006), 89 LCR 81 (Ont. Div. Ct.), and specifically affirmed on tax treatment, ibid., at 115.

109 See *Hebron Investments Ltd. v. Scarborough Bd. of Ed.* (1972), 3 LCR 356 (Ont. LCB); and *Loukras et al. v. The Queen* (1974), 7 LCR 240, at 273 (FCTD).

110 Ontario, *Royal Commission Inquiry into Civil Rights—Report*, vol. 3 (Toronto: Queen's Printer, 1968), 11; and *Toronto Area Transit Operating Authority v. Dell Holdings Ltd.*, [1997] 1 SCR 32, at 43.

111 Expropriations Act, supra note 12, sections 13, 32, and 33.

112 Jeffrey J. Wilker, "Reimbursement of the Claimant's Costs: Section 32 of the Expropriations Act," paper presented at the 1997 fall conference of the Ontario Expropriation Association.

(reasonable costs that are the natural and reasonable consequence of the expropriation). Under the flexible approach to damages advocated in *Dell Holdings*, section 13(2)(b) and section 18 are broad enough to encompass any reasonable loss to the owner occurring as a result of the expropriation, provided that compensation for such loss is not otherwise awarded under the Expropriations Act.[113]

Awards for disturbance damages have included awards for the payment of professional fees that were incurred as a consequence of an expropriation.[114] Moreover, awards have been given for other fees that the owner was forced to incur as a result of the expropriation, such as land transfer tax on the purchase of a replacement property.[115] If an owner is forced to incur out-of-pocket costs relating to tax advice as a result of the expropriation, those costs will constitute disturbance damages for which compensation is payable.

It is incumbent on the owner to demonstrate that the cost is reasonable, and that it was a natural and reasonable consequence of the expropriation.[116] In instances where the cost of tax advice would have been incurred at a later date and the expropriation has accelerated the requirement for this expense, the provision of full compensation for the tax advice remains in question. In the majority of cases, however, specific tax advice is required for the expropriation, and this expense would constitute compensable disturbance damages.

CONCLUSION

As evidenced by the discussion above, the Income Tax Act, much like the Expropriations Act, endeavours to avoid punishing an owner/taxpayer simply because her property was expropriated. An expropriation should not accelerate an owner's tax burden, because it is an involuntary event. An immediate tax liability would only serve to punish an expropriated owner for the acquisition of her property for the public good.

In order to ensure that expropriated owners receive fair tax treatment, the Income Tax Act has put in place provisions to allow the deferral of tax on awards of compensation, where certain condition are met. In addition, current expropriations legislation and jurisprudence will determine the appropriate taxation of any proceeds received from an expropriating authority, whether as "income," "capital," or a "windfall." Given the complexity of this matter, it is important for an owner to discuss the tax implications of an expropriation with a professional who is familiar with the provisions of the Income Tax Act that may apply to awards of compensation.

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113 *Dell Holdings*, supra note 110; and *Lafleche v. Ministry of Transportation and Communications* (1975), 8 LCR 77, at 85 (Ont. Div. Ct.).

114 See, for example, *Ridgeport Developments v. Metro-Toronto Conserv. Authority* (1976), 11 LCR 143, at 156 (Ont. LCB); and *Liebovitch v. City of Vanier* (1975), 8 LCR 109, at 111 (Ont. LCB).

115 *Gorczyca v. Ontario (MTC)* (1988), 41 LCR 39, at 49 (OMB).

116 *Gerencer v. The Queen* (1977), 12 LCR 97, at 111 (FCTD); and Eric C.E. Todd, *The Law of Expropriation and Compensation in Canada*, 2d ed. (Toronto: Carswell, 1992), 560.