SCC File No.: 38320

IN THE SUPREME COURT OF CANADA
(ON APPEAL FROM THE FEDERAL COURT OF APPEAL)

B E T W E E N :

JAMES S. A. MACDONALD

APPELLANT
(Appellant)

- and -

HER MAJESTY THE QUEEN

RESPONDENT
(Respondent)

FACTUM OF THE APPELLANT JAMES S. A. MACDONALD

(Pursuant to Rule 42 of the *Rules of the Supreme Court of Canada*, SOR/2002-156)

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PART I - OVERVIEW AND FACTS

1. This appeal concerns the test for determining whether gains or losses arising from financial derivative transactions[1] should be taxed on income or capital account.[2] This question arises following the Federal Court of Appeal's ("**FCA**") decision that a taxpayer's intention and close linkage in terms of quantum and timing are not prerequisites, or even meaningful considerations, in determining the tax treatment of gains or losses arising from derivative transactions. In so holding, the FCA's decision departs from a century of jurisprudence – including this Court's binding precedents.

2. The trial below concerned Mr. MacDonald's entitlement to deduct, on income account rather than on capital account, certain losses that he incurred on partial settlements of a forward contract (the "**Forward Contract**").[3] Mr. MacDonald entered into the Forward Contract in the late 1990s because he speculated that the trading price of Bank of Nova Scotia ("**BNS**") shares would experience a short-term decline due to certain world financial events. Under the Forward Contract, Mr. MacDonald would receive a payout if he speculated correctly and the price of BNS shares fell. Conversely, if he was incorrect, he would lose money and be required to make cash

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1 Financial derivatives are contracts where values are based on the fluctuation in value of an underlying asset, liability, reference rate, or index: *Placer Dome Canada Ltd. v. Ontario (Minister of Finance)*, 2006 SCC 20, [2006] 1 S.C.R. 715, at para. 29 *per* LeBel J. [*Placer Dome*].

2 Only one-half of capital gains are subject to inclusion in income. As such, tax on such gains is 50% of the tax imposed on gains that are on income account. Similarly, only one-half of capital losses are deductible against a taxpayer's capital gains. Capital losses are not deductible against gains on income account: *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), s. 38 [ITA].

3 A forward contract is a financial instrument that obligates one party to sell, and the counterparty to buy, a specific asset, at a specific price, at a specific future point in time: Expert Report of Mr. Kurgan filed February 16, 2017 (the "**Kurgan Report**"), at para. 35 [Appellant's Record ("**AR**"), Part IV, Vol. V, Tab S, p. 25].

payments to the counterparty, Toronto Dominion Securities Inc. ("**TDSI**"), to settle those losses.

3. Mr. MacDonald's speculation was incorrect and he ended up making cash payments to TDSI totalling $9,956,837 (the "**Cash Settlement Payments**"). Mr. MacDonald claimed the Cash Settlement Payments as losses on income account under subsection 9(1) of the *Income Tax Act* (the "**ITA**")[4] in each of his 2004, 2005, and 2006 taxation years.

4. The Minister of National Revenue (the "**Minister**") reassessed Mr. MacDonald and disallowed the losses claimed on income account. Instead, the Minister treated the Cash Settlement Payments as capital losses and therefore deductible only against capital gains (the "**Reassessment**s"). The Minister asserted that Mr. MacDonald had used the Forward Contract to hedge BNS shares that he held on capital account, and because the Forward Contract hedged a capital asset, any gains or losses arising from the settlement of the Forward Contract assumed a capital character and were taxable on capital account.

5. In the Tax Court of Canada, the Trial Judge carefully considered the totality of the evidence before her and allowed Mr. MacDonald's appeal.[5] The Trial Judge held that the Cash Settlement Payments were properly income losses resulting from speculation and deductible on income account. In reaching her decision, the Trial Judge applied legal principles that reach back almost 100 years. The long history of case law applied by the Trial Judge provides that, where a taxpayer's intention is to speculate on the fluctuation in the value of an underlying asset or liability with a derivative contract, gains or losses arising from the derivative contract are taxed on income account as an "adventure or concern in the nature of trade".

6. The Trial Judge rejected the Crown's argument that the Forward Contract was a hedge of BNS shares. In so doing, she referenced the two well-established elements of a hedge for tax purposes: (i) an intention of the taxpayer to mitigate an actual identified risk (*i.e.*, to hedge); and (ii) the implementation of that intention through a derivative transaction that is closely linked to an underlying asset or liability in terms of both quantum and timing. In other words, both an intent to hedge as well as a sufficient linkage to the hedged asset or liability are required to

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4 ITA, *supra* note 2.

5 *MacDonald v. The Queen*, 2017 TCC, 2017 D.T.C. 1104 *per* Lafleur J. (the "**Trial Decision**") [AR, Part I, Vol. I, Tab B, pp. 2-58].

transform a derivative transaction (which is speculative by its nature) into a hedge. Although it appears that the Trial Judge stated these two elements of a hedge for tax purposes more explicitly and clearly than in past cases, both are analyzed in and animate every decision in the tax jurisprudence of the past century where a hedge has been found.

7. With respect to Mr. MacDonald's intent, the Trial Judge thoroughly evaluated, analyzed, and weighed the evidence, including Mr. MacDonald's stated intention as corroborated by the objective surrounding evidence. In particular, she found that Mr. MacDonald owned his BNS shares (the "**BNS Shares**") for approximately a decade before entering into the Forward Contract,[6] incurred cash losses arising under the Forward Contract without selling his BNS Shares to mitigate those losses during the term of the Forward Contract,[7] and that the BNS Shares remain the cornerstone of his investment portfolio to this day.[8] Indeed, the Trial Judge held that the Crown's position "would lead this Court to speculate on what could happen as opposed to concluding as to what did happen" (emphasis added),[9] notwithstanding the fact pattern presented in the case before her. Accordingly, the Trial Judge held that Mr. MacDonald did not enter into the Forward Contract to hedge the value of his BNS Shares. Rather, he entered into the Forward Contract to speculate on the short term movement of the price of BNS shares.[10] The Trial Judge held that the losses were on income account.

8. The FCA overturned the Trial Judge's decision and with it almost 100 years of case law. The FCA allowed the Crown's appeal and held that Mr. MacDonald's losses were capital losses (the "**FCA Decision**").[11] In doing so, the FCA erroneously:

(a) imported the Ontario *Mining Tax Act*'s statutory definition of "hedging"[12] from

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6 Trial Decision, at para. 4 and Appendix A – Partial Agreed Statement of Facts, at paras. 5 and 12 [AR, Part I, Vol. I, Tab B, pp. 3 and 38-39].

7 Trial Decision, at paras. 66 and 104 [AR, Part I, Vol. I, Tab B, pp. 19-20 and 33].

8 Trial Decision, at paras. 66 and 104 [AR, Part I, Vol. I, Tab B, pp. 19-20 and 33].

9 Trial Decision, at para. 101 [AR, Part I, Vol. I, Tab B, pp. 32].

10 Trial Decision, at paras. 46, 60, and 63 [AR, Part I, Vol. I, Tab B, pp. 14 and 17-18].

11 *Canada v. MacDonald*, 2018 FCA 128, 2018 D.T.C. 5077 (the "**FCA Decision**") [AR, Part I, Vol. I, Tab F, pp. 92-123].

12 *Mining Tax Act*, R.S.O. 1990, c. M.15, s. 1, *sub nom.* "hedging".

this Court's *Placer Dome Canada Ltd. v. Ontario (Minister of Finance)*[13] decision into its analysis of the ITA (the statute at issue in this proceeding) through a misapplication of *stare decisis*;

(b) held that "nothing turns on the findings made by the [Trial Judge in regard to a taxpayer's] intent [as it] is not a condition precedent for hedging";[14]

(c) concluded that a derivative transaction does not need to be linked to an actual identified risk in terms of quantum and timing to qualify as a hedge, with the effect that any derivative transaction will constitute a hedge so long as some risk is mitigated;[15] and

(d) overturned the Trial Judge's careful findings of fact and impermissibly substituted its own view of the evidence.

9. If allowed to stand, the FCA Decision will replace the long-standing jurisprudence concerning the taxation of derivative transactions with a new test that is devoid of context, rife with uncertainty, and completely inconsistent with established principles of Canadian income tax law. By discarding taxpayer intent from consideration, and substituting an amorphous possible mitigation of risk test for the established requirement that a hedge must be sufficiently linked to an actual identified risk in terms of quantum and timing, the FCA has made the tax treatment of derivative transactions entirely unpredictable. Even the most speculative of derivative transactions will be taxed as a hedge so long as some risk, no matter how inconsequential, unintended, or theoretical, is mitigated.

10. The effect of the FCA Decision is directly contrary to this Court's caution in *Canada Trustco Mortgage Company v. Canada*[16] that taxpayers must be able to enter into commercial transactions with a reasonable level of certainty and predictability as to tax consequences.[17] The

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13 *Placer Dome*, *supra* note 1.
14 FCA Decision, at para. 65 [AR, Part I, Vol. I, Tab F, p. 113].
15 FCA Decision, at paras. 76-77 and 88 [AR, Part I, Vol. I, Tab F, pp. 116-17 and 120].
16 *Canada Trustco Mortgage Co. v. Canada*, 2005 SCC 54, [2005] 2 S.C.R. 601 [*Canada Trustco*].
17 *Canada Trustco*, *supra* note 16 at para. 12.

potential effect of the FCA Decision on the over $30 trillion Canadian derivatives market cannot be overstated.

11. Mr. MacDonald requests that this Court allow this appeal, restore the decision of the Trial Judge, and reaffirm the law governing the taxation of derivative transactions that – until the FCA Decision below – was settled law for the past century.

A. CONCISE STATEMENT OF FACTS

12. Mr. MacDonald is a sophisticated business person with over 40 years of capital markets and corporate finance experience. Over the course of his career, he has served on the boards of at least 16 public companies and, in 2012, he was awarded the Queen Elizabeth II Diamond Jubilee Medal in recognition of his significant contributions and achievements throughout his professional career.[18]

13. Mr. MacDonald began his career in 1969 with the brokerage firm of McLeod Young Weir, which was purchased by BNS in 1988. As a result of this acquisition, Mr. MacDonald acquired 183,333 shares of BNS.[19] The BNS Shares remain the cornerstone of his investment portfolio to this day. Mr. MacDonald left the BNS group of companies in 1997.

14. In the late 1990s, after leaving BNS, Mr. MacDonald speculated that BNS's stock price would fall in the short term due to certain global financial events, including, *e.g.*, the 1997 Asian financial crisis, the devaluation of Thai currency, and a one-day seven percent drop on the New York Stock Exchange that halted trading.[20] Mr. MacDonald sought to profit from any short term decrease in BNS's stock price, while continuing to own his BNS Shares for the long term.

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18 The Governor General of Canada, Queen Elizabeth II Diamond Jubilee Medal, online: <https://www.gg.ca/en/honours/canadian-honours/directory-honours/queen-elizabeth-ii-diamond-jubilee-medal> (accessed March 30, 2019); and Transcript of Examination of Mr. MacDonald dated February 13, 2017 ("**MacDonald Transcript**"), at p. 21 (lines 8-12) [AR, Part V, Vol. VI, Tab X, p. 11].

19 The number of Mr. MacDonald's BNS Shares increased after the date of acquisition due to stock splits in 1998 and 2004.

