Federal Court of Appeal  Cour d'appel fédérale

Date: 20130506

Dockets: A-4-12
A-5-12
A-331-12

Citation: 2013 FCA 122

CORAM: **EVANS J.A.**
SHARLOW J.A.
STRATAS J.A.

Docket: A-4-12

BETWEEN:

CANADIAN IMPERIAL BANK OF COMMERCE

Appellant

and

HER MAJESTY THE QUEEN

Respondent

Docket: A-5-12

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Heard at Toronto, Ontario, on November 21, 2012.

Judgment delivered at Ottawa, Ontario, on May 6, 2013.

REASONS FOR JUDGMENT BY: SHARLOW J.A.

CONCURRED IN BY: EVANS J.A.
STRATAS J.A.

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REASONS FOR JUDGMENT

SHARLOW J.A.

[1] In quantifying a taxpayer's tax liability under the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), is it ever necessary to evaluate the morality of the taxpayer's conduct? As a matter of general principle, the answer should be no. The *Income Tax Act* is intended to raise revenue for the use of the federal government. It also contains provisions intended to facilitate the distribution of social benefits according to standards established by Parliament, or to encourage or discourage certain industries or commercial practices in the public interest as perceived by Parliament from time to time. But nothing in the *Income Tax Act* expressly permits or requires the Minister of National Revenue, or the Courts, to apply the *Income Tax Act* differently depending upon the morality of the taxpayer's conduct.

[2] Indeed, it has long been accepted in Canada that a taxpayer who conducts an illegal business, or a business conducted unlawfully, is taxable on the profits of that business on the same principles as any other business, except to the extent that a different result is required by a specific provision of the *Income Tax Act*. Similarly, the Courts have consistently rejected the notion that the

Income Tax Act should be interpreted or applied more generously for a taxpayer whose conduct meets a sufficiently high moral standard.

[3] In this case, the Crown takes the position that in determining whether a particular statutory provision (paragraph 18(1)(*a*) of the *Income Tax Act*) applies to deny the deduction of a particular expenditure in computing business income for income tax purposes, the Minister (and therefore the Courts) must first determine whether the expense was incurred because of conduct of the taxpayer that was egregious or repulsive. That is so, according to the Crown, because if the answer is yes, then paragraph 18(1)(a) must apply to deny the deduction. The Crown's position is based on a certain *obiter dictum* in a decision of the Supreme Court of Canada. For the reasons that follow, I have concluded that the Crown has misinterpreted that *obiter dictum* and reached a conclusion that is wrong in law.

Introduction

[4] This case involves three appeals from two interlocutory orders of Associate Chief Justice Rossiter of the Tax Court of Canada (2011 TCC 568 and 2012 TCC 237). The orders were made in appeals of reassessments of Canadian Imperial Bank of Commerce (CIBC) under the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.). Both parties have appealed the first order, which allowed in part CIBC's motion to strike the Crown's reply (A-4-12 and A-5-12). The Crown is appealing the second order, which relates to the draft reply submitted by the Crown in its attempt to comply with the first order (A-331-12).

Standard of review

[5] The decision of a judge to grant or refuse a motion to strike is discretionary. This Court will defer to such a decision on appeal in the absence of an error of law, a misapprehension of the facts, a failure to give appropriate weight to all relevant factors, or an obvious injustice: *Apotex Inc. v. Canada (Governor in Council), 2007 FCA 374*, *Collins v. Canada*, 2011 FCA 140.

Statutory framework for the motions

[6] CIBC's motion to strike relied on Rule 53 of the *Rules of the Tax Court of Canada (General Procedure)*, SOR/90-688a, which reads as follows:

53. The Court may strike out or expunge all or part of a pleading or other document, with or without leave to amend, on the ground that the pleading or other document,	**53**. La Cour peut radier un acte de procédure ou un autre document ou en supprimer des passages, en tout ou en partie, avec ou sans autorisation de le modifier parce que l'acte ou le document :
(*a*) may prejudice or delay the fair hearing of the action,	*a*) peut compromettre ou retarder l'instruction équitable de l'appel;
(*b*) is scandalous, frivolous or vexatious, or	*b*) est scandaleux, frivole ou vexatoire;
(*c*) is an abuse of the process of the Court.	*c*) constitue un recours abusif à la Cour.

[7] There is no dispute as to the general test for striking pleadings. It was recently restated in *R. v. Imperial Tobacco Canada Ltd.*, 2011 SCC 42, [2011] 3 S.C.R. 45 at paragraph 17. In the context of a motion to strike the Crown's reply in an income tax appeal, the motion will be granted only if it is plain and obvious, assuming the facts as pleaded in the reply are true, that the reply fails to state a reasonable basis for concluding that the reassessment under appeal is correct.

Factual background and procedural history

[8] Four proceedings in the Tax Court have given rise to these appeals. They are all appeals by CIBC of reassessments made under the *Income Tax Act*, each relating to a different taxation year of CIBC (2002, 2003, 2005, and 2006) relating to the same transactions. CIBC raises the same issues in each appeal. The Crown's replies are similar, as are CIBC's motions to strike the replies.

[9] In the Tax Court, argument on the motions was focused on the Crown's reply for 2002 on the understanding that the same result would apply for the other three years. Similarly, the appeals now before this Court deal only with the Crown's reply for 2002, but by agreement the disposition of this appeal will apply to the other three years.

[10] The main issue in all four income tax appeals is the deductibility of approximately $3 billion in computing CIBC's business income. Most of that amount consists of payments made by CIBC to settle litigation that arose after the bankruptcy of Enron Corporation. The remainder consists of interest and legal expenses relating to the settlement payments. For the purposes of this appeal, it is necessary to consider only the settlement payments.

[11] The litigation that resulted in the settlement payments arose in connection with certain transactions involving Enron and CIBC and its affiliates which, for reasons that will become apparent, CIBC refers to as the "CIBC FAS 125/140 Transactions". In these reasons, it is more convenient to refer to them as the "Transactions".

[12] "FAS 125" and "FAS 140" are United States accounting standards. It appears that at this stage of the proceedings there are three items of common ground relating to FAS 125 and FAS 140. First, FAS 125 and FAS 140 state the conditions that must be met before a transaction may be treated as an asset sale in published financial reports. Second, Enron was obliged to follow FAS 125 and FAS 140 in its financial reporting. Third, Enron filed its financial reports on the basis that the Transactions were asset sales that met the requirements of FAS 125 and FAS 140.

[13] Whether the Transactions actually met the requirements of FAS 125 and FAS 140 became a matter of controversy. That controversy led to lawsuits against Enron in the United States. Two of those lawsuits, the "Newby Litigation" and the "MegaClaim Litigation", were based on the allegation that Enron mischaracterized the Transactions as asset sales in its financial reports contrary to the requirements of FAS 125 and FAS 140. It was alleged that because of that mischaracterization, Enron's debts were understated and the financial reports were materially misleading, which caused the complainants to suffer losses for which Enron was liable.

[14] CIBC was named as a defendant in both lawsuits. The complainants alleged that CIBC or affiliates of CIBC financed the Transactions with the intention of earning fees and achieving desirable recognition from Enron as a source of financing. They also alleged that CIBC or its affiliates took part in the Transactions with sufficient knowledge of the affairs of Enron to render it jointly and severally liable with Enron and other defendants for the losses suffered by the complainants because of Enron's misleading financial reports.

[15] Pursuant to the agreements under which the settlement payments were made, the claims against CIBC and its affiliates were discharged with no admission of wrongdoing or liability. CIBC alleges that the settlement payments enabled CIBC to avoid becoming jointly and severally liable with numerous other defendants in the litigation, as well as the adverse effects of ongoing litigation (CIBC notice of appeal, paragraph 3). CIBC also alleges that it considered the settlement to be legally and commercially prudent (CIBC notice of appeal, paragraphs 16 and 21).

[16] The settlement payments were deducted in computing CIBC's profit for financial statement purposes and for income tax purposes. CIBC alleges that these deductions accord with Canadian generally accepted accounting principles ("GAAP"), and also that they accord with sections 3 and 9 of the *Income Tax Act* (CIBC notice of appeal, paragraphs 4, 23, and 32).

[17] The Minister reassessed to disallow the deduction of the settlement payments. CIBC objected without success. The Minister confirmed the reassessments on the basis of paragraphs 18(1)(*a*), (*b*) and (*e*) of the *Income Tax Act* (CIBC notice of appeal, paragraph 26). CIBC appealed to the Tax Court on the basis that the deduction accords with sections 3 and 9, and is not prohibited by 18(1)(*a*), (*b*) or (*e*) of the *Income Tax Act*.

