Surrogatum, Source, and Tsiaprailis: Is There a Principled Basis for the Tax Treatment of Replacement Payments?

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PRÉCIS

L'arrêt *Tsiaprailis c. Sa Majesté la Reine* soulève de nombreuses questions au sujet des restrictions adéquates de la loi relativement à l'imposition des paiements de remplacement tant du point de vue théorique que de celui de la politique. Dans cet arrêt, le principe de la substitution a, pour la première fois, été élargi au-delà des paiements de remplacement du revenu d'entreprise ou de bien ou du produit de disposition d'une immobilisation utilisée dans un contexte commercial. Cet article examine quelles auraient été les conséquences de ce jugement, s'il avait été prononcé en 1975 plutôt qu'en 2005, à partir de deux types de versements d'indemnités que les tribunaux excluaient auparavant de l'imposition, à savoir les dommages-intérêts pour congédiement injustifié et les paiements pour options d'achat d'actions annulées (qui sont dorénavant imposés à la suite de changements subséquents apportés à la Loi de l'impôt sur le revenu). L'auteur évalue si, dans le futur, l'arrêt *Tsiaprailis* entraînera des changements dans l'imposition des indemnités de grève et des dommages-intérêts pour préjudice corporel ou violation des droits de la personne. Les conséquences politiques de l'élargissement du principe de la substitution à de nouveaux domaines sont examinées ainsi que les arrêts postérieurs à *Tsiaprailis* qui ont appliqué la règle de façon nouvelle.

ABSTRACT

The decision of the Supreme Court of Canada in *Tsiaprailis v. The Queen* raises numerous questions regarding the proper limits of the law pertaining to the taxation of replacement payments from both doctrinal and policy perspectives. In that decision, the surrogatum principle was, for the first time, clearly extended beyond payments that replace business or property income or proceeds of disposition of a capital property used in a commercial context. This article examines what the implications might have been if *Tsiaprailis* had been decided in 1975 instead of 2005, by looking back at two types of compensation

* Of the Faculty of Law, University of Victoria. I am grateful for the research assistance of Sanjeev Parmar, LLB student at the University of Victoria, whose participation was generously supported by the Fraser Milner Casgrain LLP Research Fellowship for 2005. I would also like to thank Michelle Suchow, and participants in the 2006 Deloitte Tax Policy Research Symposium for their very helpful comments.

payment that the courts formerly excluded from taxation: wrongful dismissal damages and payments for cancelled stock options (which are now taxed under subsequent amendments to the Income Tax Act). Looking to the future, the article considers whether *Tsiaprailis* will lead to changes in the taxation of strike pay and damages for personal injury or human rights violations. The policy implications of extending the surrogatum rule into new areas are assessed, together with the post-*Tsiaprailis* cases that have applied the rule in new ways.

KEYWORDS: AWARDS ■ DAMAGES ■ COMPENSATION ■ PAYMENTS ■ TAXATION ■ INSURANCE

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INTRODUCTION

The 2005 decision of the Supreme Court of Canada in *Tsiaprailis v. The Queen*[1] resolves a small but vexed issue with respect to the taxation of settlements of claims for employer-provided disability insurance benefits. However, the decision also represents a novel application of the "surrogatum" principle, a longstanding method

1 2005 DTC 5119 (SCC).

of determining the tax treatment of awards of damages and payments made in settlement of claims for damages in commercial contexts. This article seeks to gauge the extent to which *Tsiaprailis* represents a significant development in the general law of taxation of damages and settlements. Although it is too early to draw firm conclusions about the effects of the Supreme Court's ruling, the case provides an opportunity to re-examine past and current law on the taxation of such payments in non-business cases and to propose a more consistent approach, founded on clearly stated policy grounds. In particular, the issue of whether the *Tsiaprailis* decision will lead to greater equity and neutrality, or could instead undermine these values, is a central theme.

THE TSIAPRAILIS DECISION

In *Tsiaprailis*, the issue was the appropriate income tax treatment of an amount received in settlement of a claim for benefits under a disability insurance plan provided by the taxpayer's former employer. Paragraph 6(1)(f) of the Income Tax Act[2] includes in a taxpayer's income from employment amounts payable on a periodic basis in respect of the loss of all or any part of the taxpayer's income from employment, pursuant to a sickness or accident insurance plan or a disability insurance plan. Accordingly, when an employee or former employee receives periodic benefits under such a plan, those amounts are taxable as a benefit of employment, after deducting any contributions of the employee to the insurance coverage.

The issue, which arose in a long series of tax appeals before it was resolved in *Tsiaprailis*,[3] was how to treat a lump-sum payment received by an employee from an insurer in settlement of a claim for benefits under a disability insurance plan. Was the lump sum, or any part of it, taxable as an amount "payable on a periodic basis," and if so, was it paid "pursuant to a disability insurance plan"? Further, if the settlement proceeds were not taxable under paragraph 6(1)(f), could they be taxed under paragraph 6(1)(a), the general provision including benefits of employment in income?[4]

When the *Tsiaprailis* case reached the Supreme Court, the only portion of the settlement amount that the Crown was still seeking to tax was the arrears of monthly benefits up to the date of the settlement. The taxpayer no longer disputed that this amount, though *paid* in a lump sum, was *payable* on a periodic basis.[5] The issue was

2 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.

3 See, for example, *Peel v. MNR*, 87 DTC 268 (TCC); *Landry v. The Queen*, 98 DTC 1416 (TCC); *Dumas v. The Queen*, 2000 DTC 2603 (TCC); *Whitehouse v. The Queen*, 2000 DTC 1616 (TCC); *The Queen v. Siftar*, 2003 DTC 5243 (FCA); rev'g. in part 2001 DTC 938 (TCC); *Fry v. The Queen*, 2001 DTC 846 (TCC); and *Johnson Estate v. The Queen*, 2002 DTC 1535 (TCC).

4 Subparagraph 6(1)(a)(i) expressly excludes from an employee's income amounts derived from the employer's contribution to a group sickness or accident insurance plan or a private health services plan, but does not exclude lump-sum benefits under a disability insurance plan.

5 The Federal Court of Appeal in *The Queen v. Tsiaprailis*, 2003 DTC 5246, at paragraphs 19-25, followed *The Queen v. Sills*, 85 DTC 5096 (FCA). In *Sills*, the court held that arrears of periodic spousal support, though paid in the form of a series of irregular lump sums, were nevertheless

whether that portion was paid pursuant to the disability insurance plan or pursuant to the settlement agreement between the taxpayer and the insurer.

In the decision, the Supreme Court split 4-3, with the reasons of the majority evidently being written in response to the dissenting reasons. The majority (Charron J, with Bastarache, Binnie, and Deschamps JJ concurring) saw the resolution of these issues as clearcut. On the basis of the statement of facts agreed between the taxpayer and the minister of national revenue, the lump-sum settlement received by Ms. Tsiaprailis was composed of the following amounts: (1) a sum equal to the monthly payments in arrears to the date of the settlement, including pre-judgment interest; (2) an amount equal to the actuarial current value, at the date of settlement, of future monthly payments to which Ms. Tsiaprailis would have been entitled up to the age of 65, discounted by 25 percent for contingencies;[6] and (3) an additional amount as compensation for legal costs, disbursements, and goods and services tax (GST).

Both the majority and the dissenting reasons described settlement payments and awards of damages as "inherently neutral," in the sense that they have no particular tax character of their own, and stated that their treatment for tax purposes must be determined by an assessment of the character of the payments in the context in which they were paid and received. The majority applied the surrogatum principle,[7] holding that the factual issue to be determined is the nature and purpose of the payment. A two-part test was formulated in the judgment:

> The determinative questions are: (1) what was the payment intended to replace? And, if the answer to that question is sufficiently clear, (2) would the replaced amount have been taxable in the recipient's hands?[8]

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payable on a periodic basis. The court also held that the lump-sum payments were made *pursuant to* the separation agreement, so that they were taxable under paragraph 56(1)(b) (as it read in respect of the relevant tax year).

6 In calculating a settlement amount for the loss of future payments, the parties obtained actuarial evidence of the present value of the total of all amounts that would have been received in the future, and then applied a discount reflecting such contingencies as the claimant dying before the age of 65, or the possibility that she would have otherwise ceased to be entitled to ongoing disability benefits before the age of 65.

7 In Canadian judgments, the surrogatum principle is usually referenced to the words of Diplock LJ in *London and Thames Haven Oil v. Attwooll*, [1967] 2 All ER 124, at 134 (CA): "I start by formulating what I believe to be the relevant rule. Where, pursuant to a legal right, a trader receives from another person compensation for the trader's failure to receive a sum of money which, if it had been received, would have been credited to the amount of profits (if any) arising in any year from the trade carried on by him at the time when the compensation is so received, the compensation is to be treated for income tax purposes in the same way as that sum of money would have been treated if it had been received instead of the compensation. The rule is applicable whatever the source of the legal right of the trader to recover the compensation. It may arise from a primary obligation under a contract, such as a contract of insurance; from a secondary obligation arising out of non-performance of a contract, such as a right to damages, either liquidated, as under the demurrage clause in a charterparty, or unliquidated; from an obligation to pay damages for tort, as in the present case; from a statutory obligation; or in any other way in which legal obligations arise."

8 Supra note 1, at paragraph 15.

Citing the majority in the Federal Court of Appeal, Charron J agreed that

> Ms. Tsiaprailis cannot assert the insurer's liability under the policy in her action, recover an amount from the insurer in that action, and then argue that the payment does not flow from the obligations of the insurer under the policy.[9]

Thus, the portion of the settlement representing arrears of periodic disability benefit payments was paid *pursuant to* the disability insurance plan. To conclude otherwise, said Charron J, "is to render the *surrogatum* principle meaningless."[10]

The dissenting judgment of Abella J (with which Major and LeBel JJ concurred) characterized the lump sum as an amount paid, not pursuant to the disability insurance plan, but pursuant to the settlement agreement, and for the purpose of obtaining a release from all liability under the plan. The dissent accorded great importance to the fact that in the settlement agreement the insurance company denied liability. The dissenting judges doubted the correctness of applying the surrogatum principle in the circumstances of the case, without specifying why, and held that, even if applicable, surrogatum did not lead to the conclusion that any part of the lump sum received by the taxpayer was a replacement for an amount payable "pursuant to" the plan, in the sense of "in accordance with" or "in compliance with" the plan. The entire lump sum was paid to settle a court action in which liability under the plan was disputed. The agreed statement of facts notwithstanding, Abella J found that in the parties' negotiations leading up to the settlement, the amounts to which Ms. Tsiaprailis felt she was entitled under the policy were used merely "as a way to gauge as to the reasonableness of any compromise."[11] Thus, no portion of the settlement amount could be characterized as a replacement of an amount payable under the policy.

Although, by the time the case reached the Supreme Court of Canada, the taxation of the portion of the lump-sum settlement that compensated Ms. Tsiaprailis for plan benefits for the post-settlement period was no longer at issue, the majority reasons treat this amount as not being subject to tax under paragraph 6(1)(f), because there was no obligation to make such a payment under the terms of the plan. This portion of the settlement amount is characterized as being "in the nature of a capital payment," and the issue of whether it is subject to taxation under the capital gains provisions of the Act is not addressed in the judgment.[12]

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9 Supra note 5, at paragraph 23, quoted by Charron J, supra note 1, at paragraph 14.

10 Supra note 1, at paragraph 16.

11 Ibid., at paragraph 55.

12 There is no indication in the *Tsiaprailis* reasons as to whether the capital portion is to be considered proceeds of disposition of a capital asset, or how the adjusted cost base of the asset disposed of is to be determined. The Canada Revenue Agency (CRA) states that where the lump sum is paid in lieu of future long-term disability benefits "in circumstances such that the payment can reasonably be considered to be proceeds of disposition of an interest in an insurance policy," the proceeds are not taxable as a capital gain pursuant to subparagraph 39(1)(a)(iii): CRA document no. 2005-0160551E5, April 7, 2006. See also CRA document no. 2005-0141511E5, September 13, 2005.

It is questionable whether the surrogatum principle had any relevance to the outcome in *Tsiaprailis*.[13] It was arguably not necessary to apply the surrogatum rule to the arrears portion of the settlement in order to find that it should be viewed as equivalent to amounts payable on a periodic basis pursuant to the plan. The court could have simply followed a well-established line of cases, exemplified by *Sills*,[14] on the taxation of spousal and child support payments, relying on almost identical language in paragraph 6(1)(f) and former paragraph 56(1)(b).[15] In those cases, the lump-sum arrears of support payments were included in the income of the recipient on the basis of the wording of the Act, and resort to the surrogatum principle was not necessary. The fact that the taxpayer had to assert her right to the periodic support payments through collection action did not change the nature of the lump sum awarded: it was nothing more than the total of the periodic support payments owing.

Even if it was not necessary to apply the surrogatum principle in *Tsiaprailis* to include the arrears of disability payments in income under paragraph 6(1)(f), it is clear that the majority considered it relevant and binding as a general principle wherever a payment of damages or settlement proceeds replaces another amount that would have been income, for tax purposes, to the recipient. The court's clear statement that surrogatum is applicable outside the context of income from business or property, and its simple test for applying the principle broadly to any amount received as a replacement payment for another amount, arguably either diverges from or extends longstanding case law. As will be discussed below, this raises the question of just how much broader the potential application of the surrogatum rule may now be.

Unfortunately, neither the majority nor the dissenting judges situate their reasons in the context in which the surrogatum rule has previously been applied in Canadian tax law, nor do they attempt to resolve the inconsistencies in the considerable jurisprudence on the taxation of settlements and damages awards. It is disappointing that the court did not take the opportunity to review and clarify the existing law and the extent to which its ruling was intended to open the door to broader application of the surrogatum rule, or indicate that it appreciated the broader implications of its ruling.

The thesis of this article is that *Tsiaprailis* extends the surrogatum principle to income computed under part I, division B, subdivision a of the Act—that is, income from a source that is an office or employment—and allows its further extension to income from other sources under subdivision d. Moreover, the decision in *Tsiaprailis* permits the inclusion in a taxpayer's income of an amount that is taxable under a specific as opposed to a general provision of the Act, a use of surrogatum that was

13 See Richard Thomas, "Surrogatum: More Confused than Ever," Current Cases feature (2005) vol. 53, no. 2 *Canadian Tax Journal* 459-63.