20 MacDonald Transcript, at pp. 21 (line 23) – p. 22 (line 13), and p. 23 (lines 1-16) [AR, Part V, Vol. VI, Tab X, pp. 11-13].

15. To pursue his short term speculation, Mr. MacDonald searched for a counterparty that would enter into a forward contract with respect to BNS's stock price.[21] Mr. MacDonald discussed entering into such a forward contract with several banks. He ultimately entered into the Forward Contract with TDSI on June 26, 1997 because of the better terms they offered.[22] The Forward Contract was for 165,000 BNS shares (the "**Reference Shares**"). TDSI secured the Forward Contract by entering into a share pledge agreement with Mr. MacDonald for the same number of BNS shares as Reference Shares. The Forward Contract was subsequently amended and extended several times.[23]

16. Under the Forward Contract, Mr. MacDonald would receive a payout if his speculation was correct and the price of BNS shares (the "**Reference Price**") was lower than the contractual forward price (the "**Forward Price**") on the settlement date (the "**Forward Date**"). Conversely, if he was incorrect (and the Reference Price was higher than the Forward Price on the Forward Date), he would be required to make a payment to TDSI.

17. Critically, the Forward Contract could only be cash settled.[24] This meant that, instead of selling (*i.e.*, delivering) his BNS Shares to TDSI at the time he closed out the Forward Contract (in whole or in part), Mr. MacDonald had to pay cash to TDSI equal to the amount by which the Reference Price exceeded the Forward Price on the Forward Date.

18. The Trial Judge found that the cash settlement provision was very important to Mr. MacDonald because he had no intention of selling his BNS Shares to TDSI.[25] It would have been contrary to Mr. MacDonald's long term investment objectives if the Forward Contract had forced him to sell his BNS Shares to TDSI.[26] Indeed, to this day, the BNS Shares remain the largest

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21 MacDonald Transcript, at p. 22 (lines 8-13) and p. 24 (lines 3-13) [AR, Part V, Vol. VI, Tab X, pp. 12 and 14].

22 MacDonald Transcript, at p. 24 (lines 3-17) [AR, Part V, Vol. VI, Tab X, p. 14].

23 Partial Agreed Facts, at paras. 16-19 [AR, Part IV, Vol. II, Tab N, pp. 73-74].

24 Partial Agreed Facts, at para. 17 [AR, Part IV, Vol. II, Tab N, p. 73].

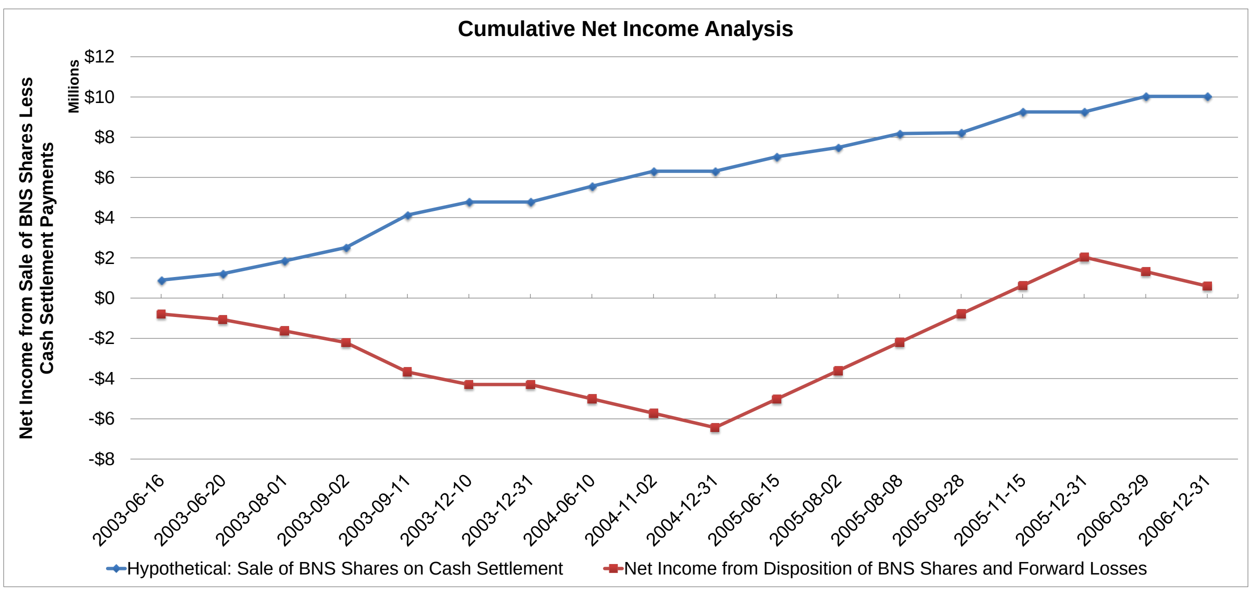
25 Trial Decision, at para. 11 [AR, Part I, Vol. I, Tab B, pp. 4-5].

26 MacDonald Transcript, at pp. 25 (line 13) – p. 26 (line 22) [AR, Part V, Vol. VI, Tab X, pp. 15-16].

single investment in Mr. MacDonald's portfolio.[27]

19. Mr. MacDonald's speculation on the price of BNS shares ended up being incorrect and he paid $9,956,837 to TDSI in Cash Settlement Payments. The evidence at trial established that, despite his heavy losses under the Forward Contract, Mr. MacDonald did not sell his BNS Shares to offset those losses. In fact, Mr. MacDonald settled approximately 60% of the original number of Reference Shares under the Forward Contract (totalling $6,498,983 in losses) without selling a single BNS Share. Moreover, even when Mr. MacDonald did sell some of his BNS Shares in 2005 and 2006, he only did so to rebalance his investment portfolio – not to offset losses under the Forward Contract.[28]

20. The disparate timing of Mr. MacDonald's Cash Settlement Payments as compared to sales of his BNS Shares make this clear.[29] The chart below, which Mr. MacDonald presented at trial, illustrates the extent of the losses he suffered as compared to the hypothetical positive economic position he would have been in if he had sold his BNS Shares to offset his losses from the Forward Contract (*i.e.*, if he had used the Forward Contract as a hedge).[30]



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27 MacDonald Transcript, at p. 22 (lines 25-28) [AR, Part V, Vol. VI, Tab X, p. 12].

28 Trial Decision, at paras. 21, and 66 [AR, Part I, Vol. I, Tab B, pp. 7, and 19-20].

29 Trial Decision, at paras. 22 and 66 [AR, Part I, Vol. I, Tab B, pp. 7 and 19-20]; and MacDonald Transcript, at pp. 40 (line 6) – p. 41 (line 12) [AR, Part V, Vol. VI, Tab X, pp. 30-31].

30 MacDonald Transcript, at pp. 53-58 [AR, Part V, Vol. VI, Tab X, pp. 43-48].

21. The top blue line represents what would have happened to Mr. MacDonald's cumulative net income position if he sold the same number of his BNS Shares as Reference Shares settled under the Forward Contract on the Forward Date to offset his losses with the proceeds of sale from his BNS Shares. The bottom red line represents Mr. MacDonald's cumulative net income position when his Cash Settlement Payments are offset by the proceeds he received from actual sales of his BNS Shares (which did not match the Reference Shares settled under the Forward Contract in terms of either timing or quantum). The divergence between the two lines illustrates that Mr. MacDonald did not offset his losses under the Forward Contract with proceeds from sales of his BNS Shares.

22. Mr. MacDonald's losses under the Forward Contract were real and substantial. The Forward Contract <u>exposed</u> Mr. MacDonald to risk and loss (as a natural consequence of speculation) instead of shielding Mr. MacDonald from risk and loss (as a hedge is designed to do). This unavoidable economic reality is an objective corroboration of Mr. MacDonald's stated intention that the Forward Contract was not a hedge of his BNS Shares. Had the Forward Contract been a hedge, one would have expected Mr. MacDonald to offset his losses under the Forward Contract by selling his BNS Shares at the same time that he settled any Reference Shares.

i. The Expert Evidence

23. Two independent experts, Mr. Kurgan and Professor Klein, were qualified by the Trial Judge to provide expert testimony in the areas of financial services, forward contracts, derivatives, and hedging.[31] Both experts testified that a hedge must result in an offset of investment risk.[32] Both experts also opined that that there must be a link between a hedging instrument and the underlying asset or liability that is the subject of the hedge. They disagreed as

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31 Trial Decision, at para. 6 [<u>AR, Part I, Vol. I, Tab B, pp. 3-4</u>].

32 Trial Decision, at para. 85 [<u>AR, Part I, Vol. I, Tab B, p. 27</u>]; Kurgan Report, at para. 3, [<u>AR, Part IV, Vol. V, Tab S, p. 19</u>]; Transcript of Examination of Mr. Kurgan dated February 14, 2017 ("**Kurgan Transcript**"), at p. 166 (lines 5-8) [<u>AR, Part V, Vol. VII, Tab Y, p. 16</u>]; Expert Report of Dr. Peter Klein filed February 16, 2017 (the "**Klein Report**"), at p. 29 [<u>AR, Part IV, Vol. V, Tab T, p. 66</u>]; Transcript of Dr. Peter Klein Transcript dated February 15, 2017 (the "**Klein Transcript**"), at p. 435 (lines 9-11) [<u>AR, Part V, Vol. VIII, Tab Z, p. 97</u>].

to what constitutes sufficient linkage.[33]

24. Mr. Kurgan offered a clear, practical, and logical explanation of when a derivative transaction constitutes a hedge. He testified that a hedge requires close symmetry between the derivative transaction and the hedged asset or liability. According to Mr. Kurgan, that symmetry must exist both in quantum and timing. That is, both the derivative transaction and the hedged asset or liability should be of approximately the same amount and be disposed of around the same time so that realized gains or losses on the derivative transaction can be offset against a similar amount of realized losses or gains on the hedged asset or liability.[34]

25. Mr. Kurgan testified that there was insufficient linkage in quantum and timing in Mr. MacDonald's case, and opined that the Forward Contract was not a hedge. In Mr. Kurgan's opinion, a hedge does not exist simply because a person enters into a derivative contract that happens to asymmetrically fluctuate in value vis-à-vis some assets or liabilities that the taxpayer holds for the long-term.[35]

26. Professor Klein, on the other hand, adopted an economic modelling approach to determining whether a taxpayer has hedged. Professor Klein opined that intention is entirely irrelevant to assessing whether a hedge exists and that a hedge may exist even where there is no symmetry in quantum and timing between the disposition of the underlying asset or liability and the associated derivative transaction.[36] Under Professor Klein's theory, there could be a hedge even where the underlying asset is held indefinitely and the alleged hedging instrument is terminated without any offset. This implies that a "hedge" might exist <u>even where the derivative transaction does not and cannot mitigate actual risk</u>.

ii. The Trial Judge's Decision

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33 Kurgan Report, at paras. 21-23 [<u>AR, Part IV, Vol. V, Tab S, pp. 22-23</u>]; and Kurgan Transcript, at pp. 177 (line 12) – p. 178 (line 5) [<u>AR, Part V, Vol. VII, Tab Y, pp. 27-28</u>].

34 Kurgan Report, at para. 23 [<u>AR, Part IV, Vol. V, Tab S, p. 23</u>]; and Kurgan Transcript, at pp. 180 (line 18) – p. 182 (line 5) [<u>AR, Part V, Vol. VIII, Tab Y, pp. 30-32</u>].