[18] The subject of CIBC's motion to strike is the Crown's amended reply filed on September 30, 2010. In that reply, the Crown defends the correctness of the reassessment on a number of alternative bases.

[19] Most of the grounds stated in the Crown's reply are not in issue in this appeal. Therefore, regardless of the outcome of this appeal, it appears at this stage of the pleadings that the Crown will be entitled to argue that the deduction of the settlement payments was properly disallowed in whole or in part for any of the following reasons:

(a) the settlement payments were not made or incurred by CIBC for the purpose of earning income from its business (paragraph 18(1)(*a*) – paragraph 133 of the reply);

(b) the settlement payments were made or incurred by CIBC on behalf of one or more of CIBC's affiliates (paragraph 135 of the reply);

(c) the settlement payments were outlays or payments on account of capital (paragraph 18(1)(*b*) – paragraph 136 of the reply);

(d) the terms or conditions made or imposed in respect of securing releases on behalf of CIBC affiliates differed from those that would have been made between persons dealing at arm's length so that 93% of the settlement payments are not deductible (subsection 247(2) – paragraph 137 of the reply);

(e) the settlement payments were contingent liabilities in the years the deductions were claimed (paragraph 18(1)(*e*) – paragraph 138 of the reply); or

(f) the settlement payments were not outlays or expenses that were reasonable in the circumstances (section 67 – paragraph 139 of the reply).

[20] CIBC's motion to strike relates primarily to paragraph 134 of the reply, which invokes paragraph 18(1)(*a*). Paragraph 134 reads as follows:

> 134. The misconduct of [CIBC and its affiliates] was so egregious and repulsive that any consequential settlement payments […] cannot be justified as being incurred for the purpose of gaining or producing income from a business or property within the meaning of paragraph 18(1)(*a*) of the [*Income Tax*] *Act*. The [CIBC affiliates] knowingly aided and abetted Enron to violate the United States' federal securities laws and falsify its financial statements. The misconduct of [the CIBC affiliates] in enabling Enron to perpetrate its frauds, known to [CIBC], or the misconduct of [CIBC] itself, was so extreme, and the consequences so dire, that it could not be part of the business of a bank.

[21] CIBC argues that paragraph 134 of the reply fails to state a reasonable basis for concluding that the reassessment under appeal is correct. I summarize CIBC's reasoning as follows. The Crown is entitled to defend the reassessment under appeal on the basis of paragraph 18(1)(*a*) by alleging facts in support of its position that CIBC did not make the settlement payments for the purpose of earning income from its business. However, as a matter of law, the interpretation and application of paragraph 18(1)(*a*) cannot turn on a moral evaluation of the conduct of CIBC as alleged in the pleadings filed by the plaintiffs in the Newby Litigation and the MegaClaim Litigation. It follows that even if the conduct of CIBC is accurately described in the unproven allegations made in that litigation, which have been adopted by the Minister as factual assumptions and have been separately pleaded as factual allegations, the Crown's characterization of that conduct as "egregious and repulsive" is not relevant to the correct interpretation or application of paragraph 18(1)(*a*). Therefore paragraph 134 of the reply, as well as all factual allegations in the reply that characterize

the alleged conduct of CIBC as egregious or repulsive, meet one or more of the tests in Rule 53 for the striking of pleadings, and should be struck.

[22] The Crown argues that paragraph 134 of its reply embodies a legal principle found in paragraph 69 of *65302 British Columbia Ltd. v. Canada*, [1999] 3 S.C.R. 804 (referred to as the "*Egg Case*" because the taxpayer was an egg producer). I discuss that case later in these reasons.

First decision of the Tax Court – motion to strike granted in part (December 21, 2011)

[23] The judge concluded that it is not plain and obvious that the Crown's theory as embodied in paragraph 134 of its reply cannot succeed. On that basis, he dismissed the portion of CIBC's motion to strike that dealt with that issue. CIBC has appealed to this Court to challenge that conclusion (A-4-12). The judge also concluded that there were other improprieties in the reply, particularly in the statement of the Minister's assumptions. The Crown takes issue with some of those conclusions. That is the subject of the Crown's appeal (A-5-12). In the discussion below, I discuss the two appeals separately.

CIBC appeal of first decision (A-4-12)

[24] CIBC argues that the judge erred in law when he concluded that paragraph 134 of the reply states a reasonable basis for defending the reassessments. Paragraph 134 is quoted above but I repeat it here for ease of reference:

> 134. The misconduct of [CIBC and its affiliates] was so egregious and repulsive that any consequential settlement payments […] cannot be justified as being incurred for the purpose of gaining or producing income from a business or property within the meaning of paragraph 18(1)(*a*) of the [*Income Tax*] *Act*. The [CIBC affiliates] knowingly aided and abetted Enron to violate the United States' federal securities laws and falsify its financial statements. The misconduct of [the CIBC affiliates] in

> enabling Enron to perpetrate its frauds, known to [CIBC], or the misconduct of [CIBC] itself, was so extreme, and the consequences so dire, that it could not be part of the business of a bank.

[25] As mentioned above, CIBC alleges in its notice of appeal that the deduction of the settlement payments accords with GAAP and with sections 3 and 9 of the *Income Tax Act*. Those provisions read in relevant part as follows:

3. The income of a taxpayer for a taxation year for the purposes of this Part is the taxpayer's income for the year determined by the following rules:	**3.** Pour déterminer le revenu d'un contribuable pour une année d'imposition, pour l'application de la présente partie, les calculs suivants sont à effectuer :
(*a*) determine the total of all amounts each of which is the taxpayer's income for the year […] from a source […] including, without restricting the generality of the foregoing, the taxpayer's income for the year from each […] business […].	*a*) le calcul du total des sommes qui constituent chacune le revenu du contribuable pour l'année […] dont la source […] sans que soit limitée la portée générale de ce qui précède, le revenu tiré de chaque […] entreprise […].
[…]	[…]
9. (1) Subject to this Part, a taxpayer's income for a taxation year from a business […] is the taxpayer's profit from that business […] for the year.	**9.** (1) Sous réserve des autres dispositions de la présente partie, le revenu qu'un contribuable tire d'une entreprise […] pour une année d'imposition est le bénéfice qu'il en tire pour cette année.

[26] Section 3 sets out the formula for determining a taxpayer's income for the year for income tax purposes. Pursuant to paragraph 3(*a*), one component of a taxpayer's income is *income from a business* of the taxpayer.

[27] According to subsection 9(1), a taxpayer's *income* for a year from a business is the taxpayer's *profit* for the year from that business. Generally, an amount that is deductible in computing profit under well accepted business principles (which includes "generally accepted accounting principles" or "GAAP" as adopted by the Canadian accounting profession) is deductible in computing business income for income tax purposes (*Canderel Ltd. v. Canada*, [1998] 1 S.C.R. 147 at paragraph 53).

[28] However, that general proposition is qualified by the phrase "subject to this Part" at the beginning of subsection 9(1). That phrase refers to Part I of the *Income Tax Act* which contains, among other things, many prohibitions on deductions. Most of those prohibitions appear in sections 18 and 67 of the *Income Tax Act*.

[29] Paragraph 134 of the reply cites paragraph 18(1)(*a*) of the *Income Tax Act* as the statutory basis for disallowing the deduction of the settlement payments. The Minister assumed that the conduct of CIBC that led to the Newby Litigation and the MegaClaim Litigation is accurately stated in the plaintiffs' pleadings in those cases. The position of the Crown is that the assumed conduct of CIBC was "egregious and repulsive", which is a sufficient basis for applying paragraph 18(1)(*a*) to disallow the deduction of any expense incurred by CIBC to settle the litigation. Paragraph 18(1)(*a*) is paraphrased above, but I quote it here:

18. (1) In computing the income of a taxpayer from a business […] no deduction shall be made in respect of	**18.** (1) Dans le calcul du revenu du contribuable tiré d'une entreprise […], les éléments suivants ne sont pas déductibles :
(*a*) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the	*a*) les dépenses, sauf dans la mesure où elles ont été engagées ou effectuées par le contribuable

purpose of gaining or producing income from the business […];	en vue de tirer un revenu de l'entreprise […] ;

[30] In support of the Crown's theory as embodied in paragraph 134 of the reply, the Crown relies on the following *obiter dictum* from paragraph 69 of the reasons of Justice Iacobucci, writing for the majority in the *Egg Case*:

> It is conceivable that a breach [of the law] could be so egregious or repulsive that the fine subsequently imposed could not be justified as being incurred for the purpose of producing income.

