Docket: 2013-3902(IT)G

BETWEEN:

THE ARMOUR GROUP LIMITED,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on April 5 & 6, 2016, at Halifax, Nova Scotia

Before: The Honourable Justice B. Paris

Appearances:

Counsel for the Appellant:	Bruce S. Russell, Q.C. Virginia Jones
Counsel for the Respondent:	David I. Besler

JUDGMENT

The appeal from the reassessment made under the *Income Tax Act* for the 2003 taxation year is dismissed with costs to the Respondent on a party and party basis, in accordance with the attached Reasons for Judgment.

Signed at Vancouver, Canada, this 24th day of April 2017.

"B.Paris"

Paris J.

Citation: 2017 TCC 65
Date: 20170424
Docket: 2013-3902(IT)G

BETWEEN:

THE ARMOUR GROUP LIMITED,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Paris J.

[1] This is an appeal of a reassessment of the Appellant's taxation year ending December 31, 2003, by which the Minister of National Revenue (the "Minister") disallowed the deduction of $2.24 million claimed by the Appellant as a lease cancellation fee.

[2] The Appellant is an investment and real estate company having its principal place of business in Halifax, Nova Scotia. The transactions giving rise to the Appellant's claim were carried out by Founders Square Limited ("FSL"), a wholly-owned subsidiary of the Appellant. FSL acts as a bare trustee, holding all of its assets for the benefit of the Appellant. All of the relevant transactions undertaken by FSL were, therefore, reported in the Appellant's tax filings.

[3] The Minister reassessed the Appellant on the basis that FSL did not pay a lease cancellation fee of $2.24 million in 2003. The Minister viewed the amount as having been paid by FSL to acquire an interest in real property and therefore laid out on capital account, the deduction of which is prohibited by paragraph 18(1)(*b*) of the *Income Tax Act* (the "*Act*").

[4] The issue in this appeal, therefore, is whether the $2.24 million amount is deductible by the Appellant in calculating its business income for its 2003 taxation year.

[5] Should I find that the amount is not a capital expenditure, the Respondent says, in the alternative, that the $2.24 million amount was a pre-payment of rent, the deduction of which is prohibited by subsection 18(9) of the *Act*.

[6] The Appellant called one witness at the hearing of the appeal: Mr. Douglas MacIssac, the President of the Appellant since 1995 and its CFO since 2009.

Facts

[7] During the 1970s, the Province of Nova Scotia ("the Province") acquired certain land and historic buildings located in downtown Halifax. This property was known as Founders Square.

[8] In 1983, FSL entered into an agreement to lease Founders Square from the Province on a long term basis and to redevelop the property for use as office space. The agreement between FSL and the Province included the following:

- the Province would be the owner of the land, the historic buildings and any new buildings constructed on the land (together "the Property");

- the Province would enter into a Ground Lease of the Property with FSL until 2064. The rent payable by FSL would be $100,000 per year for the first 10 years and a percentage of gross revenue for the remaining 70 years of the term;

- the Province would have a reversionary interest in the Property that would materialize in 2064;

- FSL would build a new development on the site which, combined with the existing buildings, would contain a total rentable area of 200,600 square feet, and

- the Province would rent 50,000 square feet of office space from FSL for a period of 30 year.

[9] In July, 1984, the Ground Lease was signed between the Province and FSL, reflecting the 1983 Agreement. Thereafter, FSL constructed the new office component of Founders Square and the Province leased 50,000 square feet of that space from FSL.

[10] In the early 1990s, the space leased by the Province from FSL fell below 50,000 square feet and FSL brought an action in the Supreme Court of Nova Scotia to enforce the 1983 Agreement. FSL was ultimately successful in that action. In Minutes of Settlement dated February 21, 2003, the parties reached an agreement on the damages owing by the Province to FSL and how that amount would be paid.

[11] The Minutes of Settlement provided that:

- the Province was liable to FSL in the amount of $4,456,250 (inclusive of HST);

- the Province would pay FSL $2,056,250 in cash within 7 days of the settlement;

- the Province would grant an irrevocable assignable option (the "Option") to FSL or its assignee to purchase the Lands and buildings known as Founders Square, together with an assignment of the Ground Lease in favour of FSL and all rights of reversion in the said Lands and buildings, all for $2,400,000,

- the fair market value of the Lands was $2.4 million;

- if FSL or its assignee did not exercise the Option, that the Province would pay FSL a lump sum of $2,400,000.