14 Supra note 5.

15 At the time the facts in *Sills* arose, the relevant wording of paragraph 56(1)(b) provided for the inclusion in income of "any amount received by the taxpayer in the year, *pursuant* to a decree, order or judgment of a competent tribunal or *pursuant to a written agreement*, as alimony or other allowance *payable on a periodic basis* for the maintenance of the recipient thereof [emphasis added]."

unusual in earlier decisions. There are already cases that test the scope of the *Tsiaprailis* judgment, and it may be expected that instances where the surrogatum principle has not been put forward or has been rejected in the past may be revisited. At the same time, it might be argued that even the simple test set out in *Tsiaprailis* fails to close gaps in the law that exempt from tax amounts that should, as a matter of equity and neutrality, be subject to tax. This situation raises broader policy issues regarding the nature of income and the boundaries of the source concept.

THE SURROGATUM PRINCIPLE IN "BUSINESS" CASES

The Act contains no rules pertaining to the taxation of awards of damages and settlement payments per se.[16] The surrogatum principle has been applied for many years by Canadian courts, following English precedent,[17] in determining whether an amount received as compensation for another amount should be included in computing income from a source that is a business or property, as proceeds of disposition of a capital property, or (rarely) as a non-taxable windfall or a "nothing." The requirement in Canadian (and English) income tax law that an amount be derived from a taxable source has therefore been a related, but adumbrated, consideration in the taxation of damages and settlements. It must be admitted that the jurisprudence has developed unevenly, responding to novel and sometimes ingenious arguments, and reflecting a wide range of circumstances that continue to generate new cases. There has been much commentary by practitioners and academics on the issue, which I acknowledge as a rich source of information and ideas for this article.[18]

What I shall refer to as the "business" cases address the taxation rules applicable to an amount paid to a business operator or commercial property owner as compensation

16 The Act contains some provisions dealing with compensation for destroyed or damaged property, as discussed below. Section 182 of the GST legislation (Excise Tax Act, RSC 1985, c. E-15, as amended) specifically assimilates compensation paid in respect of breach of contract for a taxable supply of goods or services to payment for the supply.

17 See Sandra Eden, "An Unlucky Configuration" [2006] no. 2 *British Tax Review* 150-69, where the author describes the issue of whether the receipt is a trading receipt as the threshold question in determining whether the surrogatum rule applies in English tax law.

18 See, in particular, Joel A. Nitikman, "Taxability and Deductibility of Judgments and Awards," in *1991 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 1991), tab 3; Sharon J. Hugo and L. Alan Rautenberg, "Damages and Settlements: Taxation of the Recipient" (1993) vol. 41, no. 1 *Canadian Tax Journal* 1-37; David Wentzell, "Taxation of Income from Unlisted Sources: An Analysis of Schwartz v. The Queen," in *Report of Proceedings of the Forty-Eighth Tax Conference*, 1996 Conference Report, vol. 2 (Toronto: Canadian Tax Foundation, 1997), 67:1-15; Warren J.A. Mitchell, "New Developments," in *1992 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 1992), tab 8; Michael P. Vantil, "Selected Tax Issues of Interest to Advisors of Owner-Managed Businesses," in *2003 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2003), tab 8; and Joel A. Weinstein, "Damages, Fines, and Penalties: An Update," in *Report of Proceedings of the Fifty-Second Tax Conference*, 2000 Conference Report (Toronto: Canadian Tax Foundation, 2001), 7:1-33.

for breach or early termination of a contract, or for loss resulting from the payer's negligence (or other tortious behaviour), or an amount paid as an indemnity pursuant to a liability (as opposed to life or disability) insurance policy. There is never any doubt in these cases that the amount, if it is on income account, is derived from a business or property source and should be included in the computation of income under part I, division B, subdivision b of the Act. This part of the article sets out the discernible rules established in the business cases, for purposes of comparison with the "non-business" cases discussed subsequently.

Income or Capital?

The vast majority of cases discussing the tax treatment of damages and settlements concern the perennial issue of how to distinguish between income and capital receipts. In 1922, the House of Lords issued its leading judgment in *The Glenboig Union Fireclay Co., Ltd. v. The Commissioners of Inland Revenue*,[19] drawing the often difficult distinction between a damages award for lost profits and one computed by reference to a lost future stream of income, which is treated for tax purposes as a capital receipt, provided that it compensates the taxpayer for the loss or sterilization of a capital asset. This principle is now most frequently referenced to *Commissioners of Inland Revenue v. Fleming & Co. (Machinery), Ltd.*, where, it seems, the word "surrogatum" first appears:

> The sum received by a commercial firm as compensation for the loss sustained by the cancellation of a trading contract or the premature termination of an agency agreement may in the recipient's hands be regarded either as a capital receipt or as a trading receipt forming part of the trading profit. It may be difficult to formulate a general principle by reference to which in all cases the correct decision will be arrived at since in each case the question comes to be one of circumstance and degree. When the rights and advantages surrendered on cancellation are such as *to destroy or materially to cripple the whole structure of the recipient's profit-making apparatus*, involving the serious dislocation of the normal commercial organisation and resulting perhaps in the cutting down of the staff previously required, the recipient of the compensation may properly affirm that the compensation represents *the price paid for the loss or sterilisation of a capital asset and is therefore a capital and not a revenue receipt*. . . . On the other hand when the benefit surrendered on cancellation does not represent the loss of an enduring asset in circumstances such as those above mentioned—where for example the structure of the recipient's business is so fashioned as to absorb the shock as one of the normal incidents to be looked for and *where it appears that the compensation received is no more than a surrogatum for the future profits surrendered—the compensation received is in use to be treated as a revenue receipt and not a capital receipt*.[20]

19 (1922), 12 TC 427 (HL).

20 (1951), 33 TC 57, at 63 (Scot. Ct. Sess.) (emphasis added). Another clear formulation is provided in *Burmah Steam Ship Co., Ltd. v. The Commissioners of Inland Revenue* (1930), 16 TC 67, at 71-73 (Scot. Ct. Sess.), where the court held that a payment is taxable if it is intended to fill "a hole" in the taxpayer's commercial profits.

In an early Canadian case, *Rex v. BC Fir and Cedar Lumber Co.*, the Privy Council distinguished between insurance proceeds compensating for the destruction by fire of the taxpayer's lumber manufacturing plant, which were on capital account, and the proceeds of a "use and occupancy" policy, which were held to be compensation for lost profits and thus included in computing income under the British Columbia Taxation Act.[21]

The relatively clear principles enunciated in *Glenboig* and *Fleming*, though often very difficult to apply to a particular payment in a specific fact situation, have been followed in many Canadian decisions to allocate insurance proceeds and damages or settlement payments for breach or early termination of business contracts.

A lump sum paid in respect of a termination of a contract (whether by agreement, as damages awarded by a court, or in settlement of litigation) is taxable if it is compensation for an amount that was due under the contract at the time it was terminated, or would have become due in the future but for the early termination. The receipt is on income account in the sense that it replaces revenue that would otherwise be included in computing profit under subsection 9(1) of the Act.[22] Compensation for breach of an obligation to give notice of termination under a commercial contract is treated as business income to the recipient if it replaces revenue that would have been generated if the contract had remained in force during the notice period.[23]

In *Prince Rupert Hotel (1957) Ltd. v. The Queen*,[24] the taxpayer recovered an amount from its solicitors for professional negligence in drafting a management agreement. The amount was computed as the capitalized current value of future management fees to which the taxpayer should have been entitled but would not receive as a result of the solicitors' drafting errors. Following *Fleming*, the Federal Court of Appeal treated the settlement amount as income of the taxpayer, because it was received in lieu of business income that, but for the errors, would have been received in the future under the management agreement.

If the sum is compensation for loss of a capital asset, it is treated as proceeds of disposition of a capital property and included in the computation of a capital gain.[25] While, as set out in *Fleming*, the test was originally whether the rights and advantages surrendered on cancellation are such as "to destroy or materially to cripple the whole structure of the recipient's profit-making apparatus," it may now be sufficient

21 [1932] AC 441 (PC). The companion case, *The BC Fir & Lumber Co., Ltd. v. MNR* (1929), 1 DTC 174 (Ex. Ct.), addressed the same issue under the federal Income War Tax Act of 1917.

22 *CNR v. MNR*, 88 DTC 6340 (FCTD).

23 *Packer Floor Coverings Ltd. v. The Queen*, 82 DTC 6027 (FCTD), is an example of compensation for breach of a notice provision. The distribution agreement in that case was terminated immediately, without the supplier's giving Packer the one year's notice provided for in the contract. The parties settled by agreeing that the supplier would pay the amount of the estimated profits that Packer would have earned from the distributorship over the notice period, and that amount was held to be taxable as income to Packer.

24 95 DTC 5227 (FCA); aff'g. 93 DTC 5243 (FCTD).

25 *Pe Ben Industries Company Limited v. The Queen*, 88 DTC 6347 (FCTD).

that the rights that are terminated are integral to a significant capital asset of the recipient.[26]

Application to Individuals and Corporations

The surrogatum rule applies equally to individual and corporate taxpayers. For example, in *Zygocki v. The Queen*,[27] an amount accepted in lieu of title to land in accordance with a judgment ordering specific performance of a contract for the purchase of the land was included in computing income from the taxpayer's business because the land purchase transaction was an adventure in the nature of trade for Ms. Zygocki. The argument that the amount was proceeds of disposition of rights under the judgment, and thus a capital receipt, was rejected. A more frequently cited but similar case is *The Queen v. Manley*.[28] In *Manley*, the court held that an award of damages for breach of warranty of authority replaced a finder's fee that would have been due to the taxpayer if the defendant had had the warranted authority, and was therefore income from an adventure in the nature of trade of the taxpayer. The court rejected the general proposition that an amount paid as a settlement or awarded by a court as damages was a non-taxable "nothing"; a settlement or damages award was held to be taxable if it could reasonably be viewed as a replacement for an amount that was relevant for tax purposes.

Tort Compensation

The surrogatum principle applies to damages and settlements paid as compensation for tortious conduct, as well as for breach or termination of a contract. The *London and Thames* case[29] concerned damages for negligence resulting in a collision between a tanker and the taxpayer's oil supply jetty. The taxpayer's profits from its business were reduced because it was unable to use the jetty for a period of time. The taxpayer received payments from the owner of the tanker (as well as from its insurer) to compensate for both the physical damage to the jetty, which was capital property of the business, and the consequential damages or lost profits, and the latter amount was held to be income from the taxpayer's business.

Allocation of Lump Sums

The characterization of the amount received becomes more complicated (*London and Thames* notwithstanding) where the compensation is for negligence or other

26 *The T. Eaton Company Limited v. The Queen*, 99 DTC 5178 (FCA). See also *BP Canada Energy Resources Company v. The Queen*, 2002 DTC 2110 (TCC).

27 84 DTC 6283 (FCTD).

28 85 DTC 5150 (FCA). This case seems to be the foundation of the surrogatum rule in Canadian jurisprudence, and indeed was relied on in *Tsiaprailis* by the majority of the Federal Court of Appeal.

29 Supra note 7.

tortious conduct, or where both breach of contract and negligence in performance of the contract are alleged. Some relatively recent cases grapple with the tax accounting for damages awards and settlements, particularly where the parties (or the trial court) have not clearly allocated amounts to particular types of losses.

Where the court has adequate evidence to apportion a lump-sum settlement between income and capital, it will do so. In *The Queen v. Mohawk Oil Co. Ltd.*,[30] the taxpayer had contracted with a supplier for the construction of a waste oil processing plant. When all attempts to make the plant work properly failed, the taxpayer sued the supplier, eventually settling for a global amount of US$6 million. The taxpayer allocated the settlement proceeds for financial purposes between lost profits (in the form of increased operating expenses incurred in trying to make the plant function) and proceeds of disposition of the plant itself, which had been returned to the supplier. Both levels of court dismissed the appeal on the basis that there was adequate evidence, in the form of the accounting treatment of the receipts by the taxpayer, to apportion the award between these two heads for tax purposes. The taxpayer's assertion that the supplier had made the settlement payment to preserve its reputation, given that the contract limited the damages for defective performance to a much lower amount, was not considered relevant. The broad principle is that the nature of the amount is not determined by the payer's motivation in settling, but by the character of the receipt from the point of view of the recipient. The Federal Court of Appeal specifically rejected the idea that the settlement proceeds were "akin to a windfall" and followed a number of English cases, including *London and Thames*, to allocate the settlement for tax purposes.

By contrast, in *Ipsco Inc. v. The Queen*,[31] the settlement proceeds received in a claim against a supplier for a defective pipe treatment system were held not to be allocable to reduce the taxpayer's undepreciated capital cost of the system. The claim made by Ipsco against the supplier was for damages for extra construction and installation costs incurred to make the system function properly, which were held not to constitute a claim for damage or injurious affection to the taxpayer's property.[32] Further, the taxpayer did not dispose of the system, so that no amount could be said to be proceeds of disposition, or be equated to a particular amount under the exhaustive and detailed capital cost allowance rules in the Act.[33] Finally, no portion of the payment could be considered lost profit.

30 92 DTC 6135 (FCA); aff'g. *Mohawk Oil Co. Ltd. v. The Queen*, 90 DTC 6434 (FCTD).

31 2002 DTC 1421 (TCC).

32 Compensation for damage or injurious affection to property is treated as proceeds of disposition or partial disposition of the property under paragraphs (f) and (e), respectively, of the definition of "proceeds of disposition" in section 54, and in respect of depreciable property, in the same definition in subsection 13(21).

33 This is not unlike the result in *Cominco*, infra note 34.

Specific Receipt or General Revenue?

Canadian courts are sometimes unwilling to treat replacement payments as having the specific character of any component of the recipient taxpayer's business revenue. Thus, business interruption insurance proceeds are simply revenue of a business or property nature included in the broad calculation of profit under section 9 of the Act, and are not normally treated as a direct replacement of a specifically defined type to which special rules apply. For example, in *Cominco Ltd. v. The Queen*, such insurance proceeds were not included in computing "taxable production profits from mineral resources in Canada" (as then narrowly defined) and thus were not accorded advantageous treatment under the Act.[34]

Compensation in Relation to Intangible Property

Compensation for trademark infringement and passing-off,[35] patent infringement,[36] and restitution of improperly charged fees under a franchise agreement[37] have also been held to be taxable according to the nature of the payment and what it was intended to replace.