[31] The *Egg Case* was important when it was decided in 1999 because it settled a debate rooted in two competing theories about the application of the statutory income earning purpose test in relation to fines and penalties. Typically, the Crown would argue that to allow the deduction of a fine or penalty as a business expense undermines the public policy objective of the imposition of the fine or penalty, and for that reason the deduction should be denied pursuant to paragraph 18(1)(*a*). The competing theory, typically proposed by the taxpayer, was that in matters of fiscal law, it is for Parliament and not the Courts to determine public policy. In the *Egg Case*, the majority of the Supreme Court of Canada adopted the taxpayer's theory and rejected the Crown's theory.

[32] In 2005, Parliament addressed the public policy of the deduction of fines and penalties by enacting section 16 of the *Budget Implementation Act, 2004, No. 2*, S.C. 2005, c. 19. That provision amended the *Income Tax Act* to prohibit the deduction of fines and penalties imposed after March 22, 2004. The prohibition is now in section 67.6 of the *Income Tax Act*, which reads as follows:

67.6 In computing income, no deduction shall be made in respect of any amount that is a fine or penalty	**67.6** Aucune déduction ne peut être faite dans le calcul du revenu au titre de toute amende ou pénalité (sauf celles visées

(other than a prescribed fine or penalty) imposed under a law of a country or of a political subdivision of a country (including a state, province or territory) by any person or public body that has authority to impose the fine or penalty.	par règlement) imposée sous le régime des lois d'un pays, ou d'une de ses subdivisions politiques — notamment un État, une province ou un territoire — par toute personne ou tout organisme public qui est autorisé à imposer pareille amende ou pénalité.

[33] This is not the only example of a statutory prohibition on the deductibility of certain payments based on public policy considerations. The *Income Tax Act* had previously been amended to add subsection 67.5(1), which prohibits the deduction of any payment made for the purpose of doing anything that is an offence under section 3 of the *Corruption of Foreign Public Officials Act*, S.C. 1998, c. 34, or under any of sections 119 to 121, 123 to 125, 393 and 426 of the *Criminal Code*, R.S.C. 1985, c. C-46, or an offence under section 465 of the *Criminal Code* as it relates to an offence described in any of those sections.

[34] After the enactment of section 67.6, the *Egg Case* no longer determined the deductibility of fines and penalties. However, the *Egg Case* continues to be important because it determines the correct interpretation and application of paragraph 18(1)(*a*) of the *Income Tax Act*, and therefore it is potentially applicable to the deduction of expenses other than fines and penalties. For example, in *McNeill v. Canada*, [2000] 4 F.C. 132 (C.A.), it was held (at paragraph 14) that the reasoning in the *Egg Case* applies where an issue is raised as to the deductibility of damages for breach of contract (*McNeill* is discussed below).

[35] To understand the *Egg Case*, it is useful to understand the jurisprudence that preceded it. The starting point for my review of the jurisprudence is *Commissioners of Inland Revenue v.*

Alexander von Glehn & Co., Ltd., [1920] 2 K.B. 553 (C.A.). The Crown has cited that case many times in support of the proposition, stated in various ways, that in determining the deductibility of an expense incurred because of the taxpayer's unlawful or wrongful conduct, it is relevant to consider matters of public policy that are not necessarily suggested by the language of paragraph 18(1)(*a*) (or one of its many statutory predecessors).

[36] The issue in *von Glehn* was the deductibility of a penalty imposed on an exporter for not taking sufficient care during the war to ensure that its exports did not reach an enemy country. The penalty was found not to be deductible because of a statutory test that is somewhat like paragraph 18(1)(*a*) (but more narrowly worded) on the basis that the penalty could not have served any profit making purpose. But in *obiter dicta*, the judges made the following comments:

> *Lord Sterndale MR:* This business could perfectly well be carried on without any infraction of the law at all. […] It is perhaps a little difficult to put the distinction into very exact language, but there seems to me to be a difference between a commercial loss in trading and a penalty imposed upon a person or company for a breach of the law which they have committed in that trading.
>
> *Warrington LJ:* Now it cannot be said that the disbursement in the present case is made in any way for the purpose of the trade or for the purpose of earning the profits of the trade. The disbursement is made, as I have already said -- and the same remark applies to this Rule as to the other -- because the individual who is conducting the trade has, not from any moral obliquity, but has unfortunately, been guilty of an infraction of the law.
>
> *Scrutton LJ:* I am inclined to think, though I do not wish finally to decide it, that the Income Tax Acts are to be confined to lawful businesses, and to businesses carried on in a lawful way.

[37] As will become apparent from the discussion below, the authority of *von Glehn* was diminished in 1927 by the decision of the Judicial Committee of the Privy Council in *Minister of*

Finance v. Smith, [1927] A.C. 193, *sub. nom. Reference re Income War Tax Act, 1917 (Can.)*. In 1999, the *Egg Case* rendered *von Glehn* insignificant.

[38] The *Smith* case was a reference to the Judicial Committee relating to the *Income War Tax Act, 1917*, S.C. 1917, c. 28, the earliest predecessor to the *Income Tax Act*. The question was whether it was lawful for Canada to impose tax on the profits of a liquor trading business carried on in contravention of the Ontario prohibition law. The answer was yes. Lord Haldane, speaking for the Judicial Committee, said this (at page 197, my emphasis):

> Construing the Dominion Act literally, the profits in question, although by the law of the particular Province they are illicit, come within the words employed. […]. There is nothing in the Act which points to any intention to curtail the statutory definition of income, and *it does not appear appropriate under the circumstances to impart any assumed moral or ethical standard as controlling in a case such as this the literal interpretation of the language employed.* There being power in the Dominion Parliament to levy the tax if they thought fit, their Lordships are therefore of the opinion that it has levied income tax without reference to the question of Provincial wrongdoing.

[39] *Smith* established the proposition, which is still good law, that the profit of an unlawful business is taxable in exactly the same manner as the profit of a lawful business. In reaching that conclusion, the Judicial Committee considered *von Glehn*. Without doubting the result in that case in respect of the income earning purpose test as it then read, the Judicial Committee rejected the suggestion of Scrutton LJ that fiscal laws apply only to lawful businesses or businesses carried on in a lawful way.

[40] After *Smith*, there were many cases dealing with the deductibility of an expense incurred because of the unlawful conduct of the taxpayer. Typically, the deduction was sought for a fine or

penalty, or legal expenses incurred to defend against the imposition of a fine or penalty. The most frequently cited examples are summarized below.

[41] In *Rolland Paper Co. v. Canada (Minister of National Revenue)*, [1960] Ex. C.R. 334, Justice Fournier concluded that a paper manufacturer was entitled to deduct the legal expenses it incurred in an unsuccessful appeal of its conviction for an unlawful trading practice, which at the time was a criminal offence. As part of the analysis, Justice Fournier considered whether the fact that a business is conducted unlawfully is relevant to the application of the statutory income earning purpose test in the predecessor to paragraph 18(1)(*a*). After referring to *von Glehn* and *Smith*, he concluded that such illegality is not relevant. He explained his conclusion as follows at pages 338 to 340:

> So, the trial judge who had found the appellant guilty thought that he should not look upon it as guilty of moral turpitude or of wicked intention. There had been a breach of a statute and the appellant was responsible for its unlawful act. That being the case, it becomes necessary to determine if unlawful acts committed in earning income from the operations of a business or trade are to be considered in computing the income of a taxpayer. The Act clearly states that the income of a taxpayer is his income from all sources. It is a sweeping and positive statement and it has been constantly held that income tax is a tax upon the person measured by his income and that the source of his income should not be looked at when computing a taxpayer's taxable income.
>
> […]
>
> […] It would seem that the income tax provisions are applicable to taxpayers carrying on business by means of unlawful practices […] unless specifically prohibited by the *Income Tax Act*. Were it to be otherwise, it would be most difficult to bring within the ambit of the taxation statute taxpayers responsible for such unlawful practices. In the present instance, the appellant, though charged and later found guilty of the unlawful business practice *supra*, did report in its income tax return for its taxation year its income from its business in that year, in compliance with s. 3(a) of the Act. But in reporting its income, to arrive at the amount of its taxable income – s. 2(3) – it sought to deduct legal costs incurred and paid in defending its business practices. The only change to the appellant's income tax return made by the respondent was his refusal to allow the above

> sought deduction. No doubt was ever raised as to the respondent's right to impose and levy income tax on the appellant's taxable income from its business whether or not the income flowed from unlawful practices. But the tax to be levied is not on the taxpayer's income; it is on his income minus the deductions permitted by the Act. […]

[42] This passage highlights the essential problem with prohibiting the deduction of an expense solely because it was incurred because of the taxpayer's unlawful conduct. To prohibit the deduction of such an amount, if in fact it was incurred for a profit making purpose, would contradict the fundamental principle that a business profit is the revenue of a business less the expenses incurred to earn the revenue.