[12] The Province granted the Option to FSL on March 20, 2003.

[13] On June 10, 2003, FSL entered into a Transfer Agreement with Armour Developments Limited ("ADL"), another wholly-owned subsidiary of the Appellant, whereby FSL assigned to ADL the Option to purchase the Lands. A condition of the assignment of the Option was that ADL, "upon becoming the owner of the Lands", would grant FSL a new Ground Lease of the Lands to run until 2064. The new Ground Lease was to be granted on the same terms and conditions as those contained in the Ground Lease between FSL and the Province, except that the rent payable by FSL to ADL would be $10 per year.

[14] Under the Transfer Agreement, FSL agreed to transfer a $160,000 portion of the $2.4 million amount it was entitled to receive from the Province under the

Minutes of Settlement to ADL, and ADL agreed to provide a promissory note payable to FSL in the amount of $160,000.

[15] On June 11, 2003, FSL and ADL delivered the following notices to the Province:

> - a Notice that FSL had assigned to ADL its rights under the Option "to acquire title to the lands" described in the Option, but not the Ground Lease, which FSL stated was "being canceled concurrent with delivery of the deed" to the Property to ADL.
>
> - a Notice that FSL was exercising "the option to purchase the Property referred to in the Option except the interest transferred to ADL."
>
> - a Notice that ADL, as assignee from FSL, was electing "to purchase the lands referred to in the Option."

[16] In the letter accompanying the Notices, the Appellant advised the Province that the Ground Lease would be surrendered simultaneously with the transfer of the Property to ADL.

[17] On June 20, 2003, the Province confirmed with the Appellant that the Option had been appropriately exercised.

[18] On July 22, 2003, the Province, FSL and ADL entered into the following transactions:

> -FSL surrendered the Ground Lease to the Province (the "Surrender Agreement");
>
> -the Province deeded and transferred the fee simple interest in the Property to ADL; and
>
> ADL and FSL entered into a new ground lease of the Property to run until July 31, 2064, on the same terms and conditions as the Ground Lease with the Province except that the rent was reduced to $10 per year, (the "New Ground Lease").

[19] The closing agenda for the July 22, 2003 transactions provided that all documents in respect of the transactions would be held in escrow until all

documents were delivered, at which time the escrow would terminate, the documents would be released from escrow simultaneously and the closing would be deemed to have been completed.

[20] According to the Surrender Agreement entered into between FSL and the Province, the consideration provided by FSL to the Province for the surrender was "$10.00 and other good and valuable consideration". The Surrender Agreement also provided that "the Surrender and the Conveyance (of the lands) shall be released from escrow simultaneously and that the delivery of this Surrender and the Conveyance shall in no way constitute a merger of the fee simple title and the leasehold title in the Lands."

[21] Mr. MacIsaac gave two reasons why FSL chose to surrender the Ground Lease to the Province. First, he said that it was preferable in terms of creditor-proofing that FSL not exercise the Option entirely itself, since this would have resulted in a merger of the lease and reversionary interest. Mr. MacIsaac explained that it is common practice for the Appellant to keep the ownership and leasehold interests in its properties in two separate companies and to obtain leasehold mortgages in order to finance its operations. By keeping the ownership and leaseholds interest in separate companies, the leasehold mortgagor would be precluded from seizing the freehold interest in their real property in the event of default. Mr. MacIsaac said that, in the case of the Founders Square Property, the mortgagor would not have been able to seize the reversionary interest held by ADL, should FSL ever default.

[22] The second reason given by Mr. MacIsaac for the surrender of the lease was to make the office rents for the Property more competitive. He said that the subtenants of the Property were responsible to pay a share of the operating costs for the buildings, and that those costs included a proportionate share of the underlying Ground Lease payments. Therefore, by transferring the reversionary interest to ADL and reducing the lease payments from $100,000 to $10 per year, the operating cost of the Founders Square buildings dropped considerably. This was intended to have a positive effect on attracting tenants and increasing the stability of the tenant base.

[23] Mr. MacIsaac said that he determined the amount of the lease cancellation payment, and that he did so by discounting the present value of lease payments over the remaining of the 63 years of the Ground Lease. He said that this calculation yielded a value of $2,263,362.

[24] Mr. MacIsaac testified that the value of the reversionary interest in the Property was diminished by the fact that the holder of the reversionary interest had no right of possession until 2064, by which time the buildings of Founders Square would have been approximately 80 years old, and by the fact that the holder of the reversionary interest was obliged to pay the municipal property taxes on the Property. Mr. MacIsaac also testified that the value of the reversionary interest was low because the rent that FSL had agreed to pay until 2064, $10 per year, was low.

[25] Mr. MacIsaac said that the Province was adamant that the $2.24 million value not be stated on the Surrender of Lease and that it be replaced with the phrase "other good and valuable consideration". He also said that the dollar amount of the "other consideration" was not made explicit, in part, because of the strained relationship between the Province and the Appellant.

[26] Finally, Mr. MacIsaac testified that ADL paid the Municipal Deed Transfer Tax on a declared value of $160,000 for the property it received from the Province and that the declared value was never challenged by the municipal government.

Relevant Statutory Provisions

> *Income Tax Act*
>
> 9(1) Subject to this Part, a taxpayer's income for a taxation year from a business or property is the taxpayer's profit from that business or property for the year.
>
> 18(1) In computing the income of a taxpayer from a business or property no deduction shall be made in respect of
>
> > (*a*) General limitation - 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.
> >
> > (*b*) Capital outlay or loss – an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part;
> >
> > …
>
> (9) Notwithstanding any other provision of this *Act*,
>
> > (a) in computing a taxpayer's income for a taxation year from a business or property (other than income from a business computed in

> accordance with the method authorized by subsection 28(1)), no deduction shall be made in respect of an outlay or expense to the extent that it can reasonably be regarded as having been made or incurred
>
> …
>
> (ii) as, on account of, in lieu of payment of or in satisfaction of, interest, taxes (other than taxes imposed on an insurer in respect of insurance premiums of a non-cancellable or guaranteed renewable accident and sickness insurance policy, or a life insurance policy other than a group term life insurance policy that provides coverage for a period of 12 months or less), rent or royalties in respect of a period that is after the end of the year,
>
> …
>
> (b) such portion of each outlay or expense (other than an outlay or expense of a corporation, partnership or trust as, on account of, in lieu of payment of or in satisfaction of, interest) made or incurred as would, but for paragraph 18(9)(a), be deductible in computing a taxpayer's income for a taxation year shall be deductible in computing the taxpayer's income for the subsequent year to which it can reasonably be considered to relate;

Appellant's Position

[27] The Appellant argues that the evidence confirms that $2.24 million was the amount paid by FSL to the Province by way of set-off (in addition to $10) as consideration for the surrender of the Ground Lease. It is the Appellant's position that the "other good and valuable consideration" referred to in the Surrender was, in fact, the $2.24 million paid by way of set-off against the credit owing to FSL by the Province according to the Minutes of Settlement.

[28] The Appellant submits that this position is supported arithmetically. After the deduction of the $160,000 value of the reversionary interest, $2.24 million was the remaining amount of the $2.4 million credit available to FSL under the Minutes of Settlement with the Province. The Appellant argues that consideration for the surrender of the Ground Lease therefore had to be $2.24 million as nothing else could be charged against the $2.4 million credit. The amount was not paid by FSL to acquire any interest in the Property from the Province.

[29] The Appellant asserts that the Province did not challenge the values determined by FSL for the leasehold and reversionary interests in the Property, and points to the fact that the Province confirmed that the Option had been appropriately exercised by FSL and ADL. The Appellant also says that the value declared for Municipal Deed Transfer Tax purposes supports a finding that the only property transferred to ADL was the reversionary interest.

[30] The Appellant further submits that the evidence shows that the amount of the lease cancellation payment was determined with reference to rental payments foregone by the Province. Therefore, the $2.4 million setoff against the amount owing by the Province to FSL was clearly compensation to the Province for its loss of its right to generate income from the Ground Lease until 2064. The Appellant argues that by accepting the surrender of the Ground Lease, the Province gave up or conceded the benefit of an income stream valued at $2.24 million and that the amount of the loss to the Province was accurately reflected in the equivalent dollar reduction of liability of the Province to FSL per the Minutes of Settlement. The Appellant says that the value of the Ground Lease that FSL surrendered to the Province supports its position that the true consideration given to the Province for the surrender was $2.24 million.