There is no theoretical reason why the surrogatum principle should not be applied where the compensation is for loss or destruction of eligible capital property, such as goodwill. Three-quarters of the amount would then be deducted from the taxpayer's cumulative eligible capital, as defined in subsection 14(5). So far, however, the "mirror image" test prescribed by the Act has resulted in the amount being considered general business income to the recipient because it has been characterized as a deductible business expense of the payer. Thus, if the recipient taxpayer had paid rather than received the amount, it would be treated as a business expense. The mirror image test results in the compensation being treated as business revenue for the recipient rather than a capital receipt.[38]

In *The Queen v. Toronto Refiners and Smelters Limited*,[39] the City of Toronto made a $9 million payment to compensate the taxpayer for loss of its business when it proved impossible to relocate the business. The Federal Court of Appeal held that

34 84 DTC 6535 (FCTD). However, see *Westar Mining Ltd. v. The Queen*, 92 DTC 6358 (FCA), in which business interruption insurance proceeds were held to be income "derived from the operation of a mine." The court in *Westar* distinguished *Cominco* on the grounds that the insurance proceeds in the latter case could not be assimilated to the amounts deferred for purposes of a separate scheme of special incentives. The degree of specificity of the relevant definition will determine whether the receipt can be so categorized.

35 *Donald Hart Ltd. v. MNR*, 59 DTC 1134 (Ex. Ct.). This case may be the source of the statement in *Tsiaprailis* that damages are "inherently neutral."

36 CRA document no. 2000-0043937, December 20, 2000.

37 *Violette Motors Limited et al. v. MNR*, 87 DTC 136 (TCC).

38 *The Queen v. Goodwin Johnson (1960) Ltd.*, 86 DTC 6185 (FCA); *Pe Ben*, supra note 25; and Nitikman, supra note 18, at 32-36.

39 2003 DTC 5001 (FCA).

the payment was not an eligible capital amount, on the basis that the mirror image test in subsection 14(1) required the assumption that the recipient was a non-taxable public authority paying the amount for civic purposes.[40] As a result, the payment would not be a payment made by the recipient to acquire eligible capital for the purpose of earning income from a business.

Statutory Interpretation and the Application of Surrogatum

In several provisions, the inclusive wording of the Act renders the surrogatum principle superfluous. For example, in the recent *Transocean Offshore* case,[41] the words "in lieu of payment of" as applied to rent or royalty payments[42] were held to include an amount paid by the lessee to settle the lessor's claim for compensation when the lessee repudiated the lease in advance of its commencement date. While the surrogatum principle was put forward as a basis for treating the amount as rent, the Federal Court of Appeal held that there was no need to resort to it since the Act contains clear words taxing receipts that replace rental payments.

This raises the fundamental question of whether it is *ever* appropriate to apply the surrogatum principle, which is entirely a creation of the courts, since the result is to tax (or exempt) amounts that are not clearly included in income (or exempted) by the words in the Act. For example, should the court read into the Act the words "in lieu of" when they are not there, despite the fact that this phrase is present in numerous other provisions? The dissenting opinion in *Tsiaprailis* made a similar point when it alluded to the considerable number of cases in which the Supreme Court has held that in tax law, the form of a payment or transaction matters, and should be respected. That is, if a payment is in fact made to settle litigation and gain a release from a claim, it should not be treated as if it were something else, such as the payment of disability benefits. At the very least, as this article argues, principles of statutory interpretation and form versus substance should be considered in devising a coherent framework for applying surrogatum to amounts that replace receipts that are expressly taxable.

Interface of Surrogatum and Source

The surrogatum rule has also been applied to determine whether an amount represents neither an income receipt nor proceeds of disposition of capital property, but a non-taxable "windfall." A position frequently taken by taxpayers, which seems to stem

40 This interpretation of section 14—namely, that the mirror image test assumes that the recipient has the same tax-exempt status and civic purpose for the payment as the actual payer—has been criticized: Marsha E.A. Henry, "Eligible Capital Amount: The Mirror Image Test," Current Cases feature (2003) vol. 51, no. 2 *Canadian Tax Journal* 937-41.

41 *Transocean Offshore Limited v. The Queen*, 2005 DTC 5201 (FCA).

42 Subsection 212(1) and paragraph 212(1)(d). Similarly, the meaning of "interest" for purposes of paragraph 212(1)(b) is expanded to include amounts received "as, on account or in lieu of payment of, or in satisfaction of" interest.

from the source concept, is that the amount is simply "damages," with the implication that damages are generally tax-exempt. For example, it was argued in *Pe Ben* that the amounts in question were paid in lieu of damages for a fundamental breach of contract and should be treated as non-taxable damages.[43] Strayer J in the Federal Court Trial Division rejected this approach and stated that, even if a payment were made in lieu of damages for fundamental breach, the issue was whether it was compensation for an income or capital amount.

An amount that is not compensatory in nature but is awarded to punish the defendant, such as an award of punitive damages, is not a replacement for income from a source or proceeds of disposition of property, and is thus not taxable. As the Federal Court of Appeal explained in *Bellingham v. The Queen*, a punitive damages award "does not flow from either the performance or breach of a market transaction,"[44] which could be a source of taxable income; rather, it is a sanction available to a court to express its disapproval of the conduct of the defendant. The fact that it increases the award to the plaintiff is not determinative of its character in tax law.

Where a payment is made even though there is no viable cause of action, it has been held that the amount may be a windfall.[45] More recently, however, *Mohawk Oil* and *Bellingham* have held that the strength or weakness of the taxpayer's claim is not a basis for assessing the nature or purpose of the settlement received.[46]

The Right To Sue as a Separate (Capital) Property

Another argument frequently encountered in the business cases (and adopted by the dissenting judges in *Tsiaprailis*) is that a settlement payment is an amount received in exchange for disposing of a right to sue (which accrues to the wronged party when the other party commits the tort or breaches the contract) by granting to the tortfeasor or contract breaker a release of all claims against it.[47] Before 1972, when capital gains were exempt from tax, this was a particularly attractive argument. Where the amount received is characterized as proceeds of disposition of the right to sue, it is separated from the underlying obligation under the commercial contract, and the effect is to capitalize all such receipts. In the days before capital gains taxation, the argument had the added feature of simplicity, since there was no need to establish a cost base for the right or property disposed of. The older cases treating all or part of a settlement or damages award as non-taxable proceeds of disposition

43 *Pe Ben*, supra note 25. Other cases where this argument has been made include *Zygocki*, supra note 27; *Manley*, supra note 28; and *Mohawk Oil*, supra note 30.

44 96 DTC 6075, at 6082 (FCA). See also *Cartwright & Sons Ltd. v. MNR*, 61 DTC 499 (TAB).

45 *The Queen v. Cranswick*, [1982] 1 FC 813 (CA). The law relating to the corporate oppression remedy would now probably afford Mr. Cranswick a cause of action.

46 *Mohawk Oil*, supra note 30; *Bellingham*, supra note 44.

47 Where damages are received following a court order, the doctrine of res judicata would have the same effect as a release of all claims in an out-of-court settlement, in that the cause of action or the right to sue is extinguished.

of capital property are probably one inspiration for the continuing appearance of this argument in post-1971 cases.

The Act does provide a foundation for the position that the right to sue or cause of action is a separate property of the taxpayer, although its provisions are rarely, if ever, expressly put forward or cited in the case law in support of this argument. The definition of "property" in the Act includes "a right of any kind whatever, a share or a chose in action."[48] "Proceeds of disposition" of capital property includes compensation for property destroyed and any amount payable under a policy of insurance in respect of loss or destruction of property, and compensation for property damaged and any amount payable under a policy of insurance in respect of damage to property.[49] "Disposition" of property that is a debt or any other right to receive an amount is defined as any transaction or event by which the debt or other right is settled or cancelled.[50]

The treatment of every settlement or award as proceeds of disposition of a right to sue, rather than a replacement for an amount receivable under a contract, has a tinge of practical unreality about it, because the payment is made to resolve the breach of the contractual relationship between the parties that defined their rights and obligations. Indeed, the suggestion that an amount paid in settlement of a claim for breach of contract is by its nature proceeds of disposition of capital property (as opposed to an inherently neutral amount that may replace another amount of either an income or a capital nature) has been firmly rejected in the business cases.[51]

Where a tort victim is asserting a right to compensation arising from the tortfeasor's wrongful act or omission, the argument that the victim (the taxpayer) disposes of property, in the form of a cause of action, in exchange for a payment of compensation may be more supportable, since there is no other clearly applicable tax language to characterize the payment. In the absence of a pre-existing relationship between payer and payee that is recognized as relevant in tax law, and that could help to characterize the amount as replacing income from a source, the idea that the amount

48 Subsection 248(1), paragraph (a) of the definition of "property." Hugo and Rautenberg, supra note 18, at 16-25, canvass the strengths and weaknesses of this position.

49 Section 54, paragraphs (c) and (f), respectively, of the definition of "proceeds of disposition," applicable in the computation of capital gains and losses under subdivision c. These provisions are identical to paragraphs (c) and (f) of the definition of "proceeds of disposition" in subsection 13(21), applicable to dispositions of depreciable capital property under subdivision b.

50 Subsection 248(1), subparagraph (b)(ii) of the definition of "disposition."

51 For example, in *CNR*, supra note 22, at 6342-43, Strayer J said, "With respect to purpose, the essential question is to determine what the compensation—whether paid pursuant to a contract, a court award of damages, or otherwise—is intended to replace. In some cases the contract providing for compensation may be clear. The measure employed for calculating compensation is not always determinative: potential lost income may be taken into account in calculating a capital sum to be paid. Nor on the other hand does the fact that an amount is paid as damages for breach of a contract necessarily make it a capital sum and not income. On the contrary it appears to me that whatever the source of the legal right to the compensation, be it the contract or the law of damages, the substantive issue is: what is this amount intended to replace?"

is paid in exchange for disposition of the right to sue gains credence. On the other hand, the common law recognizes that a right to sue comes into being when the tortfeasor breaches a duty of care owed to another, thereby causing loss or damage. The legally relevant relationship of "neighbour" may be sufficient to treat a settlement of a tort claim as paid *pursuant to* a right to be made whole, rather than as *proceeds of disposition* of that right. The nature of the actual loss, whether in respect of income or a capital asset, can then be used to determine the tax characterization of the payment through application of the surrogatum principle.[52]

If one does accept that a new property right comes into existence when a person suffers damage from the tortious act of another, the problem becomes how to compute the cost of the right given up in exchange for the settlement payment. In the case of tortious destruction of capital property (or a breach of contract that reduces its value), the adjusted cost base (ACB) to the owner of the property can logically be inserted into the equation as the ACB of the right.[53] Indeed, the Act mandates this result in the definition of "proceeds of disposition" noted above. Further, compensation for damage to capital property is also treated as proceeds of disposition unless it is expended on repairing the damage within a reasonable time.[54]

In the commercial context, the application of these provisions is relatively straightforward—at least in theory—provided that the compensation can be apportioned between the various types of losses suffered by the business (as was done in *Mohawk Oil*, discussed above). The calculation of the ACB of the relevant capital property is not usually discussed in the cases. However, in *Pe Ben* and *BP Canada Energy Resources*,[55] the court found the taxpayer had a nil cost of the capital asset that was disposed of, so that the full amount of the damages constituted a capital gain.

THE SURROGATUM PRINCIPLE IN "NON-BUSINESS" CASES PRIOR TO TSIAPRAILIS

Until *Tsiaprailis*, the Supreme Court of Canada had never expressly accepted the application of the surrogatum principle to an award of damages or a settlement payment received by a taxpayer other than as business or property income. Indeed, the trial judge in *Tsiaprailis* ruled that the surrogatum principle should not be extended beyond the realm of income from a business.[56] Surrogatum has been expressly rejected

52 In *London and Thames*, supra note 7, for example, the claim (in tort) for damage to the jetty was partly for a capital loss (from physical damage to a depreciable capital property) and partly for a loss of profit (from loss of use of the jetty).

53 The English jurisprudence operates more or less this way. See *Zim Properties Ltd. v. Proctor*, [1985] STC 90 (Ch. D.), and the discussion in Eden, supra note 17.

54 Section 54, paragraph (f) of the definition of "proceeds of disposition."

55 *Pe Ben*, supra note 25, and *BP Canada*, supra note 26.

56 *Tsiaprailis v. The Queen*, 2002 DTC 1563, at 1569 (TCC). Bowman ACJ (as he then was) specifically rejected the application of surrogatum to include the disability benefits in income

in the case of breach of an obligation to give reasonable notice of termination of employment and in personal injury claims for lost income from employment, and it has been ignored in other non-business contexts where, apparently, it was at least arguable.

In this section, five types of cases will be reviewed, applying the *Tsiaprailis* test to challenge the existing case law:[57]

1. damages for wrongful dismissal (failure to give reasonable notice of termination of employment);
2. compensation for terminated or cancelled employee stock options;
3. receipt of strike pay;
4. damages for personal injury to compensate for lost income from employment (or business) up to the date of trial or settlement; and
5. compensation for human rights violations in connection with employment.

Before turning to these other groups of cases, it is convenient to review the position that the Supreme Court of Canada took on these issues before *Tsiaprailis*. The most notable of the cases in which surrogatum has featured in the recent past is *Schwartz v. The Queen*,[58] which combines the source concept of income, the applicability of the surrogatum principle, and the nature of wrongful dismissal damages. It thus contains discussion of many of the difficult problems that are raised in the various types of cases listed above, and are resolved (perhaps) by *Tsiaprailis*.

In *Schwartz*, the taxpayer had accepted, without having to commence a lawsuit, a lump-sum payment to settle his claim for breach of a contract under which the defendant had agreed to employ him in the future. The trial judge found that no portion of the lump sum could be taxed as a retiring allowance, which, as defined, does not extend to payments for the loss of future or prospective employment. Following *The Queen v. Atkins*,[59] the lump sum was not a benefit of employment under

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under paragraph 6(1)(a), but also rejected the extension of the principle outside the business context generally. In *Dumas*, supra note 3, the surrogatum principle was applied to include in income the entire amount of a settlement of a claim for both arrears and future disability benefits as a benefit of employment under paragraph 6(1)(a). Mogan TCCJ cited and relied on *London and Thames* (supra note 7) and *Manley* (supra note 28), as well as *Schwartz* (infra note 58, discussed in detail below) and numerous other cases concerning damages and settlements in commercial cases. *Dumas* would be decided today on the same basis as *Tsiaprailis* and must be regarded as having been overruled in respect of its application of paragraph 6(1)(a) and the taxation of future disability benefits.

57 The original case law for the first and second categories—settlements or awards for wrongful dismissal and for cancellation or breach of employee stock option agreements—has been overruled by subsequent amendments to the Act. However, it is still relevant to review these decisions because the judicial discussion of the nature of these kinds of compensation raises interesting questions regarding the appropriate limits of the surrogatum principle.