[43] However, because Justice Fournier noted in *Rolland Paper* (at page 338) that the taxpayer was not "guilty of moral turpitude or of wicked intention", some cases after *Rolland Paper* suggest that there may be circumstances in which an expense, even if incurred for a profit making purpose, might be found not to be deductible if the taxpayer's conduct falls below a certain moral standard.

[44] In *Canada (Minister of National Revenue) v. E.H. Pooler and Co.*, [1963] Ex. C.R. 16, the issue was whether a firm of stockbrokers was entitled to deduct a fine imposed by the Board of Governors of the Toronto Stock Exchange. An employee of the firm had induced other brokerage firms to open accounts for certain individuals who then engaged in improper margin trading. The Board, after an investigation, concluded that the employee's acts were detrimental to the Exchange. Under the rules of the Exchange, the conduct of a firm's employee was attributed to the firm. Justice Thurlow concluded that for two reasons, the fine was not an expense that met the statutory income earning test in the applicable predecessor to paragraph 18(1)(*a*). First, the firm was liable to pay the

fine whether or not it continued to carry on its brokerage business. Second, the conduct of the employee that resulted in the fine was not part of the business of the firm and could not possibly have produced any profit for the firm. In respect of the second reason, Justice Thurlow said (at page 22) that there "may or may not" be a "broader principle" that could justify disallowing the deduction, but he did not elaborate.

[45] *Minister of National Revenue v. Eldridge*, [1965] 1 Ex. C.R. 758, is the first case dealing with the tax implications of an illegal business in which no comment was made about the morality of the taxpayer's conduct or the need to consider the public policy reason for the law against the business. Justice Cattanach concluded that the operator of an unlawful call girl business was entitled to deduct the expenses incurred in earning the profits of that business. The only expenses for which a deduction was not permitted were those that could not be substantiated with documentary evidence (including amounts that the taxpayer claimed to have paid the police for protection), and the cost of a bail bond for herself. Among the permissible deductions were the expenses incurred in obtaining bail bonds for her employees, legal expenses paid to defend her employees from criminal charges, the cost of hiring individuals to provide physical protection for her employees, and rent paid for the premises used by her employees.

[46] *Day & Ross Limited v. Her Majesty the Queen*, [1977] 1 F.C. 780 (T.D.), involved numerous issues, but for the purposes of this appeal the only one of interest is whether a trucking company was entitled to a deduction for fines imposed for exceeding load restrictions set by provincial laws. The Crown argued that the fines were not deductible because of the "broader principle" mentioned in *Pooler*, which the Crown identified as the common law principle that

"criminals should not benefit from their crimes" (page 793). That argument apparently was a paraphrase of the maxim sometimes expressed as "*ex turpi causa non oritur actio*", which means that a person's own dishonourable (or wrongful or unlawful) conduct cannot be the basis of a legal claim. The taxpayer argued that "the legality or illegality of the business to which the expense relates is irrelevant in interpreting the *Income Tax Act*" (page 793).

[47] Justice Dubé did not accept or reject either argument in principle. He did, however, suggest that there might be some merit in the Crown's argument when he seems to describe (at page 791) a two part test for the deductibility of a fine:

> The first determination must be as to whether or not the payment of the fines constituted an outlay made for the purpose of producing income for the plaintiff so as to meet the requirement of the exception to the prohibition of [paragraph 18(1)(*a*)]. If the determination is affirmative, then the argument of public interest must be met.

[48] Justice Dubé concluded that the fines were deductible because they resulted from the day-to-day operation of the taxpayer's transport business and were paid as a necessary expense of that business. He explained this conclusion as follows at page 794:

> In the absence of constant control by the plaintiff over the exact cargo weight carried in its trailers, and the uncontradicted evidence would suggest that such a tight control would be impractical if not impossible in a very highly competitive road transport industry, then unintentional violations of weight restrictions would seem to be inevitable. Plaintiff's method of bookkeeping, with fines paid entered as expense and fines recovered from customers booked as revenue, would also indicate that the payment of fines was very much a current item in the operation of plaintiff's business. The ready availability of advance overweight permits at the request of a shipper would also tend to show that weight restrictions can be easily overcome and that violations thereof are obviously not outrageous transgressions of public policy.

[49] *TNT Canada Inc. v. Canada* (1988), 20 F.T.R. 214 (T.D.), also involved the deductibility of penalties imposed on a trucking company, but the penalties were imposed under the *Excise Tax Act*, R.S.C. 1985, c. E-15, and the *Customs Act*, R.S.C. 1985, c. 1 (2nd Supp.), for having repair work done in the United States without paying the applicable sales and excise tax, and for making too many stops in Canada for a foreign carrier. Justice Cullen reasoned that v*on Glehn* was authority for the general principle that fines and penalties are not deductible, but because of the two-part test in *Day & Ross*, there was an exception for fines and penalties that result from the day to day operation of the taxpayer's business and are a necessary expense. He concluded that the deduction of the penalties in the case before him should not be denied in this case on grounds of public policy, since there were only a small number of offences compared to the 80,000 dispatches in the year. However, the deduction was denied for a different reason (the deduction was claimed in 1980, but the penalties had been imposed in 1979 and paid in 1981).

[50] In *Amway of Canada, Ltd. v. Canada* (1996), 193 N.R. 381 (F.C.A.), this Court followed the approach in *Day & Ross* and *TNT* in a different factual context. The taxpayer in *Amway* was found to have falsified the value of goods imported into Canada in the years 1974 to 1980 in an attempt to avoid duty and excise taxes. The goods had been undervalued by approximately $84 million, and the total tax sought to be avoided was approximately $30 million. The taxpayer was assessed for the tax, as well as civil penalties. The Crown attempted to collect the tax and civil penalties through actions in the Federal Court. Eventually all of the actions were settled for a single payment of $45 million, of which $37.1 million was found to represent the amount paid to settle the Crown's claim for the civil penalties. The issue was whether the $37.1 million payment was deductible.

[51] Generally, a payment made to settle a civil claim is deductible if the claim is for an amount that would have been deductible if paid. Under that principle, the $37.1 million payment made to settle the claim for the penalties would be deductible if the penalties were deductible. Accordingly, the issue was the deductibility of the penalties. Justice Strayer, writing for the Court, cited with approval the reasoning in *von Glehn*, *Day & Ross* and *TNT*, and concluded that a penalty is deductible as a business expense if it is unavoidable, in the sense that the penalty is a normal and ordinary risk and incidental to the business. He found that this test was not met for the *Amway* penalties because they were incurred as the result of an "intentional and cynical scheme to mislead Canadian customs officials as to the value of goods" (paragraph 31).

[52] Justice Strayer also gave a second reason for finding the penalties not to be deductible. This is explained as follows at paragraph 32 of his reasons:

> 32. […] Secondly, in my view it is contrary to public policy to allow the deduction of a fine or penalty as a business expense where that fine or penalty is imposed by law for the purpose of punishing and deterring those who through intention or a lack of reasonable care violate the laws. In a case such as the present the penalties are fixed by statute […]. It would frustrate the purposes of the penalties imposed by Parliament if after paying those penalties exigible by law a taxpayer were then able to share the cost of that penalty - and the higher his marginal rate of taxation the more he could share - with other taxpayers of Canada by treating it as a deductible expense and thus reducing his taxable income. Such a result would, I believe, clearly be contrary to public policy.

[53] *Amway* was the leading authority on the deductibility of fines and penalties until the Supreme Court of Canada rendered its decision in the *Egg Case*, to which I now turn.

[54] As mentioned above, the Crown in this case relies on the following sentence from paragraph 69 of the *Egg Case* to justify the legal theory embodied in paragraph 134 of the reply:

> It is conceivable that a breach [of the law] could be so egregious or repulsive that the fine subsequently imposed could not be justified as being incurred for the purpose of producing income.

[55] The taxpayer in the *Egg Case* operated a poultry farm business. Over a period of approximately 5 years, it deliberately produced more eggs than permitted by its egg quota. It did so in order to maintain its major customer, who was then expanding in the area, until it could purchase additional quota at what it thought was an affordable price. When the egg marketing authority learned of the taxpayer's excess egg production, it imposed an over-quota levy of approximately $270,000. In filing its income tax returns, the taxpayer included in its business income the revenue from its over-quota production, and deducted as business expenses the over-quota levy and certain related costs.

[56] The Minister disallowed the deduction of the over-quota levy on the basis that it was an avoidable fine or penalty, and therefore it did not meet the income earning purpose test in paragraph 18(1)(*a*). The Tax Court of Canada allowed the taxpayer's appeal. This Court reversed the Tax Court decision, based on *Amway*. The taxpayer appealed to the Supreme Court of Canada, which concluded that the over-quota levy was deductible and restored the judgment of the Tax Court.

