Court 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

Applicant (Appellant)

- and –

HER MAJESTY THE QUEEN

Respondent (Respondent)

MEMORANDUM OF ARGUMENT OF THE RESPONDENT IN RESPONSE TO THE APPLICATION FOR LEAVE TO APPEAL

(Rule 27 of the *Rules of the Supreme Court of Canada*)

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PART I – STATEMENT OF FACTS

A. OVERVIEW

1. This application does not raise any question of public importance that warrants consideration by this Court. This Court has settled the approach to be taken to determine what constitutes a hedge and how to tax amounts related to it. The Federal Court of Appeal decision is in line with well-established jurisprudence.

2. In order to borrow money, the applicant pledged a certain number of his Bank of Nova Scotia shares, entered into a forward contract for the same number and type of shares, and assigned all receipts under the forward contract as collateral for the loan. In determining that the forward contract was a hedge of the applicant's shares and consequently, payments under it were taxable on capital account, the Federal Court of Appeal followed this Court's guiding principles in *Shell* and *Placer Dome*.[1]

3. Rather than creating uncertainty and potential instability within Canadian derivative markets as suggested by the applicant, the decision of the Federal Court of Appeal resolved the ambiguity created by diverging Tax Court decisions in a way that maintains the principles adopted by this Court. The ensuing uncertainty from irreconcilable Tax Court decisions was conclusively resolved by the Federal Court of Appeal in this case. It does not conflict with any other appellate decision. Leave should not be granted.

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[1] *Shell Canada Ltd v R*, [1999] 3 SCR 622 [***Shell***] and *Placer Dome Canada v Ontario*, [2006] 1 SCR 715, 2006 SCC 20 [***Placer Dome***].

B. BACKGROUND FACTS

4. The applicant had over 40 years of capital markets and corporate finance experience. On June 6, 1997, he was offered a credit facility by TD Bank. The offer envisaged the applicant would pledge a certain number of his Bank of Nova Scotia ("BNS") shares, enter into a forward contract for the same number and type of shares with TD Securities Inc. ("TDSI"), and assign all receipts under the forward contract as collateral ("Forward Contract").[2]

5. On June 26, 1997, the applicant entered into the Forward Contract for 165,000 BNS shares ("Reference Shares"). The applicant had the option to extend the Forward Contract beyond the original termination date of June 26, 2002 ("Forward Date") and to make cash settlement payments on the number of Reference Shares of his choice before the Forward Date. Thus, the number of the Reference Shares that were subject to the Forward Contract varied downwards due to settlement payments made by the applicant.[3]

6. In addition to the Forward Contract, the applicant entered into a Securities Pledge Agreement, also as planned, on July 2, 1997. By this agreement, the applicant pledged 165,000 of his BNS shares to TD Bank and assigned any payment to which he could become entitled under the Forward Contract as additional collateral.[4]

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[2] Reasons of the Federal Court of Appeal in *Her Majesty The Queen v James SA MacDonald* (**FCA Decision**) at paras 6, 8, Applicant's Record, Tab F at 97, 98.

[3] FCA Decision, *supra* note 2 at paras 9–11, Applicant's Record, Tab F at 98–99.

[4] FCA Decision, *supra* note 2 at para 12, Applicant's Record, Tab F at 99.

7. The applicant accepted the credit facility offer on July 2, 1997. Pursuant to its terms, the applicant undertook to maintain in place the Forward Contract for the number of Reference Shares corresponding to the 165,000 shares which had been pledged. At no time was the number of Reference Shares that were subject to the Forward Contract greater than the total number of BNS shares the applicant owned.[5]

8. The applicant borrowed under the credit facility and repaid the borrowed funds prior to the close of his 2004 taxation year. Between 2004 and 2006, the applicant exercised his option to partially terminate the Forward Contract and made cash settlement payments totalling $9,966,149 which he claimed gave rise to business losses that were deductible against income from other sources for tax purposes.[6]

9. The Minister of National Revenue denied the applicant's claim for business losses on the basis that the cash settlement payments gave rise to capital losses.[7]

C. DECISION OF THE TAX COURT OF CANADA

10. The Tax Court judge first concluded that the Forward Contract was an adventure in the nature of trade. To reach this conclusion, the trial judge relied heavily on the applicant's

[5] FCA Decision, *supra* note 2 at para 13, Applicant's Record, Tab F at 100.