58 96 DTC 6103 (SCC); rev'g. 94 DTC 6249 (FCA); rev'g. 93 DTC 555 (TCC).

59 76 DTC 6258 (FCA), discussed in detail below.

paragraph 6(1)(a), because the employment had not commenced at the time the contract was repudiated by the prospective employer. The lump-sum award of damages could not be assimilated to income, since income refers to recurring receipts and this was a single payment to compensate for loss of a future source of income. Finally, there was insufficient evidence to allow allocation of any part of the payment to salary or stock option benefits not received. The trial judge found that "[t]he damages he [Mr. Schwartz] received was in a small part, if any, for loss of income for future services and to a larger part, according to the evidence, for embarrassment, anxiety and inconvenience."[60]

The Federal Court of Appeal, citing *Manley* and *London and Thames*, held that the surrogatum rule applied to include in the taxpayer's income the portions of the settlement that replaced salary and stock option benefits to which the taxpayer would have been entitled but for the breach of the contract. The court expressly held that although both of those cases were concerned with loss of income by traders, there was no "valid distinction in principle that would exclude application of the rule . . . to damages arising out of a breach of a contract of employment."[61] Mahoney J (for the full court) stated, "In my view, an amount received in settlement of an asserted cause of action, whatever its nature, simply cannot be characterized as a windfall even to the extent that it may be gratuitously generous."[62] The court went on to find that the trial judge had not properly considered the evidence that the parties had agreed to apportion the settlement between compensation for salary and stock options as promised in the contract of employment. The court found that the lump-sum settlement could be allocated between non-taxable compensation for embarrassment, inconvenience, etc., and taxable salary and lost stock option benefits under sections 5 and 6.

At the Supreme Court, the majority (La Forest J, with L'Heureux-Dubé, Gonthier, and McLachlin JJ concurring) held that the Federal Court of Appeal had improperly substituted its view of the evidence for that of the trial judge; it therefore restored the trial judge's findings that the evidence was insufficient to permit the court to allocate any part of the lump sum as an amount intended to replace income from a taxable source. This effectively disposed of the case in the taxpayer's favour. The minority (Major J, with Sopinka and Iacobucci JJ concurring) agreed with the majority decision on this issue and in the result. The Supreme Court thus restored the trial judge's finding of fact that the award was primarily compensation for embarrassment, anxiety, and inconvenience caused by the breach of the employment agreement.[63]

60 *Schwartz v. The Queen*, supra note 58, at 562 (TCC).

61 *The Queen v. Schwartz*, supra note 58, at 6254 (FCA).

62 Ibid., at 6253.

63 Supra note 58, at 562 (TCC). In *Wallace v. United Grain Growers Ltd.*, [1997] 3 SCR 701, decided only a year after *Schwartz*, the Supreme Court ruled that the appropriate remedy for an employer's egregious behaviour in wrongfully dismissing an employee is to extend the period of reasonable notice, rather than award damages for mental distress, humiliation, etc. It is only where the employer's behaviour amounts to a separate actionable wrong that aggravated or punitive damages would be awarded. (There is nothing in the *Schwartz* facts that suggests

The question of whether damages for breach of contract that compensate for embarrassment, inconvenience, mental distress, etc., are taxable was not directly addressed, but it was apparently assumed throughout all three levels of appeal that they are not.

Before La Forest J reached his conclusion on the evidentiary basis for allocation of the damages, he reviewed the case law on wrongful dismissal damages and retiring allowances. He concluded that by the end of the 1970s it had been accepted by courts, commentators, and the minister of national revenue that damages for wrongful dismissal were not taxable as income from employment under section 5, or as a retiring allowance, on the basis of the decisions in *Atkins* and *Specht v. The Queen*.[64] Tracing the various amendments to the Act to the 1981 amendment (discussed below) that expressly included an award of damages for loss in the definition of a retiring allowance, the Supreme Court found that damages for breach of a contract for prospective employment were not included in the new definition of a retiring allowance because the employment had not commenced and, therefore, there was no loss of employment.

The minister did not argue before the Supreme Court that any part of the settlement amount in *Schwartz* was a substitute for income from employment under section 5 or 6 of the Act (as had been accepted by the Federal Court of Appeal), but rather that a large proportion of the amount was a surrogatum for income from another source under paragraph 3(a), that source being the employment contract.[65] The majority of the Supreme Court confirmed that unenumerated sources are clearly within the contemplation of the Act,[66] but that to find that the contract for future employment was such a source would be giving precedence to the general provision (paragraph 3(a)) over the specific provision defining a retiring allowance to include only payments made for loss of *existing* employment (paragraph (b) of the definition in subsection 248(1)). Since Parliament had adopted a specific solution to

egregious behaviour on the part of the prospective employer.) There are many cases, decided either way, on whether an award of damages for mental distress related to loss of employment is taxable. The CRA's position is found in paragraph 9 of *Interpretation Bulletin* IT-337R4, "Retiring Allowances," February 1, 2006. It suggests that in *Schwartz*, if the settlement had been in respect of existing employment (that is, if the employment had commenced), there should not have been any issue with respect to apportionment and the full settlement would have been taxable: "[W]here an individual receives compensation on account of damages as a result of a loss of employment, the amount received will be taxed as a retiring allowance. This applies to both special damages as well as general damages received for loss of self-respect, humiliation, mental anguish, hurt feelings, etc."

64 See the discussion of *Atkins* below, at note 69 and following; and *Specht*, [1975] FC 150 (TD).

65 This position was likely necessary because, once it was held that the taxpayer in *Schwartz* never actually became an employee, there was no employment that could arguably have been the source.

66 The minority disagreed on this point, holding that despite the clear wording in paragraph 3(a), it was contrary to firmly established jurisprudence to tax income that did not fall within the enumerated sources in paragraph 3(a) or the additional sources listed in subdivision d.

the issue of taxation of wrongful dismissal awards (the definition of a retiring allowance), it would be wrong to tax an amount not included in the specific provision by application of a general inclusion provision.

The Supreme Court's decision in *Schwartz* is technically obiter, apart from the ruling on the deference an appellate court should accord the trial judge on findings of fact. The court did not expressly say that the surrogatum principle could never apply in the context of employment income; however, its implied acceptance of the correctness of *Atkins*, and its rejection of the use of surrogatum by the Federal Court of Appeal to include part of the lump sum in income from an unenumerated source under paragraph 3(a), suggests disapproval of the general application of the principle. The majority reasons in *Schwartz* are confusing and disorganized, contain reasoning that can be criticized for its logic, and left the law in considerable uncertainty.[67] Since *Tsiaprailis*, however, there is no doubt that the surrogatum principle can be applied generally to damages and settlements and is not confined to subdivision b income. In *Tsiaprailis*, the Federal Court of Appeal found support in its earlier ruling in *Schwartz*, and as we have seen, the majority of the Supreme Court adopted the Court of Appeal's reasons in *Tsiaprailis* when it applied the surrogatum principle.

Compensation for Wrongful Dismissal

Early cases treated damages or settlements for loss of employment on capital account, as compensation for destruction of the employee's source of income rather than a payment in lieu of income from employment.[68] In the period before capital gains were taxable, this treatment disposed of the issue.

As we have seen, *Atkins*[69] became the leading decision on the taxation of wrongful dismissal damages, despite ups and downs in judicial favour. *Atkins* held that amounts paid for breach of the implied contractual obligation to give reasonable notice of termination of an employment contract are not income from employment, or amounts replacing income from employment, and are therefore not taxable. The amounts are paid in lieu of notice of dismissal, not in lieu of salary, wages, or benefits,

67 See, in particular, Wentzell, supra note 18, at 67:7-8, for a discussion of whether in fact the Supreme Court in *Schwartz* implicitly extended the surrogatum principle to income from sources other than a business. His criticism, ibid., at 67:11-12, of the logic of excluding a receipt from income under a general provision (paragraph 3(a)) because it fails to meet all the criteria of a more specific provision (paragraph (b) of the definition of retiring allowance in subsection 248(1)) is also to be noted. It is one thing to say that when a specific provision exempts an amount, it should not be taxed under a general provision; it is another to say that when a specific provision does not include an amount, it may not be included under a general provision, especially where the specific provision begins (as does subsection 56(1), listing a retiring allowance as a specific source), "Without restricting the generality of" the general provision (section 3).

68 See, for example, *Millman v. Minister of National Revenue*, 51 DTC 305 (TAB), decided under the Income War Tax Act; and *Brown v. MNR*, 52 DTC 9 (TAB), decided under the Income Tax Act of 1948. As noted earlier, the trial judge in *Schwartz* took essentially the same position.

69 Supra note 59. The wrongful dismissal in *Atkins* occurred in 1970.

and are not to be viewed as remuneration for services. Damages compensating a dismissed employee for breach of the obligation to give reasonable notice of termination of employment, even though *measured by* the salary or other remuneration that would have been received during the period of reasonable notice, are not to be regarded as replacing such employment income. The Federal Court of Appeal ruled that "[m]onies so paid . . . are paid in respect of the 'breach' of the contract of employment and are not paid as a benefit under the contract or in respect of the relationship that existed under the contract before that relationship was wrongfully terminated."[70] The *Atkins* ruling was strongly criticized in obiter by the Supreme Court of Canada in *Jack Cewe Ltd. v. Jorgenson*,[71] but the Federal Court of Appeal subsequently refused to treat it as wrongly decided.[72] As noted earlier, La Forest J in *Schwartz* described *Atkins* as having been accepted by courts, commentators, and the minister of national revenue by the end of the 1970s; and, though he stated that the point was not in issue, he strongly implied that *Atkins* was correctly decided.

An alternative argument sometimes put forward by the Crown in wrongful dismissal cases was that payments of damages were taxable as a retiring allowance. From 1948 to 1981, the Income Tax Act defined a retiring allowance as

> an amount received upon or after retirement from office or employment in recognition of long service or in respect of loss of office or employment (other than a superannuation or pension benefit), whether the recipient is the officer or employee or a dependant, relation or legal representative.[73]

However, the reference to "loss of office or employment" did not lead to the treatment of wrongful dismissal compensation as a retiring allowance. The trial judge in *Atkins* held that the taxpayer did not retire, and therefore the payment he received was not a retiring allowance.[74] (This issue was not pursued before the Federal Court of Appeal.)

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70 Ibid., at 6258 (Jackett CJ).

71 80 DTC 6233 (SCC). Although *Jack Cewe* was not an income tax case, the court considered whether an employer who had wrongfully dismissed an employee should only have to pay an amount equal to "take-home pay," or after-tax income, that the employee would have received but for the wrongful dismissal, on the basis that *Atkins* had held that such awards were tax-exempt. The Supreme Court expressed "grave doubts" as to the correctness of *Atkins*, preferring *Quance v. The Queen*, 74 DTC 6210 (FCTD), which had held that an amount paid in lieu of notice of termination was taxable as income from employment. The court in *Atkins* had distinguished *Quance* on the basis that Mr. Quance had received his regular monthly salary for nine and a half months after his employment ended, while Mr. Atkins had received a lump sum in two instalments, which included compensation for a scholarship for his daughter. The trial judge thought that such compensation might not be classified as salary or benefits, and the lump sum was not allocated.

72 *The Queen v. Pollock*, 84 DTC 6370 (FCA).

73 See, for example, the Income Tax Act, RSC 1952, c. 148, paragraph 139(1)(aj).

74 See also *Specht*, supra note 64.

Amendments to the Income Tax Act, including an expanded definition of retiring allowance (effective November 12, 1981), resolved some of the uncertainty by including in income from other sources "an amount received . . . in respect of a loss of an office or employment of a taxpayer, *whether or not received as, on account or in lieu of payment of, damages or pursuant to an order or judgment of a competent tribunal* [emphasis added]."[75] However, there are still some categories of damages that are not viewed as retiring allowances even though received as part of the total compensation from an employer on termination of employment.

The idea that an amount received by an employee from her employer is not income from employment unless it is remuneration for employment services actually performed for the employer is pervasive, and possibly correct.[76] However, even if it is correct, an amount paid as a substitute or replacement for salary or wages does not have to constitute a quid pro quo for actual work performed by the employee. Under the surrogatum principle, an amount received by an employee to compensate for remuneration and benefits that she would have received during a reasonable notice period is analogous to the lost profits of a business when a contract is terminated or property is damaged. The business operator does not have to actually carry on the business, or perform its obligations under the contract, to be entitled to compensation for lost profits; indeed, the repudiation by one contracting party usually releases the other from its obligation to perform but does not disentitle the latter from compensation for the benefits it would have received if the contract had been performed. In the commercial context, the damages may be calculated as net profits after allowing for expenses that would have been incurred if the plaintiff's side of the contract had been performed, because that is the actual loss. In the employment context, the actual loss is normally the gross amount of salary, wages, and benefits that the employee would have received during the notice period, since there are few general deductions available to employees in computing employment income.

There are a few circumstances, however, in which damages for wrongful dismissal can be distinguished from other, non-taxable amounts related to loss of employment. Although, owing to the retiring allowance provisions, it may no longer be asserted that loss of employment is loss of a source of income, and thus that the compensation received is a non-taxable capital receipt, compensation for losses other than the employment itself, which may be received as part of a settlement or award against an employer or otherwise connected to employment, may still be tax-exempt.

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75 Subsection 248(1), paragraph (b) of the definition of "retiring allowance"; and see subparagraph 56(1)(a)(ii). Note that the effect of the amendments was not to include wrongful dismissal damages as income from employment, but as income from another source under part I, division B, subdivision d of the Act. Whether an amount is received "in respect of" a loss of employment is generally determined by applying a "but for" test: *Overin v. The Queen*, 98 DTC 1299 (TCC).

76 See *Barrette v. Crabtree Estate*, [1993] 1 SCR 1027, at paragraph 44; and perhaps suggesting the contrary, *British Columbia v. Sylvester*, [1997] 2 SCR 315, at paragraph 1. The issue of whether a benefit of employment under paragraph 6(1)(a) (which may be in the form of cash) must be received by the employee as a quid pro quo for performing employment duties was resolved in the negative in *The Queen v. Savage*, 83 DTC 5409 (SCC).