[57] Justice Iacobucci wrote the reasons of the majority of the Supreme Court of Canada. His principal conclusion, which deals with the interpretation and application of paragraph 18(1)(*a*), is set out in paragraph 39 of his reasons (my emphasis):

> [39] *The central question in this appeal is whether an over-quota levy may be deducted as a business expense from a taxpayer's business income. […] If the expense is incurred for the purpose of earning business income, it is deductible.* Section 9(1) of the Act provides that a taxpayer's business income for the tax year

> is the profit from that business. It is well established that the concept of profit found in s. 9(1) authorizes the deduction of business expenses, as profit is inherently a net concept, and such deductions are allowed under s. 9(1) to the extent that they are consistent with "well accepted principles of business (or accounting) practice" or "well accepted principles of commercial trading": *Symes v. Canada*, [1993] 4 S.C.R. 695, at p. 723. These expenses may nonetheless be prohibited by the limiting provisions found in s. 18(1), although many of these provisions are also consistent with well accepted principles of business practice. The present appeal concerns the language of s. 18(1)(*a*), which provides that, in computing taxable business income, no deduction may be made in respect of
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> > an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from the business or property.
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> The majority of this Court in *Symes, supra*, at p. 736, stated:
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> > ... no test has been proposed which improves upon or which substantially modifies a test derived directly from the language of s. 18(1)(*a*). The analytical trail leads back to its source, and I simply ask the following: did the appellant incur [the impugned] expenses for the purpose of gaining or producing income from a business?
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> To rephrase this language in the context of the present appeal, *the question to ask is: did the appellant incur the over-quota levy for the purpose of gaining or producing income from its business?*

[58] In paragraph 40, Justice Iacobucci answered the question he posed. He concluded that the over-quota levy was deductible because on the undisputed facts, the decision to produce over-quota was a business decision made in order to realize income, and the costs of the over-quota production, including the over-quota levy, were incurred as part of the taxpayer's day to day business operations. Justice Bastarache, writing for the minority, agreed in the result. However, he proposed a distinction between fines and penalties that are imposed as punishment or to deter certain conduct, which would not be deductible, and statutory payments that are essentially compensatory (including over-quota levies), which would be deductible assuming all other statutory tests are met.

[59] In my view, the importance of the *Egg Case* lies in its rejection of the reasoning that led this Court to conclude that the over-quota levy was not deductible. Essentially, the *Egg Case* rejected the reasoning in *Amway*, with the result that *Amway* could no longer be considered good law in so far as it denied a deduction for a penalty because the penalty was avoidable, or because allowing the deduction would be against public policy.

[60] Nor can it be argued, after the *Egg Case*, that v*on Glehn* and the cases that follow *von Glehn* provide any guidance with respect to the interpretation of paragraph 18(1)(*a*) (see paragraphs 41 to 43 of the *Egg Case*). That is because the *Egg Case* establishes that it is not open to the Courts to expand the scope of the prohibition stated in paragraph 18(1)(*a*) to give effect to unlegislated public policy considerations. Paragraph 66 of Justice Iacobucci's majority reasons summarizes his conclusion on that point. It reads as follows (my emphasis):

> [66] I therefore cannot agree with the argument that the deduction of fines and penalties should be disallowed as being contrary to public policy. First and foremost, on its face, fines and penalties are capable of falling within the broad and clear language of s. 18(1)(*a*). *For courts to intervene in the name of public policy would only introduce uncertainty, as it would be unclear what public policy was to be followed, whether a particular fine or penalty was to be characterized as deterrent in nature, and whether the body imposing the fine intended it to be deductible. Moreover, allowing the deduction of fines and penalties is consistent with the tax policy goals of neutrality and equity.* Although it may be said that the deduction of such fines and penalties "dilutes" the impact of the sanction, I do not view this effect as introducing a sufficient degree of disharmony so as to lead this Court to disregard the ordinary meaning of s. 18(1)(*a*) when that ordinary meaning is harmonious with the scheme and object of the Act. *When Parliament has chosen to prohibit the deduction of otherwise allowable expenses on the grounds of public policy, then it has done so explicitly.*

[61] The Crown is not relying on the *Egg Case* in support of paragraph 134 of the reply on the basis of the conclusions reached by the majority in that case, or because of Justice Iacobucci's

reasons for reaching that conclusion. Rather, the Crown is relying on the *obiter dictum* in paragraph 69 of Justice Iacobucci's reasons.

[62] Paragraph 69 is Justice Iacobucci's response to the following point made in paragraph 17 of the dissenting reasons of Justice Bastarache (emphasis in original):

> [17] I agree with my colleague, Iacobucci J., that public policy determinations are best left to Parliament. However, I am not suggesting that the deduction of penal fines be disallowed for public policy reasons, but instead because their deduction, not specifically authorized by the Act, would frustrate the expressed intentions of Parliament in other statutes if they were held to come under s. 18(1)(*a*) of the Act. In my view, penal fines are not expenditures incurred for the purpose of gaining or producing income in the legal sense. This concern is not so much one of public policy, morality or legitimacy, but one consistent with a realistic understanding of the accretion of wealth concept and the court's duty to uphold the integrity of the legal system in interpreting the *Income Tax Act*. As explained by McLachlin J. in *Hall v. Hebert*, [1993] 2 S.C.R. 159, at p. 169, in finding that a court could bar recovery in tort on the ground of the plaintiff's immoral or illegal conduct:
>
> > The basis of this power, as I see it, lies in [the] duty of the courts to preserve the integrity of the legal system, and is exercisable only where this concern is in issue. This concern is in issue where a damage award in a civil suit would, in effect, allow a person to profit from illegal or wrongful conduct, *or would permit an evasion or rebate of a penalty prescribed by the criminal law*. The idea common to these instances is that the law refuses to give by its right hand what it takes away by its left hand.

[63] In paragraph 69, Justice Iacobucci responds to Justice Bastarache. The thrust of his response was this: if Parliament concludes that the deduction of fines or penalties that are incurred for an income earning purpose would frustrate the intention of the statutes under which the fines or penalties are imposed, then it is for Parliament to exercise its authority to address that question clearly and directly. (As mentioned above, that is what Parliament did in 2005 when it enacted subsection 67.6, the prohibition on the deduction of all fines and penalties imposed by law.)

[64] Paragraph 69 of Justice Iacobucci's reasons is reproduced here in full (I have emphasized the sentence relied upon by the Crown):

> [69] Finally, at para. 17, my colleague states that penal fines are not, in the legal sense, incurred for the purpose of gaining income. It is true that s. 18(1)(*a*) expressly authorizes the deduction of expenses incurred for the purpose of gaining or producing income from that business. But it is equally true that if the taxpayer cannot establish that the fine was in fact incurred for the purpose of gaining or producing income, then the fine or penalty cannot be deducted and the analysis stops here. *It is conceivable that a breach could be so egregious or repulsive that the fine subsequently imposed could not be justified as being incurred for the purpose of producing income*. However, such a situation would likely be rare and requires no further consideration in the context of this case, especially given that Parliament itself may choose to delineate such fines and penalties, as it has with fines imposed by the *Income Tax Act*. To repeat, Parliament may well be motivated to respond promptly and comprehensively to prohibit clearly and directly the deduction of all such fines and penalties, if Parliament so chooses.

[65] The Crown submits that the emphasized *obiter dictum* affords a basis for its argument that the deduction of an expense incurred because of conduct that is "egregious or repulsive" may be prohibited by paragraph 18(1)(*a*). In my view, the Crown's submission is based on a misinterpretation of the *obiter dictum*, and the judge erred in law when he accepted it. I do not accept that Justice Iacobucci, having rejected the notion that the Courts may superimpose on paragraph 18(1)(*a*) a non-legislated public policy test, would accept in the very same case the proposition that the Courts nevertheless may superimpose on paragraph 18(1)(*a*) a non-legislated requirement that the taxpayer's conduct not be "egregious or repulsive".

[66] As I understand Justice Iacobucci's *obiter dictum*, he was making a point about determining the deductibility of a particular expense incurred as a consequence of the taxpayer's conduct, where it is necessary to consider whether and how the conduct is connected to a business or a business activity of the taxpayer. Essentially, he was recognizing that certain conduct may,

because of its egregious or repulsive nature, be so disconnected *factually* from the taxpayer's actual business (or from any business) that an expense the taxpayer incurs because of that conduct cannot meet the income earning purpose test. He was not saying or suggesting that conduct *in fact* undertaken by a taxpayer for the purpose of earning income from a business can be disconnected from that business for income tax purposes *solely* because the conduct is egregious or repulsive. Nor was he saying or suggesting that the egregiousness or repulsiveness of particular conduct, in and by itself, changes the question to be asked in determining whether paragraph 18(1)(*a*) prohibits the deduction of an expense incurred as a result of that conduct.

[67] I have not disregarded the four cases cited by the Crown as support for its interpretation of Justice Iacobucci's *obiter dictum*. Two of the four cases are not instructive because, although Justice Iacobucci's *obiter dictum* is mentioned, the "egregious or repulsive" test is held to be inapplicable on the facts of the case (*Douthwright v. Canada*, 2007 TCC 560; *Ferguson-Neudorf Glass Inc. v. Canada*, 2008 TCC 684).

[68] The third case is *Bains v. Canada*, 2003 TCC 211, in which Justice Rip (now Chief Justice) held that the taxpayer, Mr. Bains, was not entitled to a deduction for damages awarded against him for obtaining money from another person, Mr. Bhandar, by deceit. It appears that Mr. Bhandar had been given the impression that his money would be used to invest in a particular project. Justice Rip held that there was no evidence that the efforts of Mr. Bain to obtain the money were part of a business then carried on by Mr. Bains or a venture in the nature of trade. Justice Rip added that even if he erred in so concluding, "the actions of Mr. Bains in usurping money out of Mr. Bhandar is the egregious or repulsive breach that Iacobucci J. states could not be justified as being

incurred for the purpose of producing income" (paragraph 29 of his reasons). It is not clear whether the meaning of Justice Iacobucci's *obiter dictum*s was a matter of debate before Justice Rip. Nor is it clear whether Justice Rip interpreted those comments as the Crown now proposes. But if he did so, then I respectfully disagree with him.

[69] The fourth case cited by the Crown is *McNeill* (cited above), which is the only decision of this Court that gives substantive consideration to the *Egg Case*. As mentioned above, it was held in *McNeill* that the reasoning in the *Egg Case* applies not only in determining the deductibility of fines and penalties, but also in determining the deductibility of damages. However, the Crown is relying on *McNeill* as an endorsement of its understanding of Justice Iacobucci's *obiter dictum* in the *Egg Case*. To assess the Crown's position requires an understanding of *McNeill*, which in turns requires an understanding of an earlier case on the deductibility of damages, *Poulin v. Canada* (1996), 204 N.R. 376 (F.C.A.).

[70] *Poulin* was once a leading case on the question of the deductibility of damages. The facts bear some similarity to the facts alleged in this case, except that in *Poulin*, a court had determined that the taxpayer was liable for damages, while in this case, CIBC is seeking to deduct a payment made to settle a claim before the claimants' allegations were tried. However, as explained below, the authority of *Poulin* is in doubt after *McNeill*.

[71] The taxpayer in *Poulin* was a real estate broker. A client for whom Mr. Poulin had negotiated a purchase brought proceedings against the seller and Mr. Poulin for fraud and false representation. The client was awarded damages, interest, costs and legal fees totalling almost

$400,000, which Mr. Poulin paid. His claim for a deduction for the payment was disallowed. The Tax Court allowed Mr. Poulin's appeal, principally on the basis that his liability for damages arose within the context of the operation of his brokerage business.

[72] This Court allowed the Crown's appeal and held that the damages were not deductible. As the reasons were rendered in French and refer to civil law concepts, I will refer to the French text of the reasons as well as the official English translation. The Court reasoned that there is a distinction between damages arising from a normal and inevitable risk of liability for an accidental or unintentional act (*une faute involontaire*) arising in the course of operating a business, and damages arising from a deliberate or intentional act (*un délit*) that is not necessary for the conduct of the business. Justice Marceau, writing for the Court, elaborated as follows (at paragraph 10 and 12 of the reasons, my emphasis):

> [10] Mais s'il faut admettre que la commission d'une faute involontaire dans l'accomplissement d'un acte qu'implique l'exercice d'un métier ou d'une profession est inévitable et que, partant, l'obligation d'indemniser est un risque qui est inhérent à cet exercice, on ne peut étendre l'idée à la commission d'un délit au sens du droit civil, à *la commission d'un acte répréhensible fait volontairement dans le but de causer un dommage*. L'acte délictuel ne peut plus alors être considéré comme impliqué par l'exercice du métier ou de la profession. Il a été commis à l'occasion de l'exercice, mais en est complètement étranger. Il n'y a aucun moyen alors de prétendre que, dans ce cas, le paiement d'une condamnation en dommage satisfait à l'exigence de l'alinéa 18(1)*a*) de la Loi.
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> [10] However, while it must be admitted that the commission of an involuntary fault in performing an act that is necessary for carrying on a trade or profession is inevitable, and accordingly that the obligation to pay compensation is a risk inherent in that activity, we cannot extend the idea to the commission of a delict in the civil law sense, to *the commission of a reprehensible act committed deliberately with the aim of causing damage*. The delictual act cannot in that case be considered as being necessary for carrying on the trade or profession. It was committed while carrying on the trade or profession, but it is completely foreign to it. There is therefore no ground for arguing that, in this case, the payment of an award of damages meets the requirement in paragraph 18(1)(*a*) of the Act.

[…]	[…]
[12] Il s'agit donc, en l'espèce, d'un paiement en satisfaction d'un jugement de condamnation en raison d'un délit, d'un fait illicite intentionnel, d'un acte volontaire commis en vue de causer un dommage. *Je suis d'avis, pour les motifs que j'ai tenté d'expliquer, qu'un tel paiement ne satisfait pas à la condition de l'alinéa 18(1)a) pour que l'intimé puisse le déduire de son revenu en tant que dépense rattachée à l'exercice par lui de la profession de courtier en immeuble parce qu'il ne correspond pas à un risque qu'il était tenu d'assumer pour exercer comme courtier en immeuble.*	[12] Accordingly, what we have in this case is payment in satisfaction of a judgment awarding damages for a delict, an intentional unlawful act, a deliberate act committed with the aim of causing damage. *For the reasons which I have attempted to explain, I am of the opinion that such a payment does not meet the condition in paragraph 18(1)(a) in order for the respondent to be able to deduct it from his income as an expense associated with carrying on his profession as a real estate broker, because it does not correspond to a risk that it was necessary for him to assume in order to carry on business as a real estate broker.*

[73] In 1998, before the *Egg Case* was decided by the Supreme Court of Canada, the Tax Court heard *McNeill v. Canada* (1998), [1999] 1 C.T.C. 2197, 99 D.T.C. 280. The Tax Court followed *Poulin*, disallowing a deduction for damages that were found to be the result of "reprehensible" conduct by the taxpayer. In 2000, after the *Egg Case* was decided by the Supreme Court of Canada, this Court reversed the Tax Court decision because of the *Egg Case*.

[74] Mr. McNeill had sold his accountancy practice and subsequently breached a restrictive covenant in the sale agreement by providing services to his former clients. The former clients sued and were awarded damages. Mr. McNeill paid the damages and claimed a deduction, which was denied by the Minister and by the Tax Court, but allowed by this Court. Justice Rothstein, speaking for the Court in a decision rendered orally, rejected the proposition that the reprehensibility of the

conduct of the taxpayer could result in the denial of a deduction for damages if it is found that the income earning purpose test in paragraph 18(1)(*a*) is met. His analysis on this point appears in paragraphs 14 to 16 of his reasons (my emphasis):

> [14] In the appeal at bar, the issue is not the deductibility of fines or penalties, but rather, the deduction of a court ordered award of damages for breach of contract. While the Supreme Court of Canada did not refer to *Poulin* in its decision in [the *Egg Case*], the basis for the denial of deductibility of damages as an expense in *Poulin* – avoidability and public policy – was rejected by the Supreme Court in [the *Egg Case*]. In our opinion, the reasoning of Iacobucci J. in [the *Egg Case*] applies directly to a court judgment for damages for breach of contract. Counsel for the respondent suggested that while a fine or penalty may be deductible because it is payable to the government, a damage award in favour of an individual or a corporation is in a different category. We see no merit to this argument. If a fine or penalty for breach of a law is deductible because nothing in paragraph 18(1)(*a*) precludes it, it follows that court ordered damages for breach of a contract should also be deductible. The analysis of Iacobucci J. pertaining to tax neutrality and equity and the opportunity of Parliament, should it choose to do so, to disallow the deductibility of specific categories of expenses, is equally applicable to court awards of damages as to fines and penalties.
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> [15] It may be that in respect of a civil damage award that the wrongful action may be so egregious or repulsive that the damages could not be justified as being incurred for the purpose of gaining or producing income and in such rare cases deductibility would properly be disallowed. Although in the case at bar, the learned Tax Court Judge referred to the appellant's actions as reprehensible, he also found they were for the purpose of keeping his clients and his business. We are satisfied that they were incurred for the purpose of producing income.
>
> [16] Accordingly, we conclude that the finding of the Supreme Court of Canada in [the *Egg Case*] is determinative of the present appeal. In coming to this conclusion, we acknowledge that there may be policy reasons against allowing the deductibility of damages as an expense when they arise from "reprehensible" conduct of a taxpayer. Be that as it may, the [*Egg Case*] instructs that such policy questions are to be left to Parliament. If it so wishes, Parliament may legislate against the deductibility of damage awards in those circumstances.