35 Kurgan Report, at para. 5 [<u>AR, Part IV, Vol. V, Tab S, pp. 19-20</u>]; and Kurgan Transcript, at p. 264 (line 28) – p. 265 (line 12) [<u>AR, Part V, Vol. VIII, Tab Y, pp. 114-15</u>].

36 Klein Transcript, at pp. 534 (line 25) – p. 536 (line 3) [<u>AR, Part V, Vol. VIII, Tab Z, p. 195-97</u>].

27. The Trial Judge allowed Mr. MacDonald's appeal from the Reassessments. The Trial Judge held that Mr. MacDonald's losses were on income account, and not on capital account, for the following reasons.

28. *First*, the Trial Judge found that Mr. MacDonald's intent in entering into the Forward Contract was to speculate on an anticipated decline in the price of BNS shares and that his intention did not change over the years.[37] In this regard, the Trial Judge noted that an intention to hedge or speculate is not solely determined by a taxpayer's stated subjective intention. She held that a court "must look for objective manifestations of purpose, which is a question of fact to be decided from all of the circumstances".[38] The Trial Judge also found as fact that Mr. MacDonald's BNS Shares were not exposed to any risk, and therefore not the subject of a short-term hedge under the Forward Contract, because he intended to hold them for the long-term.[39] She concluded, on this basis, that the Forward Contract was an adventure or concern in the nature of trade such that gains or losses under the Forward Contract formed part of Mr. MacDonald's business income under s. 3(a) of the ITA.[40]

29. *Second*, the Trial Judge found that there was an insufficient link between the Forward Contract and a capital asset for the losses to take on a capital character as opposed to income character.[41] In answering this question, the Trial Judge applied the well-established *Reference re Grain Futures Taxation Act (Manitoba)*[42] case from the Judicial Committee of the Privy Council and held that for the profits or losses from a derivative transaction to be taxed on capital account, a taxpayer must: (i) have an intention to use the derivative instrument to hedge as opposed to speculate; and (ii) if there was an intention to hedge, then there must be a sufficient link between the derivative instrument and an underlying capital asset (as opposed to an income asset or a lack of a link to any asset).

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37 Trial Decision, at para. 59 [AR, Part I, Vol. I, Tab B, p. 17].

38 Trial Decision, at para. 65 [AR, Part I, Vol. I, Tab B, p. 19], citing *Symes v. Canada*, [1993] 4 S.C.R. 695, at p. 736 *per* Iacobucci J.

39 Trial Decision, at para. 68 [AR, Part I, Vol. I, Tab B, p. 20].

40 Trial Decision, at para. 35 [AR, Part I, Vol. I, Tab B, pp. 10-11].

41 Trial Decision, at para. 80 [AR, Part I, Vol. I, Tab B, pp. 25-26].

42 *Reference re Grain Futures Taxation Act (Manitoba)*, [1925] 2 D.L.R. 691 (J.C. P.C.), affirming [1924] S.C.R. 317 [*Grain Futures Reference*].

30. The Trial Judge rejected both the Crown's position and Professor Klein's opinion evidence in part because their position breeds uncertainty by creating unintended "hedges" in a wide variety of scenarios, including where a market participant enters into a speculative transaction that does not do what a hedge is designed to do – *i.e.*, mitigate or eliminate risk. Indeed, the Trial Judge found that Professor Klein's opinion was "based on a purely economic and financial perspective" and that following such a model "would lead this Court to speculate on what could happen as opposed to concluding as to what did happen".[43] Her Honour further explained that if the Crown's position was correct, "it will be impossible to ever speculate using a derivative instrument while maintaining a long position in an asset".[44]

iii. The FCA's Decision

31. On appeal, Noël C.J., writing for the panel, held that the Trial Judge erred in holding that an intention to hedge is a condition precedent to finding a hedge. Chief Justice Noël stated: "I am aware of no case which makes an intent to hedge a condition precedent for hedging".[45] The FCA held that the Trial Judge was bound to follow the definition of a hedge that was set out by this Court in *Placer Dome* and concluded that it is sufficient to find a hedge if "the person concerned owns assets exposed to market fluctuation risk when the derivative contract is entered into and that the contract has the effect of neutralizing or mitigating that risk".[46]

32. On this issue of linkage, the FCA effectively accepted the evidence of Professor Klein without addressing whether the Trial Judge, in this regard, made any error – let alone a reversible error – in preferring the evidence of Mr. Kurgan. The FCA essentially found that there will be sufficient linkage between a derivative transaction and an asset or liability for a hedge to exist so long as market fluctuation risk is mitigated by the derivative transaction. Put differently, the FCA held that sufficient linkage was established simply because Mr. MacDonald owned BNS Shares during the time that the Forward Contract was in force, and that a close link in terms of quantum

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43 Trial Decision, at para. 101 [AR, Part I, Vol. I, Tab B, p. 32].
44 Trial Decision, at para. 68 [AR, Part I, Vol. I, Tab B, p. 20].
45 FCA Decision, at para. 67 [AR, Part I, Vol. I, Tab F, p. 113].
46 FCA Decision, at paras. 69, 92, and 96 [AR, Part I, Vol. I, Tab F, pp. 114 and 121-22].

and timing was unnecessary.[47] The FCA set aside the Trial Judge's decision and restored the Reassessments.

PART II - ISSUES ON APPEAL

33. This appeal raises two issues: (a) did the FCA apply the wrong test for determining whether gains or losses arising from a derivative transaction are taxed on income or capital account; and (b) did the FCA apply the wrong standard of review by substituting its own opinions, which are unsupported by the record, for the Trial Judge's careful and thorough factual findings?

34. Mr. MacDonald submits that the answers to issues (a) and (b) above are "yes".

35. As this Court recently reaffirmed in *Salomon v. Matte-Thompson*, the well-known appellate standard of review framework set-out in *Housen v. Nikolaisen* applies to this Court's review of the FCA Decision below.[48] In the first appellate court, questions of law are reviewable for correctness, and questions of fact or questions of mixed fact and law are reviewable for palpable and overriding error – unless there is an extricable error of law.[49] However, as the second and final appellate court, this Court intervenes where the court below erred in its application of the law or it is "[clearly satisfied] that an error has occurred in the first appellate court's assessment of the facts".[50]

PART III - LAW AND ARGUMENT

A. THE CORRECT TEST FOR DETERMINING THE TAX TREATMENT APPLICABLE TO DERIVATIVE TRANSACTIONS

36. As the Trial Judge held, the first step in determining the tax treatment of a derivative

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47 FCA Decision, at para. 88 [AR, Part I, Vol. I, Tab F, p. 120].

48 *Salomon v. Matte-Thompson*, 2019 SCC 14, at para. 34 [*Salomon*]; and *Housen v. Nikolaisen*, 2002 SCC 33, [2002] 2 S.C.R. 235 [*Housen*].

49 *Housen*, *supra* note 48 at paras. 8, 10, and 36; and *2105582 Ontario Ltd. (Performance Plus Golf Academy) v. 375445 Ontario Limited (Hydeaway Golf Club)*, 2017 ONCA 980, 138 O.R. (3d) 561, at paras. 30-31.

50 *Salomon*, *supra* note 48 at para. 34, quoting in part *St-Jean v. Mercier*, 2002 SCC 15, [2002] 1 S.C.R. 491, at paras. 38-39 and 46.

contract is to assess the taxpayer's intention in entering into the derivative contract. Where a taxpayer enters into a derivative contract with an intention to speculate, the derivative contract is an adventure or concern in the nature of trade and taxed on income account. If the taxpayer's intention was to hedge, rather than speculate, then one must consider whether the derivative contract was sufficiently linked to an underlying capital asset or liability.[51]

37. Subsection 3(a) of the ITA defines a taxpayer's annual income to include any income derived from a source that is a "business". Subsection 248(1) of the ITA defines "business" to include "an adventure or concern in the nature of trade". In assessing whether a particular derivative contract is "an adventure or concern in the nature of trade", our courts consider all of the circumstances underlying the transaction. No single criterion is determinative.[52] Our courts have, however, consistently held that a transaction or investment that is speculative in nature and which does not yield current income constitutes an adventure or concern in the nature of trade.[53]

38. This Court held in *Shell Canada Ltd. v. Canada*[54] that where a derivative contract is used to hedge an asset or liability, the character of the asset or liability being hedged determines the tax treatment of any gain or loss derived from the derivative contract. As such, gains or losses from a derivative contract that is a hedge may or may not be subject to tax on capital account depending on whether the characterization of the underlying hedged asset or liability is on capital account.[55] If the underlying hedged asset or liability is capital in nature, gains or losses arising from the hedging transaction are subject to tax on capital account. Conversely, a gain or loss arising from a hedge is taxed on income account if the underlying hedged asset or liability is

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51 Trial Decision, at para. 35 [AR, Part I, Vol. I, Tab B, pp. 10-11].

52 *Friesen (J.) v. Canada*, [1995] 3 S.C.R. 103, at paras. 13-17 [*Friesen*]; *Minister of National Revenue v. James Taylor*, [1956] CTC 189, 1956 CarswellNat 222 (Ex. Ct.), at paras. 47 and 58-61; *Continental Bank of Canada v. Canada* (1996), 96 D.T.C. 6355, 1996 CarswellNat 1457 (Fed. C.A.), at p. 4, affirmed [1998] 2 S.C.R. 358; and *Canada Safeway Ltd. v. Canada*, 2008 FCA 24, at para. 61 [*Canada Safeway*].

53 *Aviva Canada Inc. v. The Queen*, 2006 TCC 57; *Wellington Hotel Holdings Ltd. v. Minister of National Revenue* (1973), 73 DTC 5391 (Fed. T.D.); *Tamas v. The Queen* (1981), 81 DTC 5150 (Fed. T.D.); *Canada Safeway*; *supra* note 52; and *Wisdom v. Chamberlain*, [1969] 1 All ER 332 (E.W.C.A.).

54 *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622 [*Shell*].

55 *Shell*, *supra* note 54 at paras. 68-70; and *Saskferco Products ULC v. Canada*, 2008 FCA 297, [2009] 1 C.T.C. 302, at paras. 26 and 34 [*Saskferco*].

income in nature.

39. The Trial Judge emphasized two criteria in assessing whether the Forward Contract was used to hedge Mr. MacDonald's BNS Shares: (i) whether Mr. MacDonald intended to hedge as opposed to speculate; and (ii) whether there was a close or sufficient linkage between the Forward Contract and the BNS Shares. Although previous tax jurisprudence may not express these two criteria with the same clarity and precision as the Trial Judge, they nevertheless animate the decisions in all derivative taxation cases for the past century – with the exception of the FCA Decision below. *The Law of Financial Derivatives in Canada*, cited with approval by this Court in *Placer Dome*,[56] sets out the law in this regard as follows:

> Unfortunately, the taxation principles for derivatives are not very well developed in Canada […] there are few statutory provisions with specific application to derivatives. The result has been overall uncertainty…
>
> […]
>
> It is important first to characterize the transactions as on income account or capital account (where it is applicable), because of the different treatment accorded to gains. […] Two somewhat related, but analytically distinct, issues arise in this regard. The first issue relates to the connection between the derivatives transaction and some other underlying transaction. If a sufficient link exists between the two transactions, then the derivatives transaction will take on the character of the underlying transaction. This can be described as the "linkage" principle. The second issue addresses the relationship between the derivatives transaction and the taxpayer's business operations. The question is to what extent the transaction can be said to be integrated into the profit making activities of the taxpayer. If sufficient integration exists, the transactions will be an [*sic*] income account. This can be described as the "integration" principle […] the character of the parties is also relevant to this determination and must be factored into the […] analysis.
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> […]
>
> The taxpayer's purpose in entering into the transaction, as in many other tax contexts, is relevant in determining whether a transaction will be characterized as being an [*sic*] income or capital account by Revenue Canada.