In a recent and somewhat unusual case, *Ahmad v. The Queen*,[77] the taxpayer was demoted from his senior position as a nuclear researcher with Atomic Energy Canada Ltd. ("AECL") as a result of the interference of an important client, Ontario Hydro. Dr. Ahmad sued Ontario Hydro and was later wrongfully dismissed by AECL. Dr. Ahmad's action against Ontario Hydro was successful, and he was awarded general damages for Ontario Hydro's tortious conduct, as well as damages for libel, and pre- and post-judgment interest. Even though the damages were measured by past and future lost salary and benefits, they were not compensation for these, and thus were not subject to tax. The court held that the award of general damages was outside the expanded definition of retiring allowance, being compensation for losses separate and distinct from the loss of employment. (Dr. Ahmad had already received compensation for wrongful dismissal from AECL, which was taxable as a retiring allowance.) What Dr. Ahmad lost through the tortious conduct of Ontario Hydro was not his employment, but his career in nuclear research. He lost his "capital investment" in a career he had spent years developing.

The damages for libel that Dr. Ahmad recovered from Ontario Hydro were not assessed for tax because, again, the compensation was for damage to his professional reputation. Reputation is a personal "asset" of enduring value and thus, in a sense, may be considered capital property. However, since reputation is a personal attribute and in this sense is not a marketable asset, compensation for damage to reputation is a tax "nothing." If a person's reputation were to be treated as a capital property for tax purposes, it would be necessary to calculate its ACB to the owner. These issues will be revisited below.

Compensation for Terminated Stock Options

Another line of jurisprudence that is of interest addresses the tax treatment of payments on termination of an employee stock option agreement by a corporate employer. In essence, the grant of a stock option by the employer confers a contractual right on the employee to acquire shares of the employer or a related corporation at a given price. Taxation of employee stock option benefits is governed by section 7 of the Act. Section 7 sets out detailed rules for calculating the amount deemed to be received as a benefit of employment, and thus to be taxable as employment income. Paragraph 7(3)(a) states that, except as provided in section 7, the employee is deemed not to have received any benefit under a stock option agreement. This provision excludes a stock option benefit from inclusion in income under paragraph 6(1)(a) if it is otherwise subject to tax under section 7.

There are numerous cases considering the tax consequences to an employee of accepting cash or other compensation for breach of a stock option agreement by the employer. The Act was amended, effective 2001, to ensure that such payments are treated as replacements for the benefits under the stock option agreement.[78]

77 2002 DTC 2065 (TCC).

78 See subsection 7(1.7), effective for amounts received on or after March 16, 2001.

In many of the cases that arose before the Act was amended, the corporate employer entered into a reorganization transaction, as a result of which shares of the employer could not be issued to the employee in accordance with the option agreement. The employee was notified that the employer would not be performing its obligations in accordance with the terms of the agreement, and was offered either cash or shares of another (publicly traded) company in lieu of the right to acquire shares of the employer.

In an early influential case, *Reynolds et al. v. The Queen*,[79] the employees accepted shares of the company that had acquired all the assets of their former employer (which was in the process of being wound up) as compensation for the cancellation of their rights to acquire shares of the former employer. The issue was whether the value of the shares received by the employees was subject to tax as an amount received "under the option agreement," or on the disposition of rights under the stock option agreement to a person with whom the employee was dealing at arm's length, as provided by former paragraph 85A(1)(a) or (b), respectively.[80] The Tax Review Board treated the value of the new shares as consideration received when the rights under the stock option agreements were transferred or otherwise disposed of to the former employer, ruling that it did not matter that the former employer did not actually acquire rights to acquire its own shares from the employees. The employees disposed of their rights under the option agreements by their agreement to accept shares of the company that had acquired their former employer's assets and to release their former employer from any other obligations under the option agreements. The Tax Review Board said that since the disposition of the options was for the benefit of, or at the direction of, or for the account of the former employer, the options were properly viewed as having been disposed of to an arm's-length person.[81]

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79 75 DTC 5042 (FCTD); rev'g. 74 DTC 1103 (TRB) (sub nom. *Anderson et al. v. MNR*). The Federal Court of Appeal, 75 DTC 5393 (sub nom. *The Queen v. Huestis*), upheld the decision of the Trial Division in short reasons; further appeal to the Supreme Court of Canada was dismissed in a brief oral judgment, 77 DTC 5044.

80 Income Tax Act, RSC 1952, c. 148, as amended. These provisions were carried forward into the new Act in virtually identical language in paragraph 7(1)(b). Paragraph 7(1)(b) currently reads as follows:

> [I]f the employee has transferred or otherwise disposed of rights under the agreement in respect of some or all of the securities to a person with whom the employee was dealing at arm's length, a benefit equal to the amount, if any, by which
>
> (i) the value of the consideration for the disposition
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> exceeds
>
> (ii) the amount, if any, paid by the employee to acquire those rights
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> shall be deemed to have been received, in the taxation year in which the employee made the disposition, by the employee because of the employee's employment.

81 "Disposition" has been interpreted broadly by the Canadian courts to include extinction of a property right; see, in particular, the decision of the Supreme Court of Canada in *The Queen v. Compagnie Immobilière BCN Ltée*, 79 DTC 5068. The definition of disposition in subsection 248(1) is inclusive, and the majority of the Supreme Court, ibid., at 5073, referred to the broad meaning

The Federal Court Trial Division reversed the board's decision, ruling that the employer's anticipatory repudiation of the employees' options occurred when the employer corporation resolved to wind up; this "discharged" the option agreements, and the employees acquired new causes of action for damages for breach of the agreements. The new causes of action were in turn "discharged" by the settlement agreements between the employer corporation and the employees. The Federal Court of Appeal and the Supreme Court of Canada agreed with the Trial Division's ruling.

In effect, the Trial Division treated the employees' rights under the option agreements as having been terminated by the winding-up resolution, and as completely separate from their right to sue and the subsequent settlement and release. Similarly, the dissent in *Tsiaprailis* treated the arrears lump sum received by the taxpayer as being pursuant to the settlement agreement and release of all claims against the insurer, and not pursuant to the disability plan. It is clear, however, that the shares received by the employees in *Reynolds* were intended to replace, at least in part, the benefit they would have received if the option agreements had not been breached by the employer, and that the employees accepted the shares (if reluctantly) as such. The surrogatum rule as formulated by the majority in *Tsiaprailis* could now be applied to treat the value of the shares received as a replacement for the stock option benefit, and subject to tax as if it were such a benefit. Instead, the decision in *Reynolds* treated the value of the shares as a tax-free "windfall." At no stage in the *Reynolds* case was the surrogatum principle mentioned.

In the mid-1980s, the decision of the Federal Court of Appeal in *Greiner v. The Queen*[82] reached a different result. In *Greiner*, the employer corporation was to be amalgamated with a new Canadian corporation, so that all of its shares would be cancelled. The employer offered Mr. Greiner the opportunity to either surrender or exercise his stock options in advance of the amalgamation, and he agreed to surrender them for payments equal to the total difference between the option price and the fair market value of the shares at the time. The minister assessed the payments received under paragraph 7(1)(b). The taxpayer argued that the payments were not taxable, relying on *Reynolds*. The Federal Court of Appeal upheld the ruling of Addy J in the Federal Court Trial Division, distinguishing *Reynolds* on the basis that in *Reynolds* there had been an actual breach of the stock option agreements, while in *Greiner* there

given by the *Oxford English Dictionary* to the verb "dispose": "b. To put or get (anything) off one's hands; to put away, stow away, put into a settled state or position; to deal with (a thing) definitely; to get rid of; to get done with, settle, finish." See Douglas S. Ewens and Michael J. Flatters, "Toward a More Coherent Theory of Dispositions" (1995) vol. 43, no. 5 *Canadian Tax Journal* 1377-1411. The difficulty remains that paragraph 7(1)(b) specifically refers to a disposition *to an arm's-length person*, not just a disposition of the rights. This was not a problem in *Greiner*, infra note 82, however.

82 84 DTC 6073 (FCA). The appeal in *Greiner* was heard together with *Stephens v. The Queen*, 84 DTC 6080 (FCA), on common facts. The cases were joined at the trial level, but separate judgments were given by the Federal Court of Appeal.

had been a voluntary surrender of the rights under the option agreement, so that a disposition of the rights to the arm's-length employer corporation under paragraph 7(1)(b) had occurred. The Federal Court of Appeal noted that Mr. Greiner had signed the document in which he agreed to surrender his options before the amalgamation agreement was entered into between the two corporations, and before the amalgamation had been approved by the shareholders of the employer. The fact that he signed a document of election and release, formally surrendering the options and releasing the employer from further liability, six days after the amalgamation received shareholder approval, did not affect the status of the transaction as a voluntary surrender of the options to which paragraph 7(1)(b) applied. By contrast, in *Reynolds* the options were already "discharged" by the unilateral act of the employer and therefore could not be disposed of by the employees under the settlement agreement and release.

Two further cases in which the courts' perception of the voluntary nature of the disposition determined whether the payment received was taxable are *Dundas v. The Queen*[83] and *Buccini v. The Queen*.[84] Although the appeals were heard by the Federal Court of Appeal five years apart, they arose from the same transaction, in which Canadian Reserve Oil and Gas Ltd. ("CROG") was amalgamated with a wholly owned subsidiary of its US parent corporation, Getty Oil ("Getty"). Getty held 86 percent of CROG's shares before the amalgamation and wished to hold 100 percent through its subsidiary.

Mr. Dundas was the president and a director of CROG and held 0.5 percent of the outstanding shares, together with about 46,000 stock options. The amalgamation agreement provided that all options would be terminated on the consummation of the amalgamation agreement and that option holders would be paid $26 per option, less the exercise price of the options—the same amount that the CROG shareholders were to receive when their shares of CROG were cancelled on the amalgamation. The $26 value was supported by a fairness opinion from an established securities firm.

Mr. Dundas, as a director of CROG, voted for the amalgamation, signed the amalgamation agreement on behalf of CROG (as CROG's president) on June 22, 1983, and approved the information circular sent to the shareholders in advance of the shareholders' meeting and vote to approve the amalgamation. He voted his shares in favour of the amalgamation. Immediately following the shareholder vote, he executed a release agreement with CROG. He received almost $600,000 in respect of the termination of his stock options.

In appealing the assessment of tax on this payment, Mr. Dundas argued that *Reynolds* applied and that the amount was damages for breach of the stock option agreement, and thus tax-free. However, the Federal Court of Appeal, agreeing with the Federal Court Trial Division, held that Mr. Dundas had consented to the termination

83 *Dundas v. The Queen*, 95 DTC 5116 (FCA) (application for leave to appeal to the Supreme Court of Canada dismissed); aff'g. 93 DTC 5162 (FCTD); aff'g. 90 DTC 1529 (TCC).

84 *Buccini v. The Queen*, 2000 DTC 6685 (FCA); rev'g. 99 DTC 242 (TCC).

of his options; that he had acted in his own best interests in approving the amalgamation, rather than under compulsion of his fiduciary duty to CROG; and that the release agreement had in fact been unnecessary in his case. Therefore, paragraph 7(1)(b) applied to treat the payment he received as a benefit of employment.[85]

In 2000, the Federal Court of Appeal took a different view entirely of the amount received by Mr. Buccini, holding that he had received tax-exempt damages for termination of his CROG stock options. Mr. Buccini was not a director, officer, or shareholder of CROG and thus had no right to vote for or against the amalgamation. According to the Federal Court of Appeal, CROG unilaterally repudiated Mr. Buccini's rights under the stock option agreement on the amalgamation, so that his option rights were extinguished before he signed the release agreement; therefore, the amount he received, almost $84,000, was not received as consideration for the disposition of his stock option rights, but was compensation for the unilateral breach of the option agreement.[86] The Federal Court of Appeal held that a "disposition" under paragraph 7(1)(b) refers to a transaction by which the taxpayer *voluntarily* agrees to exchange property rights under a stock option plan.

With respect, there is no legally relevant difference between the positions of Mr. Dundas and Mr. Buccini. It was clear from the evidence that the decision to make CROG a wholly owned subsidiary of Getty through amalgamation had originated with Getty without consultation of CROG's board. Before the proposed amalgamation was announced, an executive was transferred to Canada from Getty's Los Angeles office to become chairman and chief executive officer of CROG. Mr. Dundas learned of the proposed amalgamation when a draft version of the amalgamation agreement was provided to him on May 27, 1983, less than a month before it was signed. He could not have prevented the amalgamation, given that he held only 0.5 percent of the shares of CROG and Getty had 86 percent. A majority of the minority shareholders voted in favour of the amalgamation. Mr. Dundas had the right to vote in his capacity as director and shareholder; as an option holder, he had no greater rights than, and received the same compensation as, Mr. Buccini.

In *Dundas* and *Buccini*, the original stock option agreements gave all option holders the assurance that if the options were changed owing to an amalgamation or other transaction, they would be put in the same relative position. That assurance was complied with fully. It must be noted that none of Mr. Buccini's options had

85 Interestingly, the trial judge found, in the alternative, that if Mr. Dundas received damages for breach of the option agreement, the payment was received by virtue of employment and was taxable as a benefit of employment under paragraph 6(1)(a). The trial judge relied on *Jack Cewe*, supra note 71; *Savage*, supra note 76, and *Nowegejick v. The Queen et al.*, 83 DTC 5041 (SCC). Paragraph 7(3)(a) would not exclude this result, provided that paragraph 7(1)(b) was inapplicable.

86 This was a very different view of the law of contract than that applied by the trial judge. The trial judge in *Buccini* had found that the amalgamation agreement did not extinguish the option holders' rights and that those rights continued until the release was executed and the payment received. The right to seek specific performance of the option agreement (even if the likely remedy was damages) continued until it was disposed of in the release agreement in exchange for the payment.

vested, and not all of Mr. Dundas's had, so that treating them as existing rights to full payment was quite generous.

Mr. Buccini was given a copy of the information circular, along with the shareholders. He testified that he thought the $26 per share was an undervalue of the CROG shares (despite the fairness opinion) and that he would have liked to keep the options. He also testified that he did not think he would likely have received more if he had sued for breach of his option agreement. He signed the release, after the shareholder approval of the amalgamation agreement, because he was not prepared to sue his employer. Mr. Dundas and Mr. Buccini were both in the position of having to either accept the offer of cash for their options or sue their employer for breach.

Even if Mr. Dundas and Mr. Buccini were in different positions from a legally relevant perspective, the wording of paragraph 7(1)(b) does not support a distinction between a voluntary surrender of options by mutual agreement and a termination of option rights by settlement and release; as a matter of law, a release is also a voluntary agreement between employee and employer, even if the employee is not completely happy with the result. The addition of subsection 7(1.7) to the Act, effective in March 2001, to ensure the taxation of stock option benefits in these circumstances was undoubtedly a direct reaction to the Federal Court of Appeal's ruling in *Buccini*. The failure of the Crown to make the surrogatum argument in *Buccini* is curious, given that none of the evidentiary or interpretive obstacles that prevented the inclusion in income of compensation for lost stock options in *Schwartz* were present in *Buccini*.

