

TAX NOTES

December 16, 2003

DEDUCTIBILITY OF TAKEOVER COSTS: THE BJ SERVICES INCOME TAX CASE

Introduction

Given the magnitude of merger and acquisition costs, the relative lack of guidance from Canadian courts concerning their treatment is somewhat surprising. This has resulted in uncertainty and disparate positions being adopted by taxpayers and the Canada Customs and Revenue Agency. The December 3, 2003 decision of *BJ Services Company Canada (The Successor to Nowasco Well Service Ltd.) v. R.*, 2003 TCC 900 is the most recent in a series of lower court decisions¹ concerning takeover costs, and the first to consider in depth the income tax treatment of expenses incurred in fighting a hostile takeover bid.

The Facts

By way of background, on April 1, 1996, BJ Services Company Canada (“BJ Services”) made a hostile takeover bid to acquire all of the shares of Nowasco Well Service Ltd. (“Taxpayer”) for \$27 per share. In the weeks following that bid, the Taxpayer’s board of directors caused the Taxpayer to incur substantial expenditures, including investment banking fees of approximately \$18.2 million, and certain other expenditures (collectively, “Expenses”). Part of the Expenses related to the procurement of an offer from a white knight (a “hello” fee of approximately \$6.9 million), and another part related to the subsequent rejection of that offer (a “break” fee of approximately \$23.6 million). Ultimately, on June 13, 1996, roughly 2 _ months after making its initial bid, BJ Services was successful in acquiring the shares of the Taxpayer with a \$35 per share bid, which bid was superior to that of the white knight.

The Issue

BJ Services, successor to the Taxpayer, attempted to deduct the Expenses on a current basis, for its 1996 taxation year. The Minister of National Revenue (the “Minister”) reassessed the Taxpayer, and at trial took the position that the Expenses were not deductible as they were incurred to maximize shareholder value, and therefore were not incurred for the purpose of gaining or producing income from business or property. The Minister also advanced the alternative position that, if the Expenses were incurred for the purpose of gaining or producing income, they were nonetheless capital outlays, and as such non-deductible on a current basis.

¹ See also *Boulangerie St-Augustin Inc. v. Canada*, [1995] 2 C.T.C. 2149 (T.C.C.); affirmed, [1996] F.C.J. No. 1611 (F.C.A.) and *International Colin Energy Corporation v. The Queen*, [2003] 1 C.T.C. 2406 (T.C.C.), as well as the GST case concerning *BJ Services Co. Canada v. The Queen*, [2002] G.S.T.C. 124 (T.C.C.).

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The Decision

Campbell J. decided in favour of the Taxpayer. In addressing the Minister's argument that the Expenses were incurred for the purpose of maximizing shareholder value, Campbell J., adopted a common sense "business approach". Campbell, J. was of the view that "maximizing share price [i]s inextricably interwoven with the business of any company, whether that be public or otherwise", and that "it is simple logic that maximizing shareholder value must be inextricably tied to the bare bones of gaining or producing income on a daily basis in any corporate environment".

In support of her decision, Campbell J. noted: (a) maximizing shareholder value enables public corporations to successfully compete in the public marketplace for funds to be applied for the purpose of earning income; (b) paralleling the Tax Court in *Boulangerie*, in the public entity marketplace "shareholders expect informed communication from [the corporation's board of directors], which goes hand in hand with a shareholder's insistence on maximization of its shareholder value"; and (c) especially (but not exclusively) in the context of a hostile takeover, directors have both legal obligations and public capital market expectations which necessitate taking steps to maximize shareholder value. In summary, Campbell J. found that the Expenses, although related to maximizing shareholder value, were so integral to conducting its business that they could not be divorced from the corporate activities of gaining or producing income.

With respect to the Minister's alternative argument, Campbell J. rejected the argument that the Expenses were capital outlays because there was no enduring benefit obtained by the Taxpayer in incurring the Expenses. Further, the Minister was unable to provide evidence that capitalizing the Expenses would lead to a more accurate portrayal of the Taxpayer's income.

Conclusion

Based on recent lower level cases, it appears the courts are willing to recognize that business realities, legal obligations, and the capital market requirements dictate the manner in which a public corporation must operate its business, and that these factors must be taken into consideration in determining the deductibility of takeover bid costs. The fact that a corporation's response to such factors may enhance shareholder value is not a bar to deductibility.

The capital markets place a high reliance on the integrity of corporate directors and the legal rules which govern corporate behaviour. At no time has this been more apparent than now following the various scandals that have rocked the financial world. The courts appear to recognize that access to capital markets and attending to shareholder interests and expectations are essential components of operating a business and earning income. A corporation must satisfy market expectations including complying with standards of good corporate governance and legal requirements. In recognizing this broad relationship, the Tax Court of Canada appears to be willing to accept the deductibility of takeover costs, even in a hostile case. However, it is important to note that the issue of the deductibility of takeover costs still remains to be decided before a higher court.

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The comments in this Tax Note have been prepared for the purpose of providing timely notice regarding the BJ Services decision of the Tax Court of Canada and are not intended to constitute a comprehensive summary or legal advice to any reader. These comments should not be relied upon to replace professional advice.