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56 Margaret E. Grottenthaler and Philip J. Henderson, *The Law of Financial Derivatives in Canada*, (Toronto: Carswell, 2003) (loose-leaf updated 2018) [Appellant's Book of Authorities ("**ABOA**"), Tab B], cited with approval in *Placer Dome*, *supra* note 1 at para. 29.

> There are two basic forms of derivatives activity; speculation and hedging […] Canadian tax law in this area has focused on the issue of whether an activity was undertaken for speculative or for hedging purposes.[57] [emphasis added and internal footnotes omitted]

40. The FCA failed to follow these well-established principles. Instead, the FCA Decision departs from a long line of cases by erroneously holding that: (i) an intention to hedge is not a prerequisite to finding a hedge; and (ii) sufficient "linkage" in terms of quantum and timing between a derivative transaction and an underlying asset or liability is unnecessary to find a hedge. In place of these long-standing principles, the FCA created a new test for the determination of whether gains or losses from a derivative transaction should be taxed on income or capital account: the "possible mitigation of risk test". According to the FCA, regardless of intent and linkage, every derivative transaction is taxable as a hedge (and therefore potentially on capital account) so long as it has the *effect* of mitigating *some risk* (even if the risk, as in this case, was entirely theoretical or unforeseeable).

i. Taxpayer Intent and Sufficient Linkage have been Preeminent Factors in Derivative Taxation Cases For Nearly 100 Years

a. 1925 – The Grain Futures Reference

41. An early authoritative description of what constitutes a hedge for tax purposes (*i.e.*, intent to eliminate risk and linkage to an underlying asset) appeared nearly 100 years ago in the *Grain Futures Reference*.[58] In that case, the Judicial Committee of the Privy Council affirmed this Court's decision that Manitoba's taxation of gains or losses arising from grain futures was *ultra vires*. In this decision, Viscount Haldane described a hedge as follows:

> Whoever has to make the sale [of grain] naturally tries to get the best price of the moment. It may not sell at once. He accordingly watches the market. But he desires to avoid possible loss from a drop in market-price while he is watching his opportunity. To guard against this he "hedges" by selling on the Winnipeg Grain Exchange for future delivery an equivalent quantity of grain. His aim in this is to eliminate the risk which he runs from fluctuations in the general market-price while waiting to sell what he actually possesses. This he forwards to a terminal elevator and sells at a suitable moment for cash. He then extinguishes his obligation on the sale of the "future" which he has already made

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57 *The Law of Financial Derivatives in Canada*, *supra* note 56 at § 11.1-11.2.1 [ABOA, Tab B].

58 *Supra* note 42.

> as insurance by purchasing on the Winnipeg Exchange an equal quantity for future delivery, <u>thus extinguishing his liabilities as regards the two obligations in the future.</u> These are cancelled out in the books of the clearing house in Winnipeg, and, as he has now sold for cash what he actually held, the risk from fluctuation of price is at an end.
>
> There are minor variations and differences in form which affect classes of transactions upon this principle of insurance by future dealing. But the practice does not vary in its substantial aspect, and it is a characteristic one.[59] [emphasis added]

42. The above passage demonstrates that two elements are required to find a hedge for tax purposes: (i) a "desire" (*i.e.*, an intention) by the taxpayer to mitigate actual identified risk (*i.e.*, to hedge); and (ii) that the taxpayer's intention is carried out through a derivative transaction that is directly linked (or symmetrical) to an underlying asset or liability in terms of both quantum and timing. In other words, a court must assess both taxpayer intent and linkage to determine whether a hedge exists for tax purposes.

43. Since the *Grain Futures Reference*, Canadian courts have repeatedly analyzed and reaffirmed the intent and linkage elements when determining whether a derivative transaction constitutes a speculation or a hedge, and whether gains or losses arising from a derivative transaction are taxable on income or capital account.

b. 1949 – The Atlantic Sugar Decision

44. Taxpayer intent and linkage played a crucial role in this Court's 1949 decision in *Atlantic Sugar Refineries Ltd. v. Minister of National Revenue*.[60] In *Atlantic Sugar*, the taxpayer was a sugar refinery that regularly purchased sugar as inventory in the course of its business operations. Over two years, the taxpayer purchased sugar futures to hedge against any fall in sugar prices. The taxpayer realized a gain from the sugar futures in its 1937 and 1939 taxation years. The taxpayer claimed that the gain was speculative and therefore not taxable since in those

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59 *Grain Futures Reference*, *supra* note 42 at pp. 693-94.

60 *Atlantic Sugar Refineries Ltd. v. Minister of National Revenue*, [1949] S.C.R. 706, affirming [1948] Ex. C.R. 622, [1949] 1 D.L.R. 532 (Ex. Ct.) [*Atlantic Sugar*]. *Atlantic Sugar* concerned taxation under the *Income War Tax Act*, R.S.C. 1927, c. 97 [<u>ABOA, Tab A</u>], which was the predecessor to the modern ITA.

years, speculative transactions were not taxable as income.[61] The Minister reassessed the gains as arising from a hedge that was entered into in the course of business and therefore determined that the gains were taxable as income.

45. The taxpayer appealed and this Court held that the gains from the sugar futures were taxable as income from a hedging transaction because the taxpayer had an intention to hedge and the futures were linked to the taxpayer's sugar inventory, which was connected to the taxpayer's business. As such, the gains from the futures took on the character of the underlying income earning asset hedged. The Court held:

> While the circumstances of [the two futures purchased] are entirely different, the intention in each, as stated by [the taxpayer's president] was the same, i.e., to offset losses either actual or feared. His intention, and therefore the intention of the appellant, was to do something as part of the latter's business and to secure a profit.[62] [emphasis added]

46. The passage above illustrates that intention is a crucial component of a hedge. First, this Court explicitly recognized that the intention of the taxpayer was to "offset losses either actual or feared" (*i.e.*, to eliminate or mitigate risk). In regard to how taxpayer intent should be assessed in the determination of whether the futures at issue were a hedge or speculation, this Court stated that "[t]he present appeal […] may be decided by applying the principles set forth [in, among others,] *Anderson Logging Co. v. The King*", which was a case concerning how gains or losses should be characterized as either on income or capital account.[63] Thus, this Court adopted the intention analysis from the income versus capital tax jurisprudence and applied it to its

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61 At the time, profits from speculative activities were not taxable because adventures or concerns in the nature of trade and capital gains were not captured within the definition of taxable income under the ITA. The ITA was amended in 1948 to include an "adventure or concern in the nature of trade" in the definition of "business" and accordingly "income". As such, the use of the word "speculate" in *Atlantic Sugar* cannot be read as a reference to adventures or concerns in the nature of trade.

62 *Atlantic Sugar*, *supra* note 60 at p. 707.

63 *Atlantic Sugar*, *supra* note 60 at p. 708, citing *Anderson Logging Co. v. The King*, [1925] S.C.R. 45, at pp. 48-49 *per* Duff J.

assessment of a taxpayer's intent to hedge or speculate.[64]

47. Second, in terms of a sufficient link in timing, Locke J. (writing for the concurrence in *Atlantic Sugar*) stated:

> According to the witness, in the ordinary case of a hedge, the selling for future delivery synchronizes with the purchase of the commodity while, in the present case, <u>the short sales were made over the period of a month following the cash purchases</u>. I think that this circumstance does not affect the matter to be determined. <u>While not carried out contemporaneously with the purchases, the short sales were in effect a hedge by the company against possible loss on the purchases made</u>…[65] [emphasis added]

48. Given the sufficient link, the gains arising from the futures took on the income character of the underlying sugar inventory and were therefore included in the taxpayer's income.

c. 1974 – The Salada Foods Decision

49. Both taxpayer intent and linkage also featured prominently in the assessment of whether gains or losses arising from a derivative transaction were taxable on income or capital account in *Salada Foods Ltd. v. The Queen*.[66] In *Salada Foods*, the taxpayer corporation had subsidiaries with operations in the United Kingdom. The taxpayer entered into a forward sale contract for pound sterling and claimed that it was a hedge of its pound sterling denominated investments held on capital account.[67] Consequently, the taxpayer claimed the profits that it made from its forward sale contract as capital gains. The Minister reassessed the taxpayer and concluded that the forward sale contract was an adventure or concern in the nature of trade and that the profits were taxable on income account.

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64 *Atlantic Sugar*, *supra* note 60 at p. 708. See also *Minister of National Revenue v. Foreign Power Securities Corp. Ltd.*, [1967] S.C.R. 295, at p. 297: "…[the Crown] argues that the particular transactions, out of which the profit should to be taxed arose, were speculations constituting adventures in the nature of trade. The question is essentially one of fact depending on the intention with which [the taxpayer] acquired the shares".

65 *Atlantic Sugar*, *supra* note 60 at p. 711 *per* Locke J (concurring).

66 *Salada Foods Ltd. v. The Queen*, [1974] C.T.C. 201, 1974 CarswellNat 151 (Fed. T.D.) [*Salada Foods*].

67 *Salada Foods*, *supra* note 66 at paras. 8 and 11.

50. Taxpayer intent was crucial to the Federal Court's decision to uphold the reassessment. In particular, the court held that the taxpayer failed to prove that its intention was to hedge a capital asset (*i.e.*, its UK investments). Rather, the court found that the contextual factors of that case pointed to the opposite conclusion – *i.e.*, that the taxpayer intended to speculate:

> In arranging the forward sale contract the plaintiff acted in exactly the same fashion as a dealer or speculator in currencies would act. <u>There was never any intention on the part of [the taxpayer] that the transaction be in any way an investment in its normal sense and, in fact, it was acknowledged by the [taxpayer] to be wholly speculative</u>. The whole success of the enterprise depended on purchasing the £500,000 at a lower price than that at which it had contracted to deliver them six months before and the necessity for so doing in turn arose, not because the plaintiff knew the pound was to be devalued, but because it speculated that it would…
>
> […]
>
> <u>The intention of the [taxpayer] in entering the transaction is, of course, of some evidentiary value</u>…
>
> …it is […] difficult to ascertain the intention of the company as distinct from that of its officers in entering into the contract. But there is <u>no doubt whatsoever that from beginning to end the intention of the officers of the company was simply to buy and resell currency at a profit and in the absence of evidence of the company's intention to the contrary, the intention of its officers must be synonymous with that of the company</u>.
>
> …<u>I have reached the conclusion that […] the forward sale contract […] was a purely speculative transaction and was entered into with the intention and hope that a profit would accrue.</u> It was, therefore, an adventure in the nature of trade.[68] [emphasis added].

51. Although the absence of an intention to hedge was itself fatal to the taxpayer's assertion that it used the forward sale contract to hedge, it should also be noted that there was no evidence that the taxpayer acquired its UK investments contemporaneously with its entering into the forward sale contract for pound sterling. As such, there was no "triggering event" to which the forward sale contract could be linked. Furthermore, the court found that the taxpayer did not sell its UK investments contemporaneously with the close out of the forward sale contract.

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68 *Salada Foods*, *supra* note 66 at paras. 17 and 19-20. See also *Ladin v. Minister of National Revenue*, 1977 CarswellNat 424 (Tax Rev. Bd.), at para. 17 where it was held that a trader in cattle futures engaged in an adventure or concern in the nature of trade because "[t]he purpose of all [his] speculation was hopefully to make a profit".

Consequently, there was no linkage between the gain on the forward sale contract and any loss on its investment. As the court explained:

> …it should perhaps be observed that […] the value in sterling of the [taxpayer's] investment in its UK subsidiaries was approximately £532,000 while the forward sale contract was for only £500,000 […] <u>unless [the taxpayer] sold the shares of the subsidiaries, [it] might never have been able to receive any part thereof and, if it did, it might well have been a substantially lower amount than that shown on the books</u>…
>
> …The only way that [the investment's] actual value could have been determined at the time of the completion of the forward sale contract would have been by a sale or by an appraisal of their value by competent appraisers using known techniques for so doing. No such appraisal was made. Bearing in mind all of these facts then, <u>it seems to me that there is little or no relationship between the gain received by the plaintiff on its forward sale contract and its actual investment loss occurring as a result of the devaluation of the pound</u>. To that extent then, in my view, the evidence of the witness and <u>the arguments advanced by counsel for the plaintiff in support of the propositions that the gain was offset by the loss in investment and was attributable to capital account and not income tend to be specious and cannot be supported by other evidence nor withstand close scrutiny as to the result achieved by the transaction in question.</u>[69] [emphasis added]

52. Given the intent of the taxpayer, and the lack of linkage to a capital asset in *Salada Foods*, the court held that the gains from the forward sale contract were taxable on income account.

53. Notably, even though the forward sale contract in *Salada Foods* was demonstrably not a hedge of pound sterling denominated assets, it would be transformed into a hedge of a capital asset under the FCA's analysis below. This is because neither the intention nor sufficient linkage analyses in *Salada Foods* would be relevant under the new test for a hedge established by the FCA. All that would matter is that the taxpayer's forward sale contract *had the effect* of mitigating some pound sterling fluctuation risk associated with its pound sterling denominated assets. This clearly illustrates how the FCA Decision has changed the prevailing legal test and how the FCA's new test breeds ambiguity and uncertainty.

d. 1985 – The Ethicon Sutures Decision

54. Taxpayer intent was again the focus of the Federal Court's analysis in *Ethicon Sutures*

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[69] *Salada Foods*, *supra* note 66 at paras. 15-16.

Ltd. v. The Queen.[70] This case concerned whether foreign exchange profits should be taxed on income or capital account. In *Ethicon*, the taxpayer was a Canadian subsidiary of a US corporation. The taxpayer was required by its parent corporation to purchase short term deposits in US dollars. In the 1978 taxation year, the taxpayer realized a foreign exchange profit when its US dollar deposits were converted back into Canadian dollars. The taxpayer claimed that the foreign exchange profit was used to pay dividends to its parent corporation and was therefore a capital gain. The Minister reassessed the taxpayer and characterized the profit as taxable on income account because some of the profit was used to purchase inventory, which are assets with an income character.

55. On appeal, the Federal Court described the analytical framework for the determination of whether gains or losses are taxable on income or capital account as follows:

> To determine whether a foreign exchange gain is to be treated as income or capital, it is necessary to look at the nature of the underlying transaction which gives rise to the gain.
>
> Where the foreign currency was acquired as a result of the taxpayer's trading operations, or for the purpose of carrying on trading operations, any gains will be treated as occurring in the course of the taxpayer's trade and will be treated as income.
>
> Likewise, where the transaction is a speculation made in the hope of profit, it will be treated as an adventure in the nature of trade, and the gain will be taxed as income.
>
> However, if the gain arises out of the investment of idle funds or the appreciation of a temporary investment, the gain will be treated as a capital gain.[71] [citations omitted]

56. In classifying the foreign exchange profit as a gain on income account, the court found that the taxpayer's intent was, at least in part, to use the foreign exchange profit for an income purpose.[72] As the foreign exchange profit was sufficiently linked to an income transaction, it took on the character of income and was taxable on income account.[73]

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70 *Ethicon Sutures Ltd. v. The Queen* (1985), 86 D.T.C. 5290, 1985 CarswellNat 297 (Fed. T.D.) [*Ethicon*].

71 *Ethicon*, *supra* note 70 at paras. 24-27.

72 *Ethicon*, *supra* note 70 at para. 33, citing the principle of primary and secondary intention from *Regal Heights Ltd. v. Minister of National Revenue*, [1960] S.C.R. 902, at pp. 905-06 *per* Judson J.

73 *Ethicon*, *supra* note 70 at paras. 30-34.

57. Again, *Ethicon* illustrates the prominence that taxpayer intent or transaction purpose serves in the legal characterization of gains or losses for tax purposes.

e. 1992 – The Echo Bay Mines Decision

58. Particularly relevant to the instant case is the fact that the Federal Court has previously adopted a definition of a hedge that expressly includes an intent to hedge as a prerequisite element. In *Echo Bay Mines Ltd. v. Canada*,[74] the taxpayer was a silver mining company that entered into forward contracts to hedge the price of silver. At issue was whether the mining company's silver forward contracts were in fact hedges, as opposed to speculations, such that gains arising under those forward contracts were "resource profits" under the ITA and therefore deductible from taxable income.

59. One of the expert witnesses who testified in that case distinguished hedging from speculating. That expert's definition of a hedge, which included a distinction between a hedge and speculation based on taxpayer intent, was expressly adopted by the Federal Court.[75] The court summarized the expert's evidence as follows:

> In [the expert's] view, <u>the difference between hedging and speculating is that in the former the company engaged in hedging sells forward or commits a product that it has the capability of producing and that it intends to produce: if he has neither the capability nor the intention of meeting its commitments through production it is speculating in engaging in forward sales contracts.</u>
>
> Whether a transaction is a hedge depends upon assessment at the time forward sales contracts are concluded of capacity and <u>intention to produce product committed under those contracts.</u>[76] [emphasis added]

60. As the passage illustrates, in order for a hedge to have been found in *Echo Bay*, there must have been an "intention" for the taxpayer to meet its commitments through production. In other words, there needed to be an <u>intention</u> to hedge.

61. *Echo Bay* is also notable because the Crown expressly took the position that sufficient

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74 *Echo Bay Mines Ltd. v. Canada*, [1992] 3 F.C. 707, 1992 CarswellNat 323 (Fed. T.D.) [*Echo Bay*].

75 *Echo Bay*, *supra* note 74 at para. 61.

76 *Echo Bay*, *supra* note 74 at paras. 20-22.

linkage between a derivative transaction and an underlying asset or liability was a prerequisite to finding a hedge. In this regard, the court held:

> …it is urged [by the Crown] that there was insufficient matching, in respect of quantity of production and time of delivery of product and closing out of the forward sales contracts […] but I note that there is no evidence of correlation or lack of it. Rather, the only evidence is that […] <u>the estimates upon which the forward sales transactions were based, in total, were close approximations of the actual production carried out […] Exact matching was not feasible from a practical point of view, nor is it required in order to constitute hedging. In respect of this final conclusion, I rely on the reasons of Locke J. in *Atlantic Sugar*</u>…[77] [emphasis added]

62. The Trial Judge followed the *ratio* from *Echo Bay* in arriving at her correct conclusion that an intent to hedge and a sufficient linkage between the hedge and the underlying asset are necessary prerequisites to finding that a derivative transaction constitutes a hedge.[78]

f. 1999 – This Court's Shell Canada Decision

63. This Court's decision in *Shell Canada Ltd. v. Canada*[79] – the leading decision on whether gains or losses from a hedging transaction are taxable on income or capital account – was also rooted in an analysis of sufficient linkage and taxpayer intention. In that case, Shell wished to borrow US $100 million to fund its capital needs in the most tax efficient manner. To do so, it borrowed $150 million New Zealand ("**NZ**") dollars under a loan agreement and simultaneously executed a forward exchange contract whereby it immediately exchanged the NZ $150 million for US $100 million. Since the interest on NZ dollar loans was higher than US dollar loans, this borrowing structure allowed Shell to deduct from its income higher interest expenses over the term of the loan agreement than it could have if it directly borrowed US dollars. Moreover, the

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77 *Echo Bay*, *supra* note 74 at para. 61.

78 Trial Decision, at para. 88 [<u>AR, Part I, Vol. I, Tab B, p. 27</u>]. The definition of a hedge from *Echo Bay* has been followed and applied by other courts as well, including by the Ontario Superior Court of Justice in *Inco Ltd. v. Ontario (Minister of Finance)*, 2002 CarswellOnt 2685 (Sup. Ct.), at para. 8, where the court held that one of the factors guiding the assessment of whether a derivative transaction constitutes a hedge or speculation depends upon taxpayer intent.

79 *Shell*, *supra* note 54.

forward exchange contract locked in the price at which Shell could repurchase NZ dollars from the counterparty. Shell therefore intended to and was able to hedge its exposure against adverse fluctuations in the NZ dollar (relative to the US dollar) with the forward exchange contract. This effectively ensured that it would not suffer a foreign exchange loss when it came time to repay the NZ dollar loan.

64. Ultimately, the NZ dollar depreciated against the US dollar over the five-year term of the loan agreement. As a result, Shell was able to repay what was effectively a US $100 million loan with only US $79 million. Shell claimed the US $21 million gain as a capital gain. The Minister reassessed Shell and asserted that the gain was taxable on income account. This Court agreed with Shell that the gain from the hedging transaction was taxable on capital account. This Court held that:

> The characterization of a foreign exchange gain or loss generally follows the characterization of the underlying transaction […] Thus, if the underlying transaction was entered into <u>for the purpose of</u> acquiring funds to be used for capital purposes, any foreign exchange gain or loss in respect of that transaction will also be on capital account.[80] [emphasis added and internal citations omitted]

65. In *Shell*, the US $100 million loan was taken to fund capital expenditures. This Court confirmed that the gains arising from the forward exchange contract would also be on capital account if the forward exchange contract could be sufficiently linked to the loan agreement. This Court noted the following facts in holding that the forward exchange contract was sufficiently linked to the loan agreement: <u>(a)</u> the closing of the loan agreement was contingent on the closing of the forward exchange contract – in fact, the two contracts closed at the same time (*i.e.*, there was a "triggering event" for the derivative transaction);[81] <u>(b)</u> the loan agreement and the forward exchange contract were for the same amounts (NZ $150 million) (*i.e.*, there was sufficient linkage between the quantum of the derivative transaction and the underlying hedged liability);[82] <u>(c)</u> the NZ $150 million was exchanged under the forward exchange contract immediately after it was received under the loan agreement;[83] <u>(d)</u> the forward exchange contract was structured to

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80 *Shell*, *supra* note 54 at para. 68.
81 *Shell*, *supra* note 54 at para. 6.
82 *Shell*, *supra* note 54 at paras. 2-3.
83 *Shell*, *supra* note 54 at para. 32.

allow Shell to purchase NZ dollars when interest and principal payments were due under the loan agreement;[84] and (e) the forward exchange contract expired at the same time that the loan matured in 1993[85] such that there was a close link between the date that the derivative transaction was closed out and the date on which the underlying hedged liability was disposed.