One final stock option case, *Bernier v. The Queen*,[87] is of interest. In that case, the employer, Nordair, having granted Ms. Bernier and numerous other employees rights to acquire shares, was advised by the Quebec Securities Commission that it could not legally issue the shares as promised in the option agreements. Ms. Bernier agreed to accept $58,000 in cash in exchange for waiving her right to the stock options. She was assessed as having received a benefit of employment under paragraph 6(1)(a), but she argued that the payment was for a disposition of options to acquire shares under paragraph 7(1)(b), in order to have access to preferential capital gains treatment on a disposition of prescribed shares under paragraph 110(1)(d). The trial court held that the amount could be taxed under either paragraph 6(1)(a) or 7(1)(b), but that paragraph 110(1)(d) would not apply since the shares, never issued or even validly created, would not be prescribed shares under the definition provided in regulation 6204(1)(b). On appeal, the Federal Court of Appeal held that paragraph 7(1)(b) did not apply because the employer had unilaterally terminated the stock option plan. On this point, the court followed *Reynolds* and distinguished *Greiner*. However, since Ms. Bernier had not challenged the trial judge's ruling that the amount was taxable as an employment benefit under paragraph 6(1)(a), that result was affirmed.[88]

87 2000 DTC 6053 (FCA).

88 This of course contradicts the statutory interpretation applied by La Forest J in *Schwartz*, holding that if a specific provision of the Act is relevant but does not apply, the amount may not then be included under a general inclusion provision. See the contrasting reasoning of Martland J in *Curran v. MNR*, 59 DTC 1247, at 1252 (SCC). La Forest J cites *Curran* as

The treatment of the cash payments received in *Reynolds* and *Buccini* as tax-free windfalls undermines the principles of equity and neutrality. An employee who actually exercises his stock options must include the difference between the value of the shares when acquired and the price paid on exercise of the options in income from employment. An offsetting deduction of 50 percent of the inclusion is normally available (under paragraphs 110(1)(d) and (d.1)) so that the benefit is taxed at the capital gains rate and the employee is not taxed more heavily in respect of shares acquired by exercising options than on shares purchased in the open market. The employer corporation is permitted no deduction in respect of the benefit conferred on the employee (paragraph 7(3)(b)). However, in the *Reynolds* and *Buccini* situations, the employer corporation could claim a deduction of the settlement amount since it incurred expense in settling a claim arising from its obligations to its employee, while the employee received a non-taxable windfall. This is by far the better tax result for the employee, and may also benefit the employer in comparison with actually issuing the optioned shares. There is thus a strong incentive for an employer to cancel options "unilaterally" and for the employee to agree to receive the tax value of the options in cash, for whatever reason, rather than to carry out the agreement as originally provided.[89]

Nowhere in the stock option cases does the word surrogatum figure, even though the payments received in each case undoubtedly replaced the amounts that would have been benefits of employment if the stock options had been exercised, rather than cancelled, and were calculated on the same basis as they would have been under paragraph 7(1)(b). So in this area as well, until the legislature amended the Act, the courts persisted in distinguishing between an amount paid as provided by the contract and an amount paid as compensation for breach of the obligation to pay as provided in the contract. If *Tsiaprailis* had been decided before *Buccini*, it should not have been necessary to amend the Act to add subsection 7(1.7).

Strike Pay

In *Fries v. The Queen*,[90] the Supreme Court of Canada (reversing the Federal Court of Appeal) stated simply that the court was not persuaded that strike pay was income from a source within paragraph 3(a), and that the benefit of the doubt must go to the taxpayer. The Federal Court of Appeal and the Federal Court Trial Division had found that the strike pay in question was income from a taxable source. The Federal

support for the existence of other sources of income under paragraph 3(a), but takes a completely different approach on all other common points.

89 For a thorough discussion of these issues, see Amin Mawani, "Tax Deductibility of Employee Stock Options" (2003) vol. 51, no. 3 *Canadian Tax Journal* 1230-58.

90 90 DTC 6662 (SCC); rev'g. 89 DTC 5240 (FCA); aff'g. 85 DTC 5579 (FCTD); rev'g. 83 DTC 117 (TRB). The Tax Review Board had held that although the strike pay was income from a source, it was not income from an employment relationship with the union, and that in the absence of a specific provision including strike pay in income, it was exempt.

Court Trial Division was persuaded that a contract either of service or for services had been formed between the union and each striking employee, including Mr. Fries, given that the union had offered the employees the equivalent of their (after-tax) take-home pay as strike pay if they would go out on strike. The union's unilateral offer of strike pay was accepted, and a contract formed, when each employee went out on strike.[91] The Federal Court of Appeal noted that an employee who is a member of a union may deduct dues or other amounts paid to the union in computing income from employment (under subparagraph 8(1)(i)(iv)), and that such dues are used by the union to form a strike fund with which to pay striking members. Further, the union is exempt from taxation both on the dues themselves and on any investment income generated by dues received from members that may be used to provide strike pay (paragraph 149(1)(k)).[92] The Court of Appeal found that once the dues are in the union's strike fund, they can be used to pay striking employees.

The surrogatum principle was not mentioned in any of the four levels of appeal in *Fries*, so that the issue was confined to whether strike pay was income from a source—that source being either a contract or the union strike fund. Applying the two-part *Tsiaprailis* test, it seems undeniable that strike pay replaces, at least in some small part, salary or wages that, if received from the employer, would be subject to tax as income from employment.

The *Fries* decision invites the question, post-*Tsiaprailis*, of whether the effect of the broad application of the surrogatum principle mandated by that case is to make an end run around the source concept of income. On the other hand, surrogatum could provide the solution to the conundrum that has developed in case after case in which the courts have affirmed the clear wording of paragraph 3(a) that there exist other, unenumerated sources of income, in addition to those enumerated in paragraph 3(a) and subdivision d, but have never identified even one such unlisted source.[93]

Awards in Personal Injury Actions: Compensation for Lost Employment Earnings to Date of Settlement or Trial

The sum of money that a plaintiff in a personal injury action receives for loss of amenities of life, pain and suffering, and diminished life expectancy does not, of course, truly restore what the plaintiff has lost. Money is the only store of value available in tort law to put the injured person, as nearly as possible, in the same situation as before the injury. As discussed below, this does not mean that the receipt of such a sum is income (or proceeds of disposition of a capital asset) within the comprehension of the tax system.

91 See *Carlill v. Carbolic Smoke Ball Company* (1893), 1 QB 256 (CA).

92 The tax treatment of strike pay is more generous in Canada than in other common-law jurisdictions, with the exception of Australia. See Benjamin Alarie and Matthew Sudak, "The Taxation of Strike Pay" (2006) vol. 54, no. 2 *Canadian Tax Journal* 426-49.

93 See the dissenting reasons of Major J in *Schwartz*, supra note 58, at 6119 (SCC).

It is submitted, however, that compensation of an injured employee for lost income from employment prior to trial or settlement should be seen as compensation for lost taxable income. The leading case in Canada is still *Cirella v. The Queen*.[94] The taxpayer was awarded a sum of $14,500 to compensate him for lost income from the time he was injured in a motor vehicle accident to the date of the trial of his claim against the defendant tortfeasor. The trial judge in the civil trial calculated a distinct part of the award by multiplying the taxpayer's weekly wages by the number of weeks he was unable to work at the heavy welding job he had held at the time he was injured, and awarded a precise amount that was found to have been lost wages. The injuries eventually resulted in the taxpayer's leaving his employment and starting his own light welding business, and the total lost income award included an amount representing lost revenue from the new business to the date of trial. The Tax Review Board included the damages award for lost income calculated to the time of the personal injury trial in the taxpayer's income, treating it as a replacement for both income from his original employment and profits from his new business.

The Federal Court Trial Division reversed, citing but refusing to follow the *London and Thames* case. Thurlow ACJ canvassed the authorities on personal injury damages for lost employment income and distinguished such payments from damages for lost business profits where there has been tortious damage to income-producing property of a business.[95] He held that awards or settlements compensating for lost income from employment to the date of trial or settlement and amounts for lost future income attributable to the injured worker's loss of income-earning capacity are exempt from taxation on the same basis. Although the lump-sum amount for lost income to the date of trial was measured by the weekly wages during the time the taxpayer was unable to work, it represented lost earning capacity or "impairment of earning power,"[96] just like the estimated amount for future lost earnings. The award for lost salary or wages to trial was "not of an income character";[97] it was not earned from employment or business activity but compensated for the personal injury; and, following *Atkins*, it was capital in nature.

Thurlow ACJ reached this conclusion despite the clear indication in *The Queen v. Jennings et al.* (Judson J with the concurrence of the full Supreme Court) that an award of damages for lost earning capacity may be distinguishable from an amount calculated as and compensating for actual lost wages.[98] Thurlow ACJ followed two

94 77 DTC 5442 (FCTD); rev'g. 76 DTC 1211 (TRB).

95 This was the fact situation in *London and Thames*, supra note 7.

96 *Cirella*, supra note 94, at 5445 (FCTD).

97 Ibid.

98 [1966] SCR 532. Judson J made the following statement, ibid., at 544: "For what it is worth, my opinion is that an award of damages for impairment of earning capacity would not be taxable under the Canadian *Income Tax Act*. *To the extent that an award includes an identifiable sum for loss of earnings up to the date of judgment the result might well be different*. But I know of no decisions where these issues have been dealt with and until this has been done in proceedings in which the Minister of National Revenue is a party, any expression of opinion must be insecure [emphasis added]."

rulings of the High Court of Australia (which pre-date *Jennings*) to hold that there was no distinction to be made between compensation for "lost earning capacity" before and after trial or settlement. However, it seems untenable to equate a precisely determined amount replacing exactly the employment income actually lost to the date of trial with an award of compensation for loss of future income, which is necessarily an imprecise estimate of the current value of many years' lost earning capacity after discounting for contingencies.

It is not disputed here that the law is now clear that courts may make an award for lost earning capacity between the date of the injury and the trial, and that that amount may not be reduced to take into account income tax that would have been payable if the income had been earned. The leading case is *Watkins v. Olafson*,[99] where the plaintiff was rendered quadriplegic in a car accident at the age of 33. At the time of the accident, the plaintiff was self-employed in an unsuccessful business, which (as he acknowledged in his testimony) he would have had to abandon even if he had not been injured. The trial took place nine years after the accident, so that the court was put in the position of estimating what amount the plaintiff would have been able to earn if he had become employed (as the court found was reasonable to expect) instead of being injured. The Supreme Court rejected the defendant's argument that the total amount of pre-trial lost earnings should be reduced to account for the tax the plaintiff would have had to pay if the amount had been earned as ordinary income over the nine-year period. Referring to *Jennings*, the court distinguished between *identifiable* past lost earnings and past lost *earning capacity* for the purposes of determining whether the award should be reduced by the tax that would have been payable on such lost earnings.

In *Cirella*, the damages paid as compensation for lost wages prior to trial were undoubtedly a replacement for identifiable past lost earnings rather than lost earning capacity. However, since *Cirella*, the assessing policy of the Canada Revenue Agency (CRA) has been to exempt from taxation amounts received in personal injury actions that compensate for lost employment income both before trial or settlement and in the future:

> All amounts received by a taxpayer or the taxpayer's dependant, as the case may be, that qualify as special or general damages for personal injury or death will be excluded from income regardless of the fact that the amount of such damages may have been determined with reference to the loss of earnings of the taxpayer in respect of whom the damages were awarded. *However, an amount which can reasonably be considered to be income from employment rather than an award of damages will not be excluded from income*.[100]

Although the last sentence suggests that the CRA distinguishes between earning capacity and identifiable earnings lost prior to trial, the point has not been contested

99 [1989] 2 SCR 750.

100 *Interpretation Bulletin* IT-365R2, "Damages, Settlements and Similar Receipts," May 8, 1987, paragraph 2, emphasis added.

in any tax cases since *Cirella*, indicating that the CRA does not apply this distinction in practice.[101] Application of the surrogatum principle would treat compensation for pre-trial lost earnings, whether computed on the basis of identifiable amounts (as in *Cirella*) or on estimates of what the taxpayer would likely have earned if he had not been injured (as in *Watkins v. Olafson*), as the replacement of employment income, and such compensation would thus be taxable.

The result of allowing an exemption from tax is that injured employees are overcompensated in damages for identifiable or estimated lost earnings prior to trial or settlement, in that a tax-free amount is substituted for an amount that would have been taxed. At the time of trial (or settlement), all the facts are known, including the amount of tax the employee would have had to pay if he had received the amount as remuneration, and this can be calculated with great accuracy.

The non-taxation of pre-trial income loss compensation is inconsistent with the taxation of periodic disability insurance payments, and replacements for such payments, as required by paragraph 6(1)(f). The inconsistency is highlighted where an employee who is injured in a car accident has both employer-provided disability insurance and no-fault motor vehicle insurance coverage, or just motor vehicle insurance coverage, for lost employment income. It also arises where the defendant has other insurance coverage (such as homeowner liability) or no insurance that covers the circumstances of the accident, so that the defendant must compensate the plaintiff directly. In addition to being taxable under paragraph 6(1)(f), disability insurance benefits typically replace only two-thirds of the pre-accident income, and there is sometimes a maximum monthly payment. As the law currently stands, the portion of benefits under the motor vehicle or homeowner's insurance, or of damages paid by an uninsured defendant, that replaces lost income from employment is not taxable. This treatment makes it far more advantageous for an injured employee to recover past lost income from a motor vehicle insurer (or from the uninsured defendant directly where the injury is unrelated to a motor vehicle) than to claim under a disability insurance plan provided by the employer.

To avoid this result, motor vehicle accident insurance legislation in British Columbia now limits compensation payable for pre-trial income loss (up to the first day of trial) to net income after federal and BC income tax and employment insurance premiums.[102] This puts periodic disability insurance benefits (when wholly or partly paid for

101 In my view, the distinction is not justifiable despite the clearly established law. There is no reason, other than sympathy for the injured person (and perhaps the negative tax consequences of receiving a lump sum rather than periodic payments, discussed below), to provide full compensation for past lost income, whether identifiable or estimated, without taking tax into account. But it is perhaps preferable to make both types of compensation taxable, rather than reduce the award, since the latter option benefits the defendant at the expense of the fisc.