[75] Although Justice Rothstein was clearly aware of the *obiter dictum* on which the Crown relies (because he paraphrased it), he made two points that are not consistent with the Crown's interpretation of that *obiter dictum*. The first point is that if the income earning purpose test in

paragraph 18(1)(*a*) is met, a negative moral evaluation of the taxpayer's conduct ("reprehensible") will not suffice to deny the deduction. The second point is that it is for Parliament, not the Courts, to disallow the deductibility of a specific category of expenses. In my view, *McNeill* does not support the argument of the Crown in this case.

[76] I conclude, following the statement of Justice Iacobucci in the last sentence of paragraph 39 of the *Egg Case* (quoted above), that the only question to be asked in determining whether paragraph 18(1)(*a*) prohibits a particular deduction is this: Did the taxpayer incur the expense for the purpose of earning income? Since that is the only relevant question, it follows that even if CIBC conducted itself as alleged by the claimants in the Newby Litigation and the MegaClaim Litigation, and even if that conduct was egregious or repulsive, that characterization of the morality of CIBC's conduct is not legally relevant to the application of paragraph 18(1)(*a*). Therefore, I agree with CIBC that paragraph 134 of the reply should be struck. The same is true of factual assumptions or allegations elsewhere in the reply that assert a moral evaluation of the conduct of CIBC.

[77] At the hearing, the Crown argued that if CIBC's appeal is allowed in respect of its reliance on paragraph 18(1)(*a*) in paragraph 134 of the reply, the Crown should nevertheless be entitled to rely on subsection 9(1) to plead that CIBC's conduct is so outrageous that it falls outside the business of a bank, and for that reason the settlement payments are not deductible under well accepted business principles or generally accepted accounting principles in computing the CIBC's profit from its banking business. I have been able to find no case that says or suggests that an evaluation of the morality of a taxpayer's conduct is necessary before determining whether its business profit has been correctly determined for the purposes of subsection 9(1). Nor is the

Crown's argument consistent with the well established proposition that the principles to be applied in determining the profit of a business do not vary depending upon the legality of the business (see, for example, *Smith* and *Eldridge*, cited above, as well as the *Egg Case*).

[78] In my view, subsection 9(1) does not harbour an implicit morality test that could deny the deduction of a claimed business expense that is deductible under well accepted business principles and passes all of the specific statutory tests for deductibility. If it is finally determined in this case that the deduction of the settlement payments accords with well accepted business principles, that CIBC made the settlement payments for the purpose of earning income from a business, that the settlement payments were not outlays on account of capital, that the settlement payments were not contingent liabilities when made, and that the amount of the settlement payments were reasonable in the circumstances, then nothing implicit in subsection 9(1) could possibly justify the disallowance of the deduction of the settlement payments on the basis of the Crown's assertion that CIBC's conduct was egregious or repulsive.

[79] It is true that in determining whether a particular amount is deductible in computing the income of a business for income tax purposes, it may be necessary to consider whether there is a sufficient factual connection between the amount in issue and the business in respect of which the deduction is claimed. That is implicit in the word "profit" in subsection 9(1) of the *Income Tax Act* because "profit" ordinarily means the difference between the revenue of a business and the expenses incurred to derive the revenue, and therefore the determination of "profit" necessarily imports the well accepted business principles that must be applied in determining permissible deductions. In

Symes (cited in paragraph 39 of the *Egg Case*, which is quoted above), the possibility of such an argument was left open.

[80] In this case the Crown may argue, apart from irrelevant moral considerations, that the Transactions are outside of the scope of CIBC's banking business, and for that reason the deduction of the settlement payments in computing the CIBC's profit from its banking business is not acceptable under well accepted business principles (although I digress to observe that CIBC may have an income earning purpose even for a transaction that is outside the scope of its banking business). However, the Crown has already denied, in paragraph 18 of the reply, CIBC's allegation that its deduction of the settlement payments accords with generally accepted accounting principles (paragraph 23 of its notice of appeal). Whether the reply requires a further amendment to make more specific allegations about the scope of CIBC's banking business need not be determined in the context of this appeal.

[81] For these reasons, I conclude that the appeal of CIBC from the first judgment (A-4-12) should be allowed.

Crown appeal of first decision (A-5-12)

[82] The reply is unusually long. It consists of 83 pages of pleadings plus 11 pages containing two schedules in small print. It begins with an overview (9 paragraphs), specific responses to the notice of appeal (13 paragraphs), and a procedural history (5 paragraphs). Pages 6 to 41 contain a single paragraph (paragraph 28), with 22 subparagraphs and innumerable subparts, stating the Minister's factual assumptions. Further facts are alleged in paragraphs 29 to 123. The statement of

issues, the statement of statutory provisions relied upon, and the statement of the grounds relied upon are admirably succinct, totalling only 5 pages.

[83] Pleadings are not necessarily objectionable merely because of their length. In this case, however, the judge correctly noted that the reply contains unnecessary and repetitious detail, and lengthy references to evidence.

[84] After a detailed item by item review, he identified where amendments were required to remove evidence from the pleadings (including the two schedules), to condense lengthy passages to the relevant facts, and to eliminate unnecessary duplication.

[85] He found that many of the statements presented as factual assumptions about the Transactions, the Newby Litigation, and the MegaClaim Litigation actually were conclusions of law or mixed law and fact. He also found that many of the statements used language that was scandalous, prejudicial, an abuse of process or some combination of the three, because it was intended to "poison the mind of the trial judge" (paragraph 38 of his reasons). He ordered the Crown to expunge the reply of certain words and phrases, including the words "fraud" and "misrepresent" and all their variations, and the phrases "fraudulent purpose", "fraudulent conduct", "aided and abetted", "knowingly aided and abetted", "manipulated its financial results", "violate United States' federal securities laws", and "criminal conduct". He also ordered that the phrase "Disguised Loan" not be used as the defining term for the Transactions.

[86] The Crown argues that the judge erred in principle in determining that certain parts of the reply were scandalous, prejudicial or abusive, or contained conclusions of mixed fact and law, and in striking some parts of the reply on grounds not argued by the parties. In my view, the judge made no error warranting the intervention of this Court when he ordered the Crown to expunge the listed words from the reply, and to make the other changes.

[87] I agree with the Crown that merely ordering the deletion of the listed words was not a precise way of dealing with the problems presented by the Crown's reply, because merely expunging words and phrases left a number of incomplete and incoherent sentences. However, having reviewed the reply, I agree with the judge that those words and phrases were used, not only to state the facts that the Minister assumed or that the Crown wished to allege, but to colour the facts in a way that would invite the judge hearing the appeal to evaluate the propriety of the conduct of the employees of CIBC and its affiliates. That is, the listed words are used in various ways to express irrelevant points as to the Crown's disapproval of CIBC's conduct.

[88] The Crown's challenge to the judge's order to expunge the listed words and phrases, and most of the remaining points raised in the Crown's appeal, are based on the mistaken premise that in determining the deductibility of the payments made to settle civil claims, it is relevant that the conduct of CIBC that gave rise to the claims is egregious or repulsive (or, as the Crown would allege, illegal under the laws of the United States even though there was no conviction). The Crown argues that it is not necessarily inappropriate to allege in pleadings that, for example, a certain act was fraudulent because that may be a statement of a relevant fact.

[89] For the reasons stated at length in the context of the CIBC appeal in this case, an evaluation of the morality of CIBC's conduct is not relevant in determining the deductibility of the settlement payments. The same is true of an evaluation of the legality of that conduct under United States law. To include allegations of that kind in the pleadings in this case, whether as part of the assumptions or in the remainder of the reply, is bound to multiply the resources expended in pre-trial discovery with no hope of producing anything that would be helpful in determining the issues on appeal. At the very least, such allegations are likely to delay the fair hearing of CIBC's tax appeals, and I also agree with the judge that they are also prejudicial and vexatious.

[90] I appreciate that the Crown takes the position that Enron misrepresented the Transactions in its financial reports, and that CIBC knew about the misrepresentations at the relevant point in time. I appreciate that the Minister may have assumed and the Crown wishes to allege that the Transactions should have been reported to Enron's investors as loans rather than sales. But the Crown does not advance its position by defining the Transactions as "Disguised Loans", or by alleging that a mischaracterization of transactions in Enron's financial statement is an offence under the laws of the United States, or by alleging that CIBC was a party to that offence. Such allegations invite debate that is pointless because it is not relevant. CIBC should not be required to waste resources to refute assumptions or allegations of fraud or criminal conduct that will do nothing to assist the Tax Court in determining the deductibility of the settlement payments.

[91] The Crown also argues that the judge required the Crown to remove too much from its statement of assumptions, given the Crown's obligation to state the assumptions completely, precisely, accurately and truthfully, so that the taxpayer knows exactly the case it has to meet

(*Canada v. Anchor Pointe Energy Ltd*, [2008] 1 F.C.R. 839 (C.A.) at paragraph 29; *Anchor Pointe Energy Ltd. v. Canada*, 2003 FCA 294 at paragraph 23).

[92] It is now well established that the statement of factual assumptions must contain no statements of law (*Anchor Pointe* (2003) at paragraph 25), and where the assessment under appeal is based on a conclusion of mixed fact and law, the factual components must be extricated and stated as factual assumptions (*Anchor Pointe* (2003) at paragraph 26). The Crown did not observe those principles in many parts of its statement of assumptions, and the judge made no error in requiring the assumptions to be revised accordingly.

[93] One example will illustrate this point. Paragraph 28.22.7 of the reply reads, "the Settlement Payments were not expenditures incurred by the appellant for the purpose of earning income from the business it carried on". That is nothing more than an uninformative paraphrase of paragraph 18(1)(*a*). It would be appropriate in the portion of the reply that states the Crown's legal arguments. It is not appropriate in a statement of the Minister's factual assumptions. Despite the difficulty of which the Crown complains in discerning the difference between facts and law, it seems to me that paragraph 28.22.7 of the reply could be revised without difficulty to extricate the facts and state them as factual assumptions. There are potentially a number of factual elements – the purpose of the payments, the business carried on by CIBC, the factual connection or absence of a factual connection between the two – that might have been the subject of factual assumptions made by the Minister in reaching the conclusion that the income earning purpose in paragraph 18(1)(*a*) was not met. If the Minister made no factual assumptions in reaching that conclusion, then no factual assumptions can be stated, but the conclusion nevertheless may be pleaded elsewhere in the reply.

[94] I have not disregarded the cases cited by the Crown in which the Tax Court has permitted statements similar to those in paragraph 28.22.7 to remain in the statement of the Minister's assumptions. It may well be that in certain situations it is reasonable to allow a deficient pleading to stand if, for example, the facts are relatively simple, there is little or no debate about the applicable legal principles, or there is little risk that the other party will be prejudiced or will be obliged to waste resources. However, this is manifestly not such a case.

[95] The Crown also argues that in making his order, the judge relied on grounds that had not been argued by CIBC, in particular, the pleading of evidence as fact. That may be true, and it does indicate a certain lack of precision in the judge's approach to the motion. Perhaps it would have been preferable for the judge to deal only with the points raised by CIBC in its motion. However, I have concluded that it would not be appropriate to intervene on that basis. In reaching that conclusion, I have taken three factors into account. First, it is obvious that the reply includes a significant amount of evidence, contributing to its unusual length and complexity. Second, it would serve no practical purpose to attempt to identify the provisions in the reply that were found to be deficient only because they plead evidence, only to potentially require the Crown to make a further change if CIBC moves to strike the claims because they plead evidence. Third, the order under appeal was made in the context of case management, which is continuing. If, after this judgment, there remains a problem with the reply that is attributable to the manner in which the judge dealt with the CIBC motion, the problem may be dealt with in subsequent case management proceedings.

[96] For these reasons, I would dismiss the Crown's appeal of the first judgment (A-5-12).

Second decision of the Tax Court – objections to the proposed amended reply

[97] While the two appeals of the judge's order of December 21, 2011 were pending in this Court (A-4-12 and A-5-12), matters proceeded in the Tax Court. The Crown submitted an amended reply on February 20, 2012 in intended compliance with the December 21, 2011 order. Among other things, the amended reply deleted certain assumptions from the original reply and replaced them by pleading "a single set of particulars of assumptions of fact regarding conduct, acts and agreements, their purpose and effect, without reference to source and without duplication."

[98] After reviewing the amended reply and considering the submission of the parties, the judge concluded that the amended reply did not comply in certain respects with his December 21, 2011 order. He held that some of the amendments merely replaced words or phrases that were ordered removed with near synonyms that were equally problematic, and others were new statements of mixed law and fact, or were unfairly prejudicial. By order dated July 5, 2012, he required the correction of the passages he considered non-compliant with his previous order. The Crown has appealed the July 5, 2012 order.

Crown appeal of second decision (A-331-12)

[99] The Crown's appeal of the July 5, 2012 order is focused on the changes ordered by the judge to paragraph 28 of the reply, which as mentioned above contains the statement of the factual assumptions of the Minister.

[100] The Crown challenges the part of the July 5, 2012 order that orders the deletion of certain words and phrases from various parts of paragraph 28 of the reply ("knew", "knowing", "knowingly

participated in", "knew or were reckless in not knowing", "knew would disqualify", "knew that Enron was falsifying", "false", "falsely", "false and misleading", "false reporting", "secret repayment guarantees", "could not be disclosed, with actual knowledge to manipulate and misstate", "to facilitate self-dealing transactions", "were deliberately kept out", "permitted the making of", "dishonest course of conduct").

[101] The thrust of the judge's order, as I understand it, is that the attempted amendment suffers from two deficiencies. First, some of the revisions are conclusions of mixed fact and law. Second, some of the words ordered to be deleted because they were unfairly prejudicial were simply replaced with near synonyms.

[102] I have already noted the impropriety of including, in the statement of the Minister's assumptions, statements that are actually statements of mixed fact and law. I will not repeat that discussion here. I will note only that I am not persuaded that the judge misinterpreted any parts of the amended reply that he found to be statements of mixed fact and law.

[103] Nor am I persuaded that there is any basis for intervening in the judge's order to remove the listed words. The issue, in my view, is the same as the issue raised in the Crown's first appeal, and the answer is also the same. The listed words are intended to colour the facts in a way that will lead the judge hearing this matter to an assessment of the morality or legality of CIBC's conduct, which is not legally relevant and, in the context of this case, is wasteful, prejudicial and vexatious.

[104] The Crown also argues that the judge made the order he did because he wished to prevent CIBC from being required to bear the onus of proof of the Minister's assumptions as to the "knowledge" element of what the Crown alleges are CIBC's violations of United States law. In my view, this argument is based on a misinterpretation of the judge's reasons. He said that the words and phrases he ordered struck would "place an unfair onus on CIBC" if left in the reply. I interpret that as a reference to the unfairness of requiring an appellant in an income tax appeal to deal with Ministerial assumptions that are not relevant to the issues to be determined. That is a point I also addressed in the previous appeal. I need not repeat that discussion here.

[105] For these reasons, I would dismiss the Crown's second appeal (A-331-12).

Conclusion

[106] The appeal of CIBC in A-4-12 should be allowed with costs, and the appeals of the Crown in A-5-12 and A-331-12 should be dismissed with costs. This matter should be returned to Associate Chief Justice Rossiter or another judge of the Tax Court to consider what changes, if any, are required to the reply to give effect to the disposition of these three appeals.

"K. Sharlow"

J.A.

"I agree
John M. Evans J.A."

"I agree
David Stratas J.A."

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

DOCKET:	A-4-12
(APPEAL FROM AN ORDER OF THE HONOURABLE ASSOCIATE CHIEF JUSTICE ROSSITER DATED DECEMBER 21, 2011 (DOCKET NUMBERS: 2010-1413(IT)G, 2010-1414(IT)GM, 2010-1640(IT)G, and 2010-2864(IT)G))	
STYLE OF CAUSE:	CANADIAN IMPERIAL BANK OF COMMERCE v. HER MAJESTY THE QUEEN
PLACE OF HEARING:	Toronto, Ontario
DATE OF HEARING:	November 21, 2012
REASONS FOR JUDGMENT BY:	SHARLOW J.A.
CONCURRED IN BY:	EVANS J.A. STRATAS J.A.
DATED:	May 6, 2013

APPEARANCES:

Joseph Steiner Al Meghji	FOR THE APPELLANT
Michael Ezri Eric Noble Patricia Lee Craig Maw	FOR THE RESPONDENT

SOLICITORS OF RECORD:

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FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

DOCKET:	A-5-12
(APPEAL FROM AN ORDER OF THE HONOURABLE ASSOCIATE CHIEF JUSTICE ROSSITER DATED DECEMBER 21, 2011 (DOCKET NUMBERS: 2010-1413(IT)G, 2010-1414(IT)GM, 2010-1640(IT)G, and 2010-2864(IT)G))	
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FEDERAL COURT OF APPEAL

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