66. The facts in *Shell* revealed that the loan agreement was closely linked to the forward exchange contract in terms of both quantum and timing. Moreover, the trial judge in *Shell* expressly found as fact that the taxpayer's "purpose" for entering the forward exchange contract "was to hedge" the loan and that the taxpayer had "no intention of using the [NZ dollars] in its business".[86] These findings were not disturbed on appeal by this Court – indeed they appear to have been implicitly affirmed.[87] This Court held that the forward exchange contract was a hedge of a capital debt, the gains arising from the forward exchange contract took on the capital character of that debt, and the gains were taxable on capital account.[88]

g. 2008 – The Saskferco Decision

67. In a 2008 decision, the FCA explicitly applied the taxpayer intent and sufficient linkage elements in determining whether a transaction constituted a hedge. In *Saskferco Products ULC v. Canada*,[89] the taxpayer manufactured and sold product in the US. The taxpayer funded the construction of a manufacturing facility in the US with a US dollar loan. As a Canadian corporation, a depreciation of the US dollar reduced the taxpayer's reported profitability when its US dollar revenues were converted into Canadian dollars. The taxpayer claimed that to mitigate the effect of currency exchange volatility, the taxpayer used its US dollar revenues to repay the US dollar loan as it became due. Consequently, the taxpayer claimed that its US dollar loan was a hedge of its US dollar revenues and that the $13 million in foreign exchange losses it incurred under the loan agreement (because the US dollar appreciated against the Canadian dollar) were

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84 *Shell*, *supra* note 54 at para. 3.

85 *Shell*, *supra* note 54 at paras. 2-3.

86 *Shell Canada Ltd. v. The Queen* (1997), 97 D.T.C. 395, 1997 CarswellNat 401 (T.C.C.), at pp. 4 and 7-8, reversed (1998), 157 D.L.R. (4th) 655 (Fed. C.A.), affirmed in part *Shell*, *supra* note 54.

87 *Shell*, *supra* note 54 at paras. 5 and 64.

88 *Shell*, *supra* note 54 at paras. 68-70.

89 *Saskferco*, *supra* note 55.

on income account and fully deductible from its taxable income. The Minister reassessed the loss as on capital account instead.

68. In agreeing with the Minister's characterization of the foreign exchange losses as on capital account, the FCA observed that: (i) the taxpayer's intention in entering into the US dollar loan was to finance a capital asset (*i.e.*, the manufacturing facility);[90] (ii) the value of the taxpayer's US dollar revenues exceeded the value of the US dollar loan;[91] and (iii) the foreign exchange gains from the US dollar revenues occurred at different times from the foreign exchange losses under the US dollar loan.[92] For these reasons, the FCA held that there was an insufficient linkage in terms of quantum and timing between the purported hedging transaction and the alleged underlying income asset. Rather, the FCA held that the foreign exchange losses on the US dollar loan were linked to a capital asset and therefore gave rise to a capital loss. The FCA itself, therefore, explicitly used a lack of sufficient linkage as a basis for finding that a hedging transaction against an income asset did not exist for tax purposes under the ITA.

69. *Saskferco* is particularly relevant to this appeal because it illustrates that evidence of linkage (or an absence of linkage) objectively corroborates a taxpayer's stated intention for a derivative transaction. The taxpayer in *Saskferco* claimed that it intended to use its US dollar loan to hedge an income asset (*i.e.*, its US dollar revenues), but that position was rejected by the court as it was contrary to the objective evidence that there was an insufficient link between the US dollar revenues and the foreign exchange losses under the US dollar loan.

70. In this case, however, the lack of sufficient linkage *supports* Mr. MacDonald's stated intention that he entered into the Forward Contract to speculate on the stock price of BNS rather than to hedge any risk associated with his BNS Shares. As demonstrated in Schedule A to the Partial Agreed Statement of Facts[93] (and in the net income analysis chart set out above),[94] there is no link between the losses that Mr. MacDonald incurred under the Forward Contract and the disposition of his BNS Shares. As in *Saskferco*, this *lack* of a link between the purported hedge

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90 *Saskferco*, *supra* note 55 at paras. 11 and 29.
91 *Saskferco*, *supra* note 55 at para. 14.
92 *Saskferco*, *supra* note 55 at para. 29.
93 Partial Agreed Facts, Schedule A, pp. 17-20 [AR, Part IV, Vol. II, Tab N, pp. 87-90].
94 *Supra*, at para. 20.

(*i.e.*, the Forward Contract) and the allegedly hedged asset (*i.e.*, the BNS Shares) militates against a finding that Mr. MacDonald hedged his BNS Shares. Instead, this lack of a link supports the conclusion that the Forward Contract was pure speculation, and taxable on income account as an adventure or concern in the nature of trade.

h. Various Canada Revenue Agency Technical Interpretations, Advance Rulings, and Policy Bulletins

71. The central indicia of a hedge for tax purposes – *i.e.*, intention and linkage – have also been clearly set out by Canada Revenue Agency ("**CRA**") in a number of technical interpretations, advance income tax rulings, and interpretation bulletins. Although these CRA interpretations do not have the force of law,[95] this Court has recognized that they are helpful in interpreting taxation statutes and carry "persuasive force".[96]

72. In CRA Document No. 2009-0352061I7,[97] the CRA explains that it considers sufficient linkage to be necessary for a hedge to exist as follows:

> The *Income Tax Act* does not define the term "hedge". Whether a financial instrument constitutes a hedge is relevant to the computation of profit […] One would have to rely on case law principles to determine if financial instruments are hedges for income tax purposes. In the following cases, the courts have confirmed that whether an activity constitutes hedging depends on sufficient inter-connection or integration with the underlying transaction…[98]

73. Similarly, in CRA Document No. 2013-0481691E5,[99] the agency stated:

> For a derivative financial instrument to constitute a hedge there must therefore be sufficient linkage (in terms of both timing and amount) between the derivative and the underlying transaction. In our view, the timing and maturity date of the derivative should reflect the underlying capital transaction although it does not necessarily have to be a

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95 *Mattabi Mines Ltd. v. Ontario (Minister of Revenue)*, [1988] 2 S.C.R. 175, at pp. 195-96 [*Mattabi Mines*].

96 *Mattabi Mines*, *supra* note 95 at p. 196; and *Schwartz v. The Queen*, [1996] 1 S.C.R. 254, at para. 25.

97 CRA Document No. 2009-0352061I7.

98 CRA Document No. 2009-0352061I7, at p. 4.

99 CRA Document No. 2013-0481691E5.

perfect match. Where a hedge is not sufficiently linked to a capital transaction, the gain or loss is on income account.[100]

74. The Trial Judge's decision in this case was perfectly consistent with these CRA guidance documents. Her Honour recognized that well-established, binding jurisprudence required sufficient linkage between a derivative transaction and an underlying asset or liability before a hedge exists for tax purposes.

i. 2015 – The George Weston Decision

75. More recently, in *George Weston Limited v. The Queen*,[101] the Tax Court of Canada again confirmed the need to assess both taxpayer intent and linkage in determining whether a particular transaction constitutes a hedge. In *George Weston*, the taxpayer, a Canadian public company, entered into long-term cross-currency swap contracts (the "**Swaps**") with the stated intention to hedge its indirect interest in various US-based operating subsidiaries that it had acquired in 2001.

76. The acquisition was funded primarily with debt denominated in Canadian dollars. Absent the Swaps, the taxpayer had an increased risk of eroding its consolidated equity position on its financial statements and worsening its debt to equity ratio due to foreign exchange rate fluctuations. The Swaps were used to effectively offset the foreign exchange risk emanating from the taxpayer's investment in its US operations.

77. By 2003, the taxpayer had repaid its debt to a point where the remaining foreign exchange risk was at an acceptable level and the taxpayer terminated the Swaps without an associated disposition of the underlying US operations. Critically, however, the *risk* of currency fluctuation abated because the debt had been sufficiently repaid. The termination of the taxpayer's Swaps resulted in the taxpayer realizing gains of approximately $317 million. The taxpayer reported the gains on capital account. The Minister reassessed the gains on income account.

78. The court in *George Weston* held that the gains from the Swaps were taxable on capital

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[100] CRA Document No. 2013-0481691E5, at p. 2.

[101] *George Weston Limited v. The Queen*, 2015 TCC 42 [*George Weston*].

account because there was both a sufficient link to a capital asset (*i.e.*, its US dollar capital investments)[102] and an intention to hedge and not speculate.[103]

79. Unlike the case at hand, the facts in *George Weston* fully supported the finding that the Swaps were a hedge of a capital asset for three reasons. *First*, the following findings of fact in that case demonstrated the taxpayer's clear and express intention to use the Swaps to hedge its US asset acquisition: (a) the taxpayer would not have entered into the Swaps in the absence of the US acquisition; (b) the Swaps were inconsistent with an intention to speculate in the derivatives market because they were long-term in nature and had high transaction costs; (c) the taxpayer was only permitted to enter into hedging arrangements to manage its risks in a manner consistent with the derivatives risk management policy approved by its board of directors and it was not the taxpayer's policy generally to speculate on currency fluctuations as the taxpayer was not permitted to do so under either its credit facilities or its corporate policy; (d) absent the Swaps, a devaluation of the US dollar relative to the Canadian dollar would have had a negative impact on the taxpayer's equity in its consolidated financial statements; (e) the Swaps hedged risk associated with the taxpayer's debt to equity ratio, which was to be strictly maintained on a 1:1 basis, establishing clear and direct linkage; (f) the taxpayer reported the Swaps as hedges for accounting purposes; and (g) the taxpayer's Annual Reports publicly confirmed that the Swaps were used as a hedge.[104]

80. In regard to the above, the court made the following comments that unquestionably demonstrate the central role that taxpayer intent played in its determination that the Swaps were a hedge: (a) "the most determinative factor is the intention of the taxpayer at the time of acquiring the property. If that intention reveals a profit-making scheme, the transaction is an adventure in the nature of trade" (emphasis added);[105] (b) "[the taxpayer's] intention at the time of entering into the swaps was to hedge the currency risk associated with an increased debt to

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102 *George Weston*, *supra* note 101 at paras. 96-98.

103 *George Weston*, *supra* note 101 at paras. 70, 89-90, 96, 100, and 105.

104 *George Weston*, *supra* note 101 at para. 70, where the court adopted the taxpayer's evidence at paras. 33-42 of the reasons as factual findings.

105 *George Weston*, *supra* note 101 at para. 102.

equity ratio as a result of translating its US assets" (emphasis added);[106] and (c) "[i]n no sense was [the taxpayer] speculating in derivatives or engaged in an adventure in the nature of trade".[107]

81. *Second*, the quantum of the Swaps in *George Weston* closely matched the underlying value of the US assets that the taxpayer intended to hedge. In other words, there was symmetry or a close link between the quantum of the hedging instrument (*i.e.*, the Swaps) and the underlying capital asset (*i.e.*, the US operations). Indeed, the taxpayer conducted itself at all times in a manner consistent with its intention to hedge, including by selling off swap contracts equal in value to the disposition of the underlying US assets that were hedged by the Swaps.[108]

82. *Third*, the court held that the timing of the Swaps was sufficiently close in time to the acquisition of the underlying US assets to corroborate the taxpayer's intention to hedge. In this respect, the court held that "[t]he fact that the swaps were not all carried out contemporaneously with the Bestfoods acquisition is not fatal as they were entered into over a period that was fairly close to the transaction date".[109]

83. The above discussion illustrates that both indicia of a hedge were abundantly present in *George Weston*. The court expressly found that the taxpayer had both an intention to hedge an actual identified risk (*i.e.*, its debt to equity ratio), and carried that intention out through derivative transactions that were sufficiently linked to a capital asset in terms of quantum and timing.

j. 2017 – The Barrick Gold Decision

84. The Tax Court of Canada again reaffirmed the importance of taxpayer intention in its *Barrick Gold Corp. v. Canada*[110] decision. In that case, the court considered whether gains from derivative transactions entered into by the taxpayer (a gold mining corporation) were "gross resource profits" under the ITA. The court stated:

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106 *George Weston*, *supra* note 101 at para. 105.
107 *George Weston*, *supra* note 101 at para. 108.
108 *George Weston*, *supra* note 101 at para. 22.
109 *George Weston*, *supra* note 101 at para. 71.
110 *Barrick Gold Corp. v. The Queen*, 2017 TCC 18, 2017 D.T.C. 1010 [*Barrick*].