102 See sections 52 and 54 of the British Columbia Insurance (Motor Vehicle) Act, RSBC 1996, c. 231, as amended, effective for payments after June 17, 1997. A review of the motor vehicle insurance legislation in all 13 Canadian jurisdictions is beyond the scope of this article; however, it appears that a similar effect is obtained through legislation or policy restrictions in jurisdictions

by an employer) and motor vehicle accident insurance benefits for past lost income on the same tax footing, so that motor vehicle accident victims without disability insurance are no longer in a better position than those who have it, in respect of no-fault pre-trial income replacement. The insurer benefits at the expense of the provincial and federal governments (a result that might be viewed as a covert transfer from Ottawa to Victoria, given the provincial government monopoly on automobile insurance in British Columbia).

The different tax treatment of motor vehicle insurance benefits and employer-provided disability insurance benefits has caused somewhat questionable results in at least one tax case. In *Chapman v. The Queen*,[103] the taxpayer had been injured in a car accident. Her motor vehicle insurer paid her 80 percent of her lost employment income while she was unable to work. She also had employer-provided disability insurance. The motor vehicle insurer was entitled to be reimbursed by the disability insurer and recovered some $19,000. The court found that the $19,000 payment from one insurer to the other was to be included in Ms. Chapman's taxable income under paragraph 6(1)(f), even though she had had no involvement in the discussions between the two insurers, did not receive any payment personally from the disability insurer, and simply received a tax assessment. The CRA now takes the position that where provincial legislation requires a taxpayer who receives long-term disability payments to assign them to the automobile insurance company, there is no inclusion in income for the disability benefits.[104] Thus, the non-taxable type of payment has preference, but the taxpayer is receiving compensation for exactly the same loss—wages, salary, benefits, and other remuneration—to the relevant date.

There is a much stronger basis for a tax exemption for a lump-sum payment to compensate an injured employee for lost future earning capacity, as accepted and established in *Jennings*. The various contingencies that may arise in the future and are applied to increase or decrease the award are admittedly only projections and probabilities, filtered through a judge's sense of what the future most likely holds. The injured party's tax situation, including future variations in basic exemptions and rates, and the availability of medical and disability credits or deductions, are impossible to predict over the long term. In addition, the lump sum for lost earning capacity is awarded so that it may generate a stream of investment income to replace the lost earnings. The stream of income will be taxed according to the injured person's actual tax situation at the time it is received. In effect, the surrogatum rule already operates indirectly on this head of damages by treating the loss of future earning capacity as a disposition of a valuable capital asset, or source of income, but one that is outside

other than British Columbia. See, for example, CRA document no. 9811355, July 2, 1998, regarding recent amendments to the New Brunswick Insurance Act. In Ontario, an employee covered by an employer-provided plan who receives periodic disability benefits is required to pay these amounts over to the motor vehicle accident defendant, with the result that they cease to be taxable: CRA document no. 2003-0010273, June 11, 2003.

103 98 DTC 1443 (TCC).

104 See CRA document no. 2004-0085121R3, February 9, 2005.

the income tax net because it represents the personal attributes and physical integrity of an individual. The lump sum replaces the lost earning capacity, but no capital gain is realized because tax law does not (and in my view should not) treat an individual's earning capacity as a marketable asset comparable to the tangible and intangible capital property of a business. All subsequent references to compensation for income loss in personal injury cases in this article should therefore be understood to mean compensation for pre-trial or pre-settlement income loss, whether to replace estimated income based on lost earning capacity before trial or to replace identifiable items of lost income.

Compensation for Human Rights Violations in Respect of Employment

It is evident from the cases discussed above that compensation for some losses or injuries, though paid in money as a matter of tort law, is considered to fall outside the reach of the tax system. This concept underlies the jurisprudence that allows exemption from tax for compensation awarded for human rights infringements, whether or not associated with wrongful dismissal or constructive dismissal—for example, to compensate for mental distress and injury to dignity and self-respect resulting from harassment or discrimination in the workplace.[105] Damages for defamation of an employee by the employer are also tax-exempt, even when associated with the termination of employment, since the employer has committed a separate actionable wrong.[106]

It has recently been held that an award to compensate for a breach of the human right to equality in employment is taxable as income from employment under section 5 of the Act. In *Morency v. AG of Canada*,[107] the taxpayer (Ms. Morency) was a member of a group of women employed by the government of Quebec who alleged that they had suffered sexual discrimination, contrary to the Quebec Charter of Human Rights and Freedoms, in that they were paid less than male employees for work of equal value that was usually performed by men. After the Human Rights Commission found that the complaint was made out, a global settlement in the amount of $1.3 million was agreed between the Quebec government and the employees' union. Each member of the employee group was allocated a portion of the

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105 *Stolte v. The Queen*, [1996] 2 CTC 2421 (TCC); and *Fournière v. The Queen*, 99 DTC 3526 (TCC). The CRA's position is found in paragraph 12 of IT-337R4, supra note 63: "[G]eneral damages relating to human rights violations can be considered unrelated to a loss of employment, despite the fact that the loss of employment is often a direct result of a human rights violation complaint. If a human rights tribunal awards a taxpayer an amount for general damages, the amount is normally not required to be included in income. When a loss of employment involves a human rights violation and is settled out of court, a reasonable amount in respect of general damages can be excluded from income. The determination of what is reasonable is influenced by the maximum amount that can be awarded under the applicable human rights legislation and the evidence presented in the case."

106 *Bedard v. MNR*, 91 DTC 573 (TCC).

107 2006 DTC 6069 (FCA); aff'g. 2003 DTC 4035 (TCC).

award based on the number of days worked during the period the discrimination persisted. Ms. Morency was assessed tax on the amount she received ($5,284.00).

Because Ms. Morency had not suffered a loss of employment, the amount she received could not be classified as a retiring allowance. The Tax Court of Canada held that the amount was in the nature of special rather than general damages, and since it was paid by the employer, and was calculated pro rata based on the days worked at the discriminatory wage, the payment was income from employment under subsection 5(1) of the Act. Even though the reason for the payment was breach of the human right not to be discriminated against on the basis of sex, and to receive equal pay for work of equal value under sections 10 and 19 of the Quebec Charter, the payment was held to be compensation for loss of salary and not compensation for mental distress or injury to dignity caused by the infringement of the taxpayer's human rights. The Federal Court of Appeal upheld the judgment of the Tax Court, noting that the parties that had negotiated the settlement regarded it as income to the recipients, and that there was no evidence of mental distress suffered by the taxpayer.

This case is interesting for two reasons. On the one hand, the award was not made in respect of a market transaction—a breach of a human right is not, per se, an infringement of an economic interest comparable to a breach of contract or negligent damage to commercial property. Rather, the substance of the rights infringement was refusal to pay employment earnings that ought to have been paid for work that was actually performed. Without referring to the surrogatum principle (or, indeed, any authorities), the Federal Court of Appeal treated the settlement of the human rights violation as a replacement for income from employment. It appears that the court was treating the award as a replacement of the actual wages the employee was owed for years prior to 1990, rather than as a replacement of, or compensation for not having received, equal pay for work of equal value. However, the amount of the award was evidently not the amount that Ms. Morency ought to have been paid in those years, given the Federal Court's statement that, compared with the amount she was paid under the new collective agreement that took effect in 1990, the amount of the settlement was very small. On the other hand, the Tax Court's characterization of the award as being in the nature of special rather than general damages is significant, in light of the treatment of special damages that compensate for loss of identifiable employment earnings when the reason is personal injury or wrongful dismissal.

So, is it the nature of the payment (additional pay) or the nature of the injury (human rights violation) that should determine the tax treatment of the compensation? Strong arguments can be made on both sides. A policy-based decision of a court on this point is still lacking.

POST-TSIAPRAILIS CASES

There are two cases of particular interest decided after the Supreme Court's disposition of *Tsiaprailis*. The first is *Farrell v. The Queen*.[108] This too was a disability benefits

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108 2005 DTC 842 (TCC).

case in which the taxpayer had had to sue to obtain benefits and settled for an amount that included arrears of periodic payments. Ms. Farrell sought to deduct the legal expenses she incurred in suing the insurer pursuant to paragraph 8(1)(b) of the Act, which (in its current version) allows a deduction for legal expenses incurred "to collect or establish *a right to salary or wages owed to the taxpayer by the employer or former employer of the taxpayer* [emphasis added]." The Tax Court of Canada found that although it was the insurer that paid the settlement directly, it was the employer's obligation to provide the insurance, and therefore the amounts were owed by the employer. The court also applied the surrogatum rule, citing *Tsiaprailis* in interpreting paragraph 8(1)(b) as including legal expenses to establish a right to a replacement for salary or wages. In a sense, the court found that if disability insurance payments are a replacement for employment income, then legal expenses to recover such payments are a replacement for legal expenses to recover salary or wages. Draft legislation released July 18, 2005 proposes to amend paragraph 8(1)(b), effective 2001, to allow a deduction for legal expenses incurred to collect, or to establish a right to, any amount taxable under subdivision a. If the proposal is enacted,[109] the *Farrell* situation will not arise again. However, the application of surrogatum to a specific deduction or exemption provision, in order to balance its application with an inclusion of an amount in income, is original and could be revisited in future cases.

The second post-*Tsiaprailis* case that raises (but does not really resolve) an interesting issue is *Au v. The Queen*.[110] As a member of a professional accounting firm, Mr. Au had provided much-appreciated advice and services to Paul Johnson and his companies for some years. Mr. Au and Mr. Johnson developed a relationship of trust and friendship. In 1987, Mr. Johnson asked Mr. Au to accept employment as a senior officer of at least two companies in the Johnson Financial Ltd. ("JFL") group. At the time Mr. Au joined the JFL group, Mr. Johnson wrote him a letter describing his employment duties and remuneration, and also stating that his (Johnson's) will would provide a bequest for Mr. Au constituting one-ninth of the residue of his estate. Later, a draft of the will provided to Mr. Au indicated that his share of the residue would be one-tenth, on the condition that he was still employed within the JFL group at the time of Paul Johnson's death.

In 1996, JFL sold its insurance subsidiary (the business with which Mr. Au had been most closely engaged) and Mr. Au was advised that his expertise was no longer needed. Paul Johnson's lawyer advised Mr. Au that under Johnson's then current will, there was no provision for Mr. Au. Mr. Au commenced wrongful dismissal proceedings against JFL and its insurance subsidiary, and against Paul Johnson personally, alleging that he had been in an employment relationship with all three. He sought damages for loss of employment and breach of agreement to provide a one-ninth interest in the estate, or a declaration of constructive trust of one-ninth of the

109 The fate of the proposed amendments, which should be uncontroversial, is not clear at the time of writing, owing to the change of government following the federal election in January 2006.

110 2005 DTC 794 (TCC).

estate. Mediation resulted in an out-of-court settlement, and each of the two corporations made payments to Mr. Au. In addition, Paul Johnson personally paid him $3.08 million, which represented one-tenth of the value of the estate in 1997, as part of the settlement of the claim. Mr. Au was assessed for tax on all three amounts. He appealed in respect of the $3.08 million paid by Mr. Johnson.

The issue was whether the $3.08 million was paid as a replacement for a gift or bequest (which would be tax-free) or as a replacement for a benefit of employment (which, of course, would be taxable). Both Mr. Au and the Crown relied on the Supreme Court of Canada's ruling in *Tsiaprailis* and sought the application of the surrogatum rule. The Tax Court unfortunately draws some very peculiar conclusions about the payment. Some statements in the court's reasons suggest that the promise of a one-tenth interest in the estate was binding, but the court also says that there was no binding contract with respect to the legacy and that Mr. Au had no obligation to provide any services in exchange for it—a test that is not relevant in determining whether an amount is a benefit of employment, following *Savage*.[111] Further, since Mr. Johnson was still alive at the time the payment was made, it is hard to see how Mr. Au could have been entitled to it: if the bequest really was a pure gift, it could have been revoked by a new will. Certainly Mr. Johnson must have received legal advice that there was some merit to Mr. Au's claim, or he would not have paid so much to settle it before trial. Mr. Au's statement of claim clearly asserted his right to the amount as owed to him in connection with his employment. The conclusion is inescapable that the basis of the settlement was that the promise was binding, so that the payment was not a gift. The Tax Court found, however, that the settlement payment was a surrogatum for a bequest, and thus exempt from tax. This ruling is a departure from the approved approach to determining what the payment replaces, in which the Tax Court is not supposed to revisit the merits of the plaintiff's case in determining whether the receipt is a windfall.[112]

The *Au* case is the first example of the application of the *Tsiaprailis* reasoning to an amount alleged to be income from employment under section 5 or paragraph 6(1)(a), rather than under paragraph 6(1)(f), indicating that it is not just settlements for arrears of disability benefits that may now be subject to the surrogatum rule. The case raises again the question of form versus substance. In determining what the settlement replaces, should the court focus on the form of the entitlement (in this case, replacement of a bequest) or on its underlying nature and purpose (a contractual promise to provide additional amounts in respect of employment)? The dissent in *Tsiaprailis* was constrained by the court's entrenched jurisprudence in which form, and a taxpayer's right to arrange his affairs to minimize his tax liability, takes precedence over "substance" or commercial reality. That is, the taxpayer is taxed according to

111 Supra note 76. Curiously, neither *Savage* nor the obviously relevant *Phaneuf Estate v. The Queen*, 78 DTC 6001 (FCA), is referred to in *Au*.

112 See *Mohawk Oil*, supra note 30, and *Bellingham*, supra note 44.

the form of the transaction, not a different form of the transaction that has a different tax consequence. In the dissent in *Tsiaprailis*, the lump-sum arrears were treated as a settlement of a contested claim in which no liability was admitted by the defendant, rather than as, in substance, the sum of periodic payments that should have been made pursuant to the policy. The *Au* decision resembles the dissenting reasons in *Tsiaprailis*. The court attributed the form that the underlying entitlement was to take (a bequest) to the settlement payment, rather than looking through the bequest to determine its substance—namely, a benefit of any kind whatever received or enjoyed in respect of, in the course of, or by virtue of an office or employment.

POLICY CONSIDERATIONS

Some of the policy implications of the *Tsiaprailis* decision have been raised already in this article. This section gathers these issues together in one place for re-examination.

Although the result in *Tsiaprailis* is hard to criticize, there are good policy reasons that deserve consideration for not extending the surrogatum principle, from its original base in business and property income, to employment income. In *Schwartz* and implicitly in *Fries*, the Federal Court of Appeal was open to the application of the surrogatum principle to non-business income for some time before *Tsiaprailis*, but was overruled in both cases by the Supreme Court of Canada. When the Supreme Court finally did extend surrogatum to employment and other sources of income, neither the majority nor the dissent addressed why the principle had hitherto been restricted to business income, or considered any broader policy reasons for either continuing the narrow application or extending it.