[31] Therefore, the Appellant states that the $2.24 million lump-sum payment (by way of credit set-off) was incurred as a lease cancellation payment to compensate the Province for its loss of its right to generate income from the Ground Lease until 2064. As a lease cancellation payment, this amount was deductible as a business expense under section 9 and paragraph 18(1)(*a*) of the *Act*.

[32] Drawing from the test as enunciated by Strayer J. in *Canadian National Railway Co. v. Minister of National Revenue*, 1988 DTC 6340 (FCTD), the Appellant maintains that the effect of the $2.24 million payment was to replace income, not capital because the effect of the amount was paid to relieve FSL of the obligation to pay anything more than nominal rent thereafter. Since the rent that had been payable to the Province was a deductible expense to FSL, the payment made to relieve it of the obligation to pay rent is also a deductible expense.

[33] Consequently, the Appellant submits that the expense of $2.24 million incurred by FSL was a deductible cost and necessary to provide an accurate picture of profit.

Analysis

[34] I will deal firstly with the question of whether FSL gave consideration of $2.24 million to the Province for the surrender of the lease. In my view, the Appellant has failed to meet the onus on it to show that such consideration was provided.

[35] In order to determine the consideration given for the surrender, it is necessary to interpret the terms of the Surrender Agreement entered into between FSL and the Province. The Appellant maintains that the phrase "other good and valuable consideration" used in the Agreement, should be interpreted to mean $2.24 million.

[36] In interpreting a contract, the goal is to discover the objective intention of the parties at the time they entered into it, and evidence of a party's subjective intention is not relevant or admissible. Also, if words in a contract are ambiguous, the court may consider extrinsic evidence.

[37] Where the question of interpretation relates to the consideration agreed to by the parties, the following principles apply:

> Extrinsic evidence is admissible to prove the actual consideration where no consideration or nominal consideration is stated in the contract; where the consideration is ambiguous; or where substantial consideration is stated, but additional consideration exists. However, the additional consideration must not be inconsistent with the terms of the written contract…
>
> *Fawcett v. Western Canadian Coal Corp*., 2010 BCCA 70, at para. 26.

[38] According to the Surrender Agreement, the surrender was given in exchange for payment of $10 and other good and valuable consideration by FSL to the Province. It is reasonable to conclude in this case that the express monetary consideration of $10 is nominal. It is also clear that the expression "other good and valuable consideration" is ambiguous. Therefore I accept that extrinsic evidence concerning any additional consideration that may have been agreed to by the parties is admissible in this case.

[39] Mr. MacIsaac was the only witness called to support the Appellant's position that monetary consideration in excess of $10 was given for the surrender. The substance of his testimony was that FSL alone determined a value for the surrender and that FSL sought the Province's agreement to show this amount as the consideration for the surrender. However, according to Mr. MacIsaac, the Province insisted that the agreement <u>not</u> show consideration of $2.24 million for the

surrender. I infer, then, that the Province did not agree to the consideration suggested by the Appellant.

[40] The Appellant did not call anyone from the Province to testify, and no explanation for the failure to call any such witness was provided by counsel. In J. Sopinka, S.N. Lederman and A.W. Bryant, *The Law of Evidence in Canada*, 3rd ed. (Toronto: Butterworths, 2009) the authors state at page 377:

> In civil cases, an unfavourable inference can be drawn when, in the absence of an explanation, a party litigant does not testify, or fails to provide affidavit evidence on an application, or fails to call a witness who would have knowledge of the facts and would be assumed to be willing to assist that party. In the same vein, an adverse inference may be drawn against a party who does not call a material witness over whom he or she has exclusive control and does not explain it away. Such failure amounts to an implied admission that the evidence of the absent witness would be contrary to the party's case, or at least would not support it.

[41] In this case, I draw the inference that the testimony of the officials of the Province who were involved in the relevant transactions would not have been favourable to the Appellant on the issue of consideration given for the surrender. Given that FSL and the Province had reached a settlement of the prior litigation between them in 2003, it is not apparent to me that the officials of the Province would have been hostile to the Appellant in these proceedings, or that any strained relationship that may have existed at the time the transactions occurred would have affected the willingness of those officials to testify about any additional consideration for the surrender that the parties may have agreed to at the time.

[42] I therefore find that the Appellant has not shown that it gave consideration of $2.24 million to the Province for the lease surrender.

[43] While this conclusion alone is sufficient to dispose of the appeal, I would also add that I am satisfied that FSL paid the $2.24 million to the Province in order to permit ADL to acquire the fee simple interest in the Property, and that the payment was therefore on capital account.

[44] While the Appellant argued that ADL acquired only the reversionary interest in the Property from the Province and that the value and consideration given for this interest was $160,000, I reject this characterization of what took place.

[45] In the Transfer Agreement between FSL and ADL (concerning the transfer of the Option to purchase the Property), the parties state that ADL "upon becoming

owner of the lands will grant" FSL a ground lease identical to the existing ground lease with the Province, except that the annual rental would be only $10. In order for ADL to be able to grant the New Ground Lease to FSL, it was necessary for ADL to acquire the entire fee simple interest in the Property beforehand. If it had acquired only the reversionary interest from the Province, it would not have been able to give the New Ground Lease to FSL, because one cannot give what one does not own (*Friedberg v. Canada*, 92 DTC 6031 (F.C.A.) at paragraph 9). Likewise, the Province could not have given ADL the unencumbered fee simple title to the Property if it held only the reversionary interest prior to the transfer.

[46] Regardless of the provision in the Surrender Agreement that "the delivery of this Surrender and the Conveyance shall in no way constitute a merger of the fee simple title and the leasehold title in the Lands", the surrender of the Ground Lease to the Province caused it to merge with the fee simple title by operation of law.

[47] This view of what took place in law is also supported by the Warranty Deed given to ADL by the Province. According to the Deed, the Province conveyed the fee simple title to the Property to ADL, free and clear of any encumbrances.

[48] Given that the Province and FSL had agreed in the Minutes of Settlement that the fair market value and purchase price of the Property was $2.4 million, it would appear that all of the $2.4 million credit owing to FSL by the Province provided for in the Minutes of Settlement was set off against the purchase price of the Property, rather than just $160,000.

[49] I would attach little weight to the fact that, for municipal tax purposes, ADL reported a value of $160,000 for the property it received from the Province. While the Appellant maintained that this value was accepted by the municipality, there is no evidence that the details of the transactions between FSL, ADL and the Province were ever examined or analyzed by the municipality.

[50] In my view, upon the proper construction of the agreements that are before me, FSL used the $2.4 million credit under the Minutes of Settlement to pay for the transfer of the Property to ADL. Since, under the Transfer Agreement, FSL transferred to ADL the option to acquire the fee simple interest to the Property, it appears to me that FSL paid the $2.4 million purchase price on ADL's behalf.

[51] In exchange, ADL gave FSL the right to enter into a new long-term ground lease of the Property with ADL at a minimal rent.

[52] A leasehold interest, such as that given in the New Ground Lease, is a capital asset. In *T. Eaton Company Limited v. The Queen*, 99 DTC 5178, the Federal Court of Appeal stated that:

> …A leasehold interest in land also represents a capital asset, the value of which depends on both the terms of the lease and market conditions. For example, a tenant whose rent obligation is one-half the market rate has a valuable asset which can be sold by way of assignment, subject to any restriction protecting the interests of the landlord…(at para 36)

[53] It seems clear to me that the leasehold interest that FSL obtained from ADL at a nominal rent under the New Ground Lease was a capital asset and therefore that the payment made by FSL by offset on behalf of ADL was on capital account.

Conclusion

[54] For all of these reasons, the appeal is dismissed, with costs to the Respondent on a party and party basis.

Signed at Vancouver, Canada, this 24th day of April 2017.

"B.Paris"

Paris J.

CITATION:	2017 TCC 65
COURT FILE NO.:	2013-3902(IT)G
STYLE OF CAUSE:	THE ARMOUR GROUP LIMITED AND HER MAJESTY THE QUEEN
PLACE OF HEARING:	Halifax, Nova Scotia
DATES OF HEARING:	April 5 & 6, 2016
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DATE OF JUDGMENT:	April 24, 2017

APPEARANCES:

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