> …the Forward Contracts were entered into and closed out in the course of the [taxpayer's] business of production and processing from the Doyon Mine. There is no doubt on this point. The [Crown] admits that the [taxpayer's] sole reason for entering into the Forward Contracts was to hedge the risk of price fluctuations in the price of gold that it expected to produce from the Doyon Mine…
>
> […]
>
> …the [taxpayer's] sole intention in entering into the Forward Contracts was to hedge the price of gold produced from the Doyon Mine.[111] [emphasis added].

85. The court in *Barrick* held that the taxpayer's profit arising from the forward contracts were properly characterized as income and "gross resource profits" for the purposes of the *ITA* as the forward contracts were intended to hedge (and were sufficiently linked to) an income asset (*i.e.*, gold produced from the taxpayer's mining operations).

ii. FCA's Erroneous Decision that Taxpayer Intent is Irrelevant

86. The jurisprudence discussed above amply demonstrates that taxpayer intent and sufficient linkage are key factors in the analysis of whether gains or losses arising from derivative transactions are to be taxed on income or capital account. History reveals an uninterrupted line of case law that emphasizes the necessity of analyzing taxpayer intent and linkage for this purpose – up until the FCA's decision below.

87. The FCA cast doubt on the Trial Judge's factual findings concerning Mr. MacDonald's intention, but stated that it did not need to review the factual determination because it held that intention was not a condition precedent to finding a hedge as follows: "[t]he finding by the Tax Court judge that Mr. MacDonald's sole intent was to speculate is questionable when regard is had to the sequence of events which unfolded […] However, nothing turns on the findings made by the Tax Court judge in this regard as intent is not a condition precedent for hedging".[112] Put differently, the FCA avoided the impediments presented by the Trial Judge's factual findings by holding that intention was unnecessary to find a hedge as a matter of law. That decision is fundamentally flawed and entirely inconsistent with the jurisprudence set out above, and this Court's more general tax jurisprudence holding that intention is central to the determination of

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111 *Barrick*, *supra* note 110 at paras. 39-41.
112 FCA Decision, para. 65 [AR, Part I, Vol. I, Tab F, p. 113].

whether a transaction is taxable on income or capital account.[113]

88. In its effort to circumvent a century of case law, the FCA invoked this Court's *Placer Dome*[114] decision. The FCA stated that it was bound to follow the definition of a hedge set out in *Placer Dome*[115] and that *Placer Dome* stood for the proposition that taxpayer intent and sufficient linkage were irrelevant to finding a hedge.[116] Its interpretation was erroneous.

89. First, *Placer Dome* is not binding precedent. The narrow issue in *Placer Dome* was whether cash-settled derivative transactions constituted "hedging" under the statutory definition of "proceeds" in Ontario's *Mining Tax Act*.[117] This Court held that profits from cash-settled derivative transactions fell within the statutory definition of hedging, provided that the notional value of those derivative transactions did not exceed the output of the mine.[118] This Court did not purport to provide an all-encompassing definition of a hedge to be applied beyond the *Mining Tax Act*[119] that supplants the common law definition of a hedge established in the case law reviewed above.

90. The FCA failed to recognize the limitations inherent in *Placer Dome* and erroneously applied a statutory definition of "hedging" to the instant case, which concerns the common law definition of a hedge in the context of the ITA. Moreover, *Placer Dome* did not concern the central issue in this appeal, which is whether profits or losses from a derivative transaction should be taxed on income or capital account. Instead, *Placer Dome* concerned whether profits from a forward contract satisfied the *Mining Tax Act* definition of "hedging" and therefore fell within the statutory definition of "proceeds" from a mine. Indeed, the court in *George Weston* rejected the Crown's argument that *Placer Dome* was binding because *Placer Dome* did not involve a "capital versus income characterization" issue.[120] By holding that *Placer Dome* was

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113 *Friesen*, *supra* note 52.
114 *Placer Dome*, *supra* note 1.
115 FCA Decision, at paras. 61 and 95 [AR, Part I, Vol. I, Tab F, pp. 111-12 and 122].
116 FCA Decision, at para. 90 [AR, Part I, Vol. I, Tab F, pp. 120-21].
117 *Mining Tax Act*, *supra* note 12.
118 *Placer Dome*, *supra* note 1 at paras. 47-49.
119 *Placer Dome*, *supra* note 1 at para. 20.
120 *George Weston*, *supra* note 101 at para. 97.

binding on the Trial Judge,[121] the FCA stretched the *stare decisis* doctrine beyond its limits and failed to follow well-established legal principles for determining whether a hedge exists as a matter of common law for ITA purposes.[122]

91. Second, the FCA's interpretation that *Placer Dome* stands for the proposition that taxpayer intent is irrelevant to finding a hedge is factually incorrect. In *Placer Dome*, it was admitted that the forward contracts involved were entered into as part of a hedging program. The trial judge in *Placer Dome* found as fact that the purpose of the derivative transaction "was to protect the output of [Placer Dome] worldwide from fluctuations in the spot price of gold",[123] that "[Placer Dome] wishe[d] to avail itself of […] foreign currency hedging activity",[124] and that the derivative contracts were "designed" to hedge gold production.[125] As such, it was clear that an intent to hedge existed in *Placer Dome*. Contrary to the FCA's interpretation, *Placer Dome* does not hold that an intent to hedge is irrelevant to the determination of whether a derivative transaction is a hedge or whether gains or losses arising therefrom are taxable on income or capital account. This Court did not discuss the issue given that taxpayer intent to hedge was evident and uncontested in *Placer Dome*.

92. Finally, the FCA's statement that "no case […] makes an intent to hedge a condition precedent for hedging" is incorrect. Regardless of whether there is an express statement in the prior case law that an intention to hedge is a prerequisite to finding a hedge, our courts have unquestionably referred to the taxpayer's intention to hedge in each and every decision in which a hedge was found. There is, quite simply, not a single case where a hedge was found in circumstances where the court found that the taxpayer did not intend to hedge. Indeed, both the Crown and Mr. MacDonald agreed on appeal that intention was a key factor in determining

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121 FCA Decision, at para. 69 [AR, Part I, Vol. I, Tab F, p. 114].

122 See, *e.g.*, *Edmonton (City) v. Edmonton East (Capilano) Shopping Centres Ltd.*, 2016 SCC 47, [2016] 2 S.C.R. 293, at para. 71 *per* Côté and Brown JJ. (dissenting) (McLachlin C.J. and Moldaver J. concurring).

123 *Placer Dome Canada Ltd. v. Ontario (Minister of Finance)* (2002), 61 O.R. (3d) 628, 2002 CarswellOnt 3165 (Sup. Ct.), at para. 7(H) [*Placer Dome Trial*], reversed 2004 CarswellOnt 3491 (C.A.), affirmed *Placer Dome*, *supra* note 1.

124 *Placer Dome Trial*, *supra* note 123 at para. 7(I).

125 *Placer Dome Trial*, *supra* note 123 at para. 8.

whether a derivative transaction is taxable on income or capital account.[126] Moreover, the FCA's assertion that *George Weston* did not address taxpayer intention is incorrect.[127] As explained above, intent was a central feature of *George Weston*[128] as well as in a number of other cases discussed above.[129]

93. In sum, by holding that taxpayer intent is not a necessary component in the analysis of whether a derivative transaction is a hedge – and that a taxpayer can be found to have hedged despite an objective intention to the contrary – the FCA impermissibly diverged from a consistent and binding line of Canadian jurisprudence that stretches back for nearly a century.

iii. FCA's Erroneous Decision that Linkage Exists where Theoretical Risk is Mitigated

94. With respect to linkage, the FCA held that sufficient linkage between the Forward Contract and BNS Shares existed simply because Mr. MacDonald owned BNS Shares during the time that the Forward Contract was in force, and that a close link in terms of quantum and timing was unnecessary. The FCA stated:

> Based on the case law, an intention to hedge is not a condition precedent to hedging. <u>It suffices that the person concerned owns assets exposed to market fluctuation risk when the derivative contract is entered into and that the contract has the effect of neutralizing or mitigating that risk</u>.[130] [emphasis added]

95. The FCA's analysis with respect to sufficient linkage in terms of quantum and timing is faulty and based on an erroneous interpretation of *George Weston*. As explained above, the court in *George Weston* extensively analyzed whether there was sufficient linkage in terms of quantum and timing to support its conclusion that a hedge of a capital asset existed.[131]

96. The difference between *George Weston* and its predecessors was the identified risk to which the hedging transaction was linked. Prior to *George Weston*, hedges in tax case law were

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126 FCA Decision, at para. 66 [<u>AR, Part I, Vol. I, Tab F, p. 113</u>].
127 FCA Decision, at para. 92 [<u>AR, Part I, Vol. I, Tab F, p. 121</u>].
128 *Supra*, at paras. 78-80.
129 *Supra*, at paras. 44ff.
130 FCA Decision, at para. 92 [<u>AR, Part I, Vol. I, Tab F, p. 121</u>].
131 *Supra*, at paras. 81-82.

linked to risks identified in respect of specific transactions. *George Weston* concerned a hedge to mitigate the identified daily risk that the taxpayer faced arising from fluctuations in the US dollar which could have had the effect of putting the taxpayer offside its required 1:1 debt to equity ratio.[132] Nonetheless, the court maintained the requirement for proof of sufficient linkage in terms of quantum and timing. There was a close link in timing between the execution of the Swaps and the genesis of the currency exchange risk, *i.e.*, the date of acquisition of the US operations. The same close link existed between the termination of the Swaps and the abatement of the currency exchange risk, *i.e.*, the date when US dollar loans were sufficiently repaid such that the debt to equity ratio stabilized. There was also a clear link in terms of quantum.

97. The FCA's critique that the Trial Judge "failed to appreciate the distinction between transactional and ownership risk"[133] is flawed. Contrary to the FCA Decision, the tax jurisprudence over the past century has never distinguished "transactional risk" from "ownership risk". A taxpayer must always hold (or at least have an interest in) any asset or liability that is hedged. Our tax law has never concerned itself with the theoretical ownership risks espoused by academics like Professor Klein, whose evidence the Trial Judge rejected, holding that "[t]o follow the economic and financial model presented by Dr. Klein at the hearing <u>would lead this Court to speculate on what could happen as opposed to concluding what did happen</u>. This is not what this Court should do when determining the tax consequences resulting from a specific fact pattern" (emphasis added).[134]

98. Instead, with respect to the analysis of hedging for tax purposes, our courts have quite properly focused the inquiry on whether the taxpayer intends to mitigate or hedge an <u>actual identified risk</u>. This is because there are any number of theoretical "ownership risks" that a taxpayer could hedge unintentionally at any given time. The Trial Judge was fully and properly alive to the applicable law. She observed that there was no link in terms of timing between the Forward Contract and Mr. MacDonald's ownership risk because Mr. MacDonald *had no risk to mitigate*. Mr. MacDonald acquired his BNS Shares in 1988, almost a decade before he entered

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132 *George Weston*, *supra* note 101 at paras. 33, 35, 42, and 70.

133 FCA Decision, at para. 85 [<u>AR, Part I, Vol. I, Tab F, p. 119</u>].

134 Trial Decision, at para. 101 [<u>AR, Part I, Vol. I, Tab B, p. 32</u>], citing *Shell*, *supra* note 54 at para. 45.

into the Forward Contract, and intended to hold them for the long-term. As noted above, he continues to hold a majority of those BNS Shares today and they remain a cornerstone of his investment portfolio. Unlike the situation in *George Weston*, Mr. MacDonald did not have a debt to equity ratio restriction to adhere to. The Trial Judge correctly observed that, unlike the circumstances of *George Weston*, there was no creation and abatement of risk in respect of the BNS Shares to which the Forward Contract could be sufficiently linked to establish that it was a hedge of the BNS Shares.[135]

iv. The Untenable Effect of the FCA's Novel Test for the Taxation of Derivative Transactions

99. The effect of the FCA Decision to remove both linkage and an intent to mitigate an actual identified risk from the analysis regarding whether gains or losses from derivative transactions are taxable on income or capital account is significant, immediate, and far reaching. As the authors of *The Law of Financial Derivatives in Canada* caution, "[t]he income tax issues raised by derivatives transactions are a primary focus for parties and their advisers. <u>Determining the tax treatment of payments made and received is crucial because pricing spreads will generally not support any distortion to the economics of a transaction by reason of unexpected tax cost</u>" (emphasis added).[136]

100. Taxpayers who entered into derivative contracts prior to the FCA's decision and who arranged their bargain with the intention and expectation that the transaction would engender one type of tax treatment can no longer be certain that their economic bargain will hold upon the closing of the derivative contract because unanticipated tax consequences may be imposed under the FCA's novel test. Similarly, taxpayers who had no intention to hedge can now review their gains and losses in each taxation year and engage in after-the-fact tax planning by linking gains or losses to theoretical hedges of capital assets or income assets. What would have been taxed on income account in the past may ultimately be taxable on capital account, and vice-versa.

101. The FCA's new formulation of the linkage analysis exacerbates problems of uncertainty. By removing quantum and timing from the linkage analysis, the FCA has created a test whereby

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135 Trial Decision, at para. 104 [<u>AR, Part I, Vol. I, Tab B, p. 33</u>].

136 *The Law of Financial Derivatives in Canada*, *supra* note 56 at § 11.1 [<u>ABOA, Tab B</u>].

the mitigation of any theoretical "ownership" risk by virtue of a derivative contract will result in the creation of a hedge. This test has few limits. For example:

(a) Speculative derivative instruments may be found to hedge the short-term risk of fluctuation of a taxpayer's US vacation home value even in circumstances where there is no identified risk to the taxpayer from fluctuations in the home value because the taxpayer has no intention of selling the home for decades.

(b) According to the FCA Decision, a Canadian taxpayer who seeks to speculate on the movement of the US dollar relative to the Canadian dollar may discover that the derivative contract is hedging the taxpayer's US dollar savings if those savings exceed the US dollars at risk in the derivative contract.

(c) It may now be impossible to predict whether a derivative transaction is "speculation" or a "hedge" in complex corporate structures, since without intent or sufficient linkage, one corporation could be unknowingly hedging the risk in an affiliate corporation.[137]

102. Our tax courts have never concerned themselves with theoretical hedging of risk. The focus has always properly been on whether there exists an intention to hedge an actual identified risk. The breadth of scenarios captured under the FCA's test for a hedge creates significant uncertainty in Canadian financial derivative markets – a market valued by the Bank of Canada as worth $30 trillion and described as "an important component of the Canadian and global financial systems"[138] where a "disruption in one of these [derivative] markets could affect the financial system and the broader economy by impeding access to funding and the hedging of risks for financial institutions".[139]

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137 See Kurgan Leave Affidavit, at para. 22 and Exhibit H [AR, Part III, Vol. II, Tab M, pp. 9-11 and 63-64] for more detailed examples of the uncertainty created by the FCA Decision.

138 Kurgan Leave Affidavit, at para. 15 and Exhibit F [AR, Part III, Vol. II, Tab M, pp. 5-6 and 40].

139 Kurgan Leave Affidavit, at para. 15 and Exhibit F [AR, Part III, Vol. II, Tab M, pp. 5-6 and 42].

B. FCA'S UNJUSTIFIED INTERFERENCE WITH THE TRIAL JUDGE'S FINDINGS OF FACT

103. It is trite law that the scope of review by intermediary appellate courts of trial court reasons is limited. As this Court held in *Housen*:

> The role of the appellate court was aptly defined in *Underwood v. Ocean Realty Ltd.* (1987), 12 B.C.L.R. (2d) 199 (C.A.), at p. 204 where it was stated:
>
> > The appellate court must not retry a case and must not substitute its views for the views of the trial judge according to what the appellate court thinks the evidence establishes on its view of the balance of probabilities.[140]

104. Here, the FCA exceeded the scope of its appellate review by substituting its own assessment of the evidence for the Trial Judge's findings of fact. The FCA found that Mr. MacDonald "was fully aware that the [Forward Contract] would mitigate risk on [BNS Shares]",[141] that "Mr. MacDonald's BNS shares were exposed to market fluctuation and that this risk was neutralized by the Forward Contract",[142] and that Mr. MacDonald "wanted the credit facility (Transcripts of Mr. MacDonald's cross-examination, p. 113, lines 4 to 8), and he took steps proposed by the lender in order to obtain it".[143]

105. The FCA reached these conclusions despite the Trial Judge's express finding that "Mr. MacDonald did not have a clear intention to hedge when he entered into the Forward Contract",[144] that Mr. MacDonald was not exposed to risk in holding his BNS Shares,[145] and that the credit facility was unrelated to the Forward Contract.[146] Moreover there was absolutely no evidence that Mr. MacDonald was aware that the Forward Contract would mitigate any theoretical risk arising from his mere ownership of BNS Shares. Furthermore, in respect of the credit facility, the FCA failed to reconcile its selective citation of the trial transcript with the

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140 *Housen*, *supra* note 48 at para. 3.

141 FCA Decision, at para. 71 [AR, Part I, Vol. I, Tab F, pp. 114-15].

142 FCA Decision, at para. 88 [AR, Part I, Vol. I, Tab F, pp. 120].

143 FCA Decision, at para. 73 [AR, Part I, Vol. I, Tab F, pp. 115-16]. Notably, the citation provided by the FCA does not stand for the proposition for which it was advanced.

144 Trial Decision, at paras. 80 and 96 [AR, Part I, Vol. I, Tab B, pp. 25-26 and 31].

145 Trial Decision, at paras. 103-04 [AR, Part I, Vol. I, Tab B, pp. 32-33].

146 Trial Decision, at paras. 62, 74, 106, and 114-17 [AR, Part I, Vol. I, Tab B, pp. 18, 23-24, 33, and 35-36].

evidence that Mr. MacDonald gave in re-examination in which he expressly stated that there was no link between his decision to enter into the Forward Contract and the credit facility.[147]

106. The FCA exceeded its appellate jurisdiction by substituting its own interpretation of the evidence in place of the Trial Judge's careful findings.[148] The FCA's substitution of the Trial Judge's findings and inferences of fact for its own opinion is exactly the type of impermissible appellate review that this Court admonished in *Housen*.[149]

107. The FCA provided no reasons for why it disregarded the Trial Judge's factual findings. Nor did the court identify any reviewable error in the Trial Judge's finding that Mr. MacDonald was exposed to no risk and intended to speculate with the Forward Contract. Indeed, there is no evidentiary basis for any of the FCA's substituted findings. The FCA exceeded its appellate review jurisdiction and its novel and erroneous factual findings must be set aside. The appeal should be allowed on this basis alone.

C. APPLYING THE CORRECT TEST

108. As explained above, the test for determining whether profits or losses arising from a derivative transaction are taxable on income or capital account is comprised of two parts:

(a) First, where a taxpayer intends to speculate for profit through the use of a derivative transaction, the taxpayer engages in an adventure or concern in the nature of trade. As a result, gains or losses arising therefrom are taxed on income account pursuant to s. 9(1) of the ITA.

(b) Second, where a taxpayer intends to hedge an actual identified risk through the use of a derivative transaction, the gains or losses arising therefrom are taxed either:

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147 MacDonald Transcript, pp. 144 (line 16) – p. 146 (line 13) [AR, Part V, Vol. VI, Tab X, pp. 134-36].

148 *Salomon*, *supra* note 48 at para. 108 *per* Côté J. (dissenting); *Perez v. Galambos*, 2009 SCC 48, [2009] 3 S.C.R. 247, at para. 49; and *Hodgkinson v. Simms*, [1994] 3 S.C.R. 377, at pp. 425-26.

149 *Housen*, *supra* note 48 at para. 23.

(i) on income account pursuant to s. 9(1) of the ITA if the derivative transaction is <u>sufficiently linked in terms of quantum and timing</u> to an income asset or liability; or

(ii) on capital account pursuant to s. 38 of the ITA if the derivative transaction is <u>sufficiently linked in terms of quantum and timing</u> to a capital asset or liability.

109. Here, the overwhelming evidence, accepted by the Trial Judge, is that the Forward Contract was entered into with an intention to speculate. The Trial Judge found as fact that Mr. MacDonald had no intention to use the Forward Contract to hedge his BNS Shares and the Forward Contract was not sufficiently linked to any actual identified risk emanating from his ownership of BNS Shares. The Trial Judge noted that Mr. MacDonald did not offset his losses under the Forward Contract by selling his BNS Shares and that the value of his BNS Shares were not exposed to any real risk because he had no intention of selling them during the period in which the Forward Contract was extant. The Trial Judge's finding that Mr. MacDonald had no actual identified risk to hedge, and that he intended to speculate with the Forward Contract, is fully supported by the evidence and reveals no error – much less a palpable and overriding one.

110. Consequently, the Forward Contract is an adventure or concern in the nature of trade under branch (a) of the above test and the losses Mr. MacDonald incurred thereunder are deductible on income account.

PART IV - COST SUBMISSIONS

111. Mr. MacDonald submits that costs should be awarded in this Court and in the courts below if he is successful on this appeal.

PART V - ORDERS SOUGHT

112. Mr. MacDonald respectfully requests that this Court allow this appeal, set aside the order of the FCA, and restore the order of the Tax Court of Canada, with costs in this Court and in the courts below.

ALL OF WHICH IS RESPECTFULLY SUBMITTED this 7th day of June, 2019.

Elie S. Roth

Stephen S. Ruby

Chenyang Li

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James S. A. MacDonald

PART VI - SUBMISSIONS ON CONFIDENTIALITY

113. None.

PART VII - TABLE OF AUTHORITIES

	CITATION	At Paragraph(s)
Cases		
1.	*2105582 Ontario Ltd. (Performance Plus Golf Academy) v. 375445 Ontario Limited (Hydeaway Golf Club)*, 2017 ONCA 980, 138 O.R. (3d) 561	35
2.	*Anderson Logging Co. v. R.*, [1925] S.C.R. 45	46
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4.	*Aviva Canada Inc v The Queen*, 2006 TCC 57	37
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