Horizontal equity between taxpayers and neutrality of tax law are the two policy values that are most clearly and directly involved in an assessment of the broader application of the surrogatum principle mandated by *Tsiaprailis*. Horizontal equity demands that taxpayers who have the same level of income (which is a proxy for ability to pay tax) be subject to the same level of taxation, regardless of the form of the income. Thus, a taxpayer who receives a payment from his employer to compensate him for the salary and benefits he will not receive because his employment has been terminated without notice has (at least) the same ability to pay tax as the taxpayer who is given reasonable notice, continues to perform his employment, and receives his salary and benefits throughout the notice period.

Neutrality requires that, as far as possible, tax rules should not distort a taxpayer's economic choices. If settlements and damages were always exempt from tax, there would be an economic benefit for taxpayers who breach their contracts and then settle for an amount equal to the payment due under the contract, net of the recipient's tax liability. The recipient would not have to include the amount in income, and the payer would reduce its expenses by the amount of the tax saving. In a sense, the legislation limiting a motor vehicle insurer's liability for lost income to the net after-tax amount is a measure that restores neutrality to the system. The employee who is able to work must pay tax on the income; therefore, the injured employee who receives full compensation for lost income should not receive the pre-tax amount.

Limitation on Deductions in Respect of Employment Income

One reason to hesitate in applying surrogatum to employment income is that the deductions allowed in computing income from employment are expressly limited to specific amounts set out in the Act,[113] while income from business or property is computed net of all expenses incurred for the purpose of producing income.[114] There is therefore a substantial risk, which does not arise in the case of business or property income, that an amount may be held to be taxable in the employee's hands where the outlay to gain the entitlement to the amount—whether it be insurance premiums, legal fees, or an expenditure of another character—is not deductible. In the case of disability insurance payments taxed under paragraph 6(1)(f), inclusion and deduction are balanced: the portion of the premiums paid by the employer is deductible as an expense of earning business income, and any premiums paid by the employee are deductible from the periodic benefits received. This not only ensures that expenses incurred by the employee to obtain the income are deductible, but also creates a direct link between the employment relationship and the receipt of benefits, or the replacement for such benefits.[115] The issue of whether the replacement payment relates to a source of income recognized by the Act as taxable does not arise.

Correcting for Receipt of a Lump Sum in a Single Taxation Year

One problem that will arise if lump-sum payments to compensate for employment income lost over several years are now to be taxed on the same basis as the lost income itself is how to avoid overtaxing the income. For example, Ms. Tsiaprailis received approximately three years' accumulated arrears of periodic benefits in one year, undoubtedly increasing the total amount of tax payable on the benefits beyond what would have been payable if they had been received over three years.

The "bunching" problem of receiving a lump sum in one year instead of periodic payments over several years relates to whether the surrogatum principle should apply outside the business-income context because the issue does not arise so starkly in the case of business or property income. Damages or settlements may increase profit in one year, but losses of a previous year that were caused or exacerbated by the breach of contract or property damage can usually be carried forward to reduce the effect of the receipt of compensation. By contrast, it is rare for an employee to have actual losses, as opposed to nil or very low income from employment in a given year, so that losses are usually not available to reduce taxable income in another year.

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113 Subsection 8(2).

114 This is the result of subsection 9(1), which imposes tax on the profits of business or property. "Profits" has been interpreted in many leading cases to mean net profit after all expenses incurred for the purpose or in the course of earning the income; see, among others, *Minister of National Revenue v. Irwin*, [1964] SCR 662, and *Symes v. The Queen*, [1993] 4 SCR 695.

115 This second aspect is really a source issue, rather than an issue of balance or horizontal equity.

Other differences between the taxation of corporations and individuals make the problem greater for recipients of non-business income. Corporations are subject to tax on the first dollar of income and are not taxed at progressive rates (except for income subject to the small business deduction). A significant increase in income in one year attributable to receipt of a lump sum does not result in the additional income being taxed at a higher rate. Businesses also have greater flexibility to adjust their taxable income from year to year than most employees, because the computation is based on accrual of revenue and expenses, and there are optional deductions in respect of certain assets, such as capital cost allowance for depreciable property and cumulative eligible capital amount for eligible capital property.

In relatively recent amendments to the Act, sections 110.2 and 120.31 seek to provide relief for individuals who receive a lump-sum payment as either income from business or income from employment that relates to previous taxation years. The lump sum is spread over the past years to which it relates and is deducted in the same portions from income for the year of receipt. The notional additional tax is calculated for each past year by including the allocated portion of the lump sum in the computation of the individual's taxable income for that year. Interest is calculated on a compound basis on the notional additional tax for the previous years as a result of adding a portion of the lump sum. As has been noted by others,[116] the interest provision effectively eliminates any benefit of the application of these provisions if the period over which the lump sum is allocated is greater than four years. A fairer provision is needed to address the sometimes very adverse tax impact of receiving a lump sum instead of periodic salary, benefits, etc.

Source as a Threshold Issue

An injured employee (or independent businessperson) who has personally paid 100 percent of the premiums for disability insurance coverage is not entitled to claim a deduction for those payments, but is also not taxable on any resulting compensation for lost income. This is because the compensation is not connected to a source of income recognized by the Act. If the employer does not contribute any portion of the premium payments, the plan is not a source of employment income, and any benefits received under the plan are not taxable as income from employment.

The injured person whose car insurance covers his lost employment (or business) income (or who is covered by the other driver's insurance) receives an amount that replaces taxable income, but the source of the payment is an insurance contract unrelated to any business or employment source. It is said that in this case the source of the payment is the personal injury, which is not a recognized source, or possibly the insurance contract, which is personal to the individual and also not a source that is employment or business. Since the source of the payment is not recognized, the legal and other costs of recovering benefits are not deductible. This has given rise

116 See Evans JA of the Federal Court of Appeal in *Tsiaprailis*, supra note 5, and *Milliken v. The Queen*, 2002 DTC 1510 (TCC).

to the situation described earlier where it is better for an employee who is injured in a car accident to be compensated directly by the defendant (or, in the days before changes to car insurance laws limited coverage to after-tax lost income, by motor vehicle insurance) than by disability insurance to which the employer has contributed, even though the compensation is for the same loss.

Given that motor vehicle insurance law now limits personal injury compensation to after-tax income, should claimants not be entitled to claim the full amount of any legal expenses paid to recover the compensation? Would it be better to focus on what the compensation replaces (income from employment) rather than the nature of the loss (physical and/or mental injury)? That would lead to making the compensation taxable, and allowing the deduction of car insurance premiums paid by the recipient to acquire the insurance, and of legal expenses incurred in recovering the compensation.[117] Where there is no insurance coverage (disability or motor vehicle), the defendant has to pay the full pre-tax compensation, but the plaintiff is exempt from tax. Should that (admittedly somewhat rare) anomaly be allowed to persist? Or is the present situation "fair enough"? There is a dearth of analysis of these issues, owing to the longstanding precedent set in *Cirella*.

Capital Gains

The business cases are largely concerned with whether a settlement or damages award replaces an amount that should be included in income or treated as proceeds of disposition of a capital property used to earn income from the business or property. In *Tsiaprailis*, the portion of the lump sum that compensated for the entitlement to future benefits was treated as being in the nature of a capital payment, but the judgment did not identify a capital property for which the payment could be proceeds of disposition. The CRA's position is that the compensation constitutes proceeds of disposition of an insurance policy, and thus is not taxable. While this may answer the specific question raised in *Tsiaprailis*, it leads to many more difficult questions. A full canvassing of the issues and their potential solutions is beyond the scope of this article, but there follows a brief tour of some of the more salient points.

If damages and settlements received by individuals outside the commercial and property investment context are now to be treated as allocable to income and capital, depending on the nature of the loss for which the payment is intended to compensate, it will become important to clarify what constitutes a capital asset for an individual taxpayer. We have seen in *Ahmad*, for example, that the court treated the damages for the taxpayer's loss of his career, and the damage to his professional reputation,

117 The draft legislation referred to above in the discussion of the *Farrell* case, supra note 108, would allow the deduction of legal fees in personal injury cases to offset the inclusion in income of compensation for lost income from employment to the date of trial. The injured employee in personal injury litigation covered by no-fault motor vehicle insurance would not just be exempt from tax on costs reimbursed but would also be able to deduct the total legal expenses incurred to gain the settlement or damages compensating for lost employment income prior to trial, provided that this portion of the settlement or damages became taxable.

as separate from compensation for his loss of employment. Is a person's career a capital asset? Is a person's professional reputation a capital asset? Should training, experience, education, and more personal aptitudes and attributes such as strength, youth, dexterity, diligence, leadership and communication skills, intelligence, etc., which add up to the capacity to earn income, be treated as capital assets? Are they property, which is disposed of when a person loses these assets or the physical ability to use them to advantage? If they are property, how should we determine the tax cost of these assets?

As pointed out earlier, the compensation that a plaintiff may receive for loss of dignity and self-esteem resulting from a violation of human rights (including discrimination), or for loss of amenities of life or diminished life expectancy, is merely a monetary surrogate for advantages that are arguably not "property" as the Act perceives it. These very personal aspects and benefits of individual integrity cannot, of course, be replaced with money; it is therefore submitted that financial compensation for their loss, whether by breach of contract or tort, should be treated as following outside the realm of taxation. This reasoning corresponds with the *Bellingham* analysis—namely, where the payment does not flow from performance or breach of a market transaction recognized as a source of income, it is not taxable. Thus, for example, since peace of mind or life expectancy is not a tradable or marketable asset, compensation for loss or diminishment of these attributes should not be taxable.

The case of *Manrell v. The Queen*[118] supports this approach. In that case, the payment made to the taxpayer for his personal covenant not to compete with the businesses of the companies whose shares he had just sold was held not to be proceeds of disposition of property, since the right to carry on a particular business is not a right in the nature of property. By the same reasoning, an individual's capacity to earn income is essentially her personal "goodwill," developed over the course of her life. Although goodwill is an intangible asset, and certainly one that has worth, if it is not "in respect of a business of a taxpayer,"[119] it is not recognized as a source of income under the Act. The Act only recognizes actual employment, not the capacity to be employed (or self-employed), as a source of income. Compensation for injury to dignity and self-worth owing to a human rights violation by an employer (or otherwise) is similarly outside the tax realm.

If this analysis is incorrect,[120] the courts will have to develop a method for computing the tax cost of a person's reputation in a particular employment milieu, his mental and physical integrity, ability to use his skills, experience, and other attributes employed in earning income. An easy solution would be to simply conclude that the

118 2003 DTC 5225 (FCA).

119 Subsection 14(1). This provision brings into the tax sphere eligible capital property, such as goodwill and other intangible assets of a business.

120 For this part of the discussion, I have profited from the access kindly granted by Tamara Larre to her draft paper "The Taxation of Personal Injury Damages for Loss of Earnings: Towards a Coherent yet Workable Approach."

cost is equal to the value; that is, the taxpayer has "invested" through past activities (education, training, experience, development of skills) an amount in money's worth that is equal to the cumulative value of the lost capacity at the time it is damaged or destroyed. This would result in a capital gain of nil when compensation is paid for the loss. However, it could also lead to a capital loss of the same value in cases where no compensation was paid, such as where the tortfeasor had no insurance and insufficient assets.

Alternatively, one could determine that the cost of the earning capacity is nil: we do not pay anything for the personal attributes we acquire at birth, and in most cases they develop without any identifiable outlays of money that can be specifically connected to such development. Education is largely state-funded, and the personal financial contribution to post-secondary training is reduced to a degree by scholarships, bursaries, and tuition, education, and other tax credits. In the same vein, on-the-job training is usually paid for by employers, and experience is presumably compensated for by current income as it is acquired.

The result of attributing a nil cost to the asset is that when a person becomes disabled and permanently incapable of earning employment income, the award for lost past and future earning capacity should be seen as proceeds of disposition of a capital asset. In this case, the full amount received would constitute a capital gain, and would be taxed at half the taxpayer's otherwise applicable marginal rate. The after-tax sum for lost future earning capacity would then probably be inadequate to produce the stream of income that would be necessary to replace the estimated lost earnings of the injured taxpayer over his remaining working life. Arguably, the sum left after tax in respect of past lost earning capacity would still sometimes overcompensate the taxpayer (or undercompensate, if its character as a capital gain eliminated deductions or credits that would otherwise have been available). This is because the payment should be taxed at the taxpayer's actual progressive rates and should be subject to the various deductions, exemptions, and credits that would have applied had the taxpayer earned the employment income over the relevant years (based on the civil court's estimate, on a balance of probabilities and taking all contingencies into account, of the amount the taxpayer would have earned).

Finally, the court could attempt to actually compute a cost for the career, earning capacity, reputation, dignity, self-esteem, or other capital asset of the employee. The prospect is daunting, at least as daunting as trying to determine the future tax impact on a person's potential earnings over many years. In *Jennings*, Judson J rejected a deduction from the award for lost earning capacity to take account of tax that would be payable on the future earnings themselves, finding the practical difficulties insurmountable. It is submitted that the option of computing an ACB of the personal income-earning attributes of an individual in order to compute appropriate compensation for loss of such attributes should be rejected on the same basis.

CONCLUSION

This article has attempted to demonstrate that the decision in *Tsiaprailis* extends the surrogatum principle to replacement payments for all sources of income, rather than just business and property, even if it was not necessary to apply it in the circumstances of that case. A similarly broad application of surrogatum in the early development of the principles of Canadian income tax law would have prevented some anomalous, and arguably non-neutral and inequitable, exclusions from the tax base, which have persisted for long periods and ultimately have to be resolved by amending the legislation. Surrogatum could now be put forward as a basis for bringing into the tax base certain amounts that have so far been excluded (also with negative implications for neutrality and equity), such as compensation for lost employment income owing to personal injury, and strike pay. However, the extension of the replacement payment theory from the commercial world to employment and other forms of income that are personal and restricted to individuals, including compensation for personal injury or breach of human rights, brings with it a need to draw new limitations. Most obviously, an individual's income-earning capacity should not be treated as a capital property, the disposition of which can give rise to a capital gain or loss for tax purposes. This treatment can be avoided by taking into account the nature of the loss and applying the source concept of income.

It remains to be seen whether the courts will apply the *Tsiaprailis* test to a broad range of new situations beyond the business or property sources of income, or confine it to its specific context. As new potential applications arise, it will be important to evaluate carefully the policy issues raised in each new case to ensure that outcomes are fair and as predictable as possible.