[6] FCA Decision, *supra* note 2 at paras 14–17, Applicant's Record, Tab F at 100–101.

[7] FCA Decision, *supra* note 2 at para 18, Applicant's Record, Tab F at 101.

testimony that he entered into the Forward Contract with the intention of making a profit and he viewed the credit facility as ancillary to and a by-product of the Forward Contract.[8]

11. The trial judge then considered whether the Forward Contract was a hedge of a capital asset, so as to "convert" the payments from income to capital account. She concluded that the Forward Contract was not a hedge of the applicant's BNS shares because he did not intend to sell his BNS shares and therefore, he did not intend the Forward Contract to offset any investment risk because he had no risk. She also concluded that the Forward Contract could not be viewed as a "same asset hedge" because the applicant could not settle the Forward Contract by transferring his BNS shares to TDSI. In order to find there was a hedge, the trial judge required that settlement on termination of the Forward Contract be satisfied by the exchange of shares and the presence of an "offsetting transaction" to which the Forward Contract could be linked.[9]

D. DECISION OF THE FEDERAL COURT OF APPEAL

12. In a unanimous decision, the Federal Court of Appeal allowed the respondent's appeal. In reaching this conclusion, the Federal Court of Appeal relied on well-established principles set out by this Court and other appellate courts. The Federal Court of Appeal concluded that an intention to hedge was not a condition precedent for hedging and it sufficed that the person concerned owned assets exposed to market fluctuation risk when the derivative contract was

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[8] Reasons of the Tax Court of Canada [**TCC Decision**] at paras 63–64, 74–75, Applicant's Record, Tab B at 21, 26–27.

[9] TCC Decision, *supra* note 8 at paras 99, 104, 105, 112, Applicant's Record, Tab B at 35, 36, 38.

entered into, the derivative contract had the effect of neutralizing or mitigating that risk, and the person was aware of the effect of risk mitigation.[10]

13. The Federal Court of Appeal found that the Tax Court judge erred in law in not following binding precedents, in particular, *Placer Dome* and *Shell*, and in distinguishing an earlier Tax Court decision on the erroneous basis that the applicant had no ownership risk to hedge. The Federal Court of Appeal followed this Court's guiding principles in *Placer Dome* with respect to the hedging analysis, and concluded that the risk to which the applicant was exposed was mitigated by the Forward Contract and therefore, the Forward Contract hedged the applicant's BNS shares.[11]

14. As such, the linkage principle, as articulated by this Court in *Shell*, applied so that the settlement payments made by the applicant were on capital account because the corresponding number of BNS shares that he held while the Forward Contract was in place, were capital property.[12]

PART II – POINT IN ISSUE

15. The sole issue on this application is whether the Federal Court of Appeal's decision raises an issue of public importance, or an issue that is of such significance as to warrant a decision by this Court.

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[10] FCA Decision, *supra* note 2 at paras 70–71, 92–93, Applicant's Record, Tab F at 117, 124.

[11] FCA Decision, *supra* note 2 at paras 53–57, Applicant's Record, Tab F at 112–113.

[12] FCA Decision, *supra* note 2 at paras 94–95, Applicant's Record, Tab F at 124–125.

PART III – ARGUMENT

1) ***The question sought to be addressed has been answered by this Court***

16. The applicant seeks this Court opine on a question it has already answered, namely, what is the proper test to determine whether a derivative instrument was a hedge of an asset or liability?

17. This Court articulated three elements that characterise hedging:

(a) a party had assets or liabilities exposed to market fluctuations; [13]

(b) there existed business or commercial reason for the hedge;[14] and

(c) the hedge reduced or eliminated risk to which the party was exposed.[15]

18. By recognising that the first element in the hedging analysis is to identify an asset or liability which exposed the person to risk, this Court recognised that ownership risk could be hedged even though the facts in *Placer Dome* concerned transactional risk from the production of gold or output from a mine.

19. This Federal Court of Appeal's approach accords with this Court's guiding principles in *Placer Dome*, *Atlantic Sugar Refineries* and *Shell*. The Federal Court of Appeal correctly opined that there is no basis in law for the proposition that a derivative transaction must

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[13] *Placer Dome*, *supra* note 1 at para 29.

[14] *Placer Dome*, *supra* note 1 at para 32; *Shell*, *supra* note 1 at paras 69–70.

[15] *Placer Dome*, *supra* note 1 at paras 32–35.

be linked to a gain or loss resulting from a separate transaction for it to be considered a hedge of an asset or liability.[16] Rather, the focus of the hedging analysis is what effect did the financial derivative instrument have on risk from the asset or liability that it purported to hedge? The Federal Court of Appeal examined whether the Forward Contract had the effect of neutralizing or mitigating risk on a specific block of BNS shares which was pledged by the applicant while the credit facility was in place.[17] The Federal Court of Appeal correctly concluded that the Forward Contract hedged the applicant's BNS shares.

2) *Business or commercial reason for hedging, not taxpayer's intention, is relevant for the hedging analysis*

20. This Court has consistently referred to business or commercial reasons for hedging as a factor in the hedging analysis.[18] By insisting on intention as a prerequisite for a hedge, the applicant conflated the hedging analysis with the tax issue, which, in this case was whether the applicant carried on an adventure in the nature of trade from his participation in the Forward Contract. Factors that are relevant for the hedging analysis are not the same factors that are relevant to determine whether a taxpayer carried on an adventure in the nature of trade.[19]

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[16] FCA Decision, *supra* note 2 at para 78, Applicant's Record, Tab F at 120.

[17] FCA Decision, *supra* note 2 at para 56, Applicant's Record, Tab F at 113.

[18] *Atlantic Sugar Refineries Ltd v Minister of National Revenue*, [1949] SCR 706 [***Atlantic Sugar Refineries***] at paras 11–12; *Placer Dome*, *supra* note 1 at para 32; *Shell*, *supra* note 1 at para 69.

[19] *Friesen v Canada*, [1995] SCR 103 at 115 [***Friesen***] regarding adventure in the nature of trade, contrast with *Placer Dome*.

21. As the Federal Court of Appeal correctly concluded based on this Court's guiding principles, the hedging analysis does not revolve around a taxpayer's intention about the financial derivative or the item being hedged. Rather, the hedging analysis depends on the effect of the purported hedge, the Forward Contract in the applicant's case, on risk exposure from the asset being hedged, namely, the applicant's BNS shares.[20] The Federal Court of Appeal correctly identified the lack of jurisprudential support for the applicant's position that intent is a condition precedent for hedging.[21]

3) ***The hedging analysis is distinct from the tax issue***

22. The Federal Court of Appeal properly considered *Placer Dome* to be the leading and binding authority for the hedging analysis under Canadian law, and on that basis, determined the Forward Contract hedged the applicant's BNS shares.[22]

23. As such, there was no reason why the established rule set out by this Court in *Shell*, that hedging gains or losses are treated the same way as the assets being hedged for tax purposes, should not also apply. The linkage principle, developed in the case law, only applied because the Forward Contract was a hedge of the applicant's BNS shares. By applying the linkage principle,

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[20] FCA Decision, *supra* note 2 at paras 63–64, 68, 70–71, Applicant's Record, Tab F at 115, 116, 117.

[21] FCA Decision, *supra* note 2 at para 78, Applicant's Record, Tab F at 120.

[22] FCA Decision, *supra* note 2 at paras 52, 57, 62, 67, 78, 82, Applicant's Record, Tab F at 112, 113, 115, 116, 120, 121.

the Federal Court of Appeal resolved the tax issue of how to characterize the settlement payments.[23]

24. Had the Forward Contract been determined not to have hedged the applicant's BNS shares, the linkage principle would not have applied and as such, the taxpayer's intention would have been relevant to the tax issue which was did the taxpayer's course of conduct amount to an adventure in the nature of trade?[24] Nonetheless, the Federal Court of Appeal concluded that the applicant could neither gain nor lose by entering into the Forward Contract while owning BNS shares whose value was protected by the financial derivative. In essence, the applicant's own circumstance and conduct precluded any other conclusion regardless of his self-serving statements about intention.[25]

4) ***The Federal Court of Appeal decision does not create uncertainty***

25. Whatever the hedging instrument or method used (forward contract, option, short sale), this Court has consistently articulated the hedging analysis in terms risk neutralization or mitigation, and that requires an examination of the hedging effect of the financial derivative instrument on the asset or liability being hedged.[26] This Court's guiding principles about what

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[23] FCA Decision, *supra* note 2 at para 94, Applicant's Record, Tab F at 124; *Shell*, *supra* note 1 at paras 68, 70.

[24] *Friesen*, *supra* note 19 at 115 "scheme for profit-making" or intention of gaining a profit to determine whether purchase and sale transactions are of a business nature.

[25] FCA Decision *supra* note 2 at paras 62, 71–72, Applicant's Record, Tab F at 115, 117–118.

[26] *Placer Dome*, *supra* note 1 at paras 30–31, 34–35; *Shell*, *supra* note 1 at paras 68–70; *Atlantic Sugar Refineries*, *supra* note 18 at paras 11–12.

constitutes "hedging" was derived from general principles articulated in a tax case.[27] This Court has also recognized financial derivatives as hedging instruments regardless of how they were settled (cash or physical delivery). The Federal Court of Appeal correctly followed these principles.[28]

26. The applicant's assertion that Federal Court of Appeal's decision created potential instability within Canadian derivatives market and destabilised any certainty gained from tax planning, is without merit. Rather, this Federal Court of Appeal decision resolved uncertainty created by diverging Tax Court decisions[29] in a manner that maintains the principles adopted by the Court.

27. There is no basis for the applicant to require this Court's intervention on an issue that has been settled by the case law.

5) Conclusion

28. In deciding the applicant's case, the Federal Court of Appeal applied this Court's guidance in *Placer Dome* and *Shell* to the facts. The Court broke no new ground and created no new law. The applicant's proposed appeal raises no new issues of public importance. A desire to re-litigate the hedging issue, which has been settled by this Court, is not a sufficient ground upon which to base an appeal to this Court.

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[27] *Placer Dome*, *supra* note 1 at paras 34–35; *Echo Bay Mines Ltd v Canada*, [1992] 3 FC 707.

[28] FCA Decision, *supra* note 2 at paras 60–61, 90, Applicant's Record, Tab F at 114, 123.

[29] FCA Decision, *supra* note 2 at paras 83, 87, 91, Applicant's Record, Tab F at 121, 123, 124.

PART IV – SUBMISSIONS CONCERNING COSTS

29. The respondent seeks its costs in this application. There is no reason to depart from the general principles that costs follow the event.

PART V – NATURE OF ORDER SOUGHT

30. The respondent requests that the application for leave to appeal be dismissed with costs.

ALL OF WHICH IS RESPECTFULLY SUBMITTED

Dated at Ottawa' Ontario, this day of October, 2018.

Suzanie Chua
Counsel for the Respondent

PART VI – TABLE OF AUTHORITIES

		Cited at paragraphs
1.	*Atlantic Sugar Refineries Ltd v Minister of National Revenue* [1949] SCR 706	19, 20, 25
2.	*Echo Bay Mines Ltd v. Canada* [1992] 3 FC 707	25
3.	*Friesen v Canada* [1995] SCR 103	20, 24
4.	*Placer Dome Canada v Ontario*, [2006] 1 SCR 715, 2006 SCC 20	17, 18, 19, 20, 22, 25, 28
5.	*Shell Canada Ltd v R*, [1999] 3 SCR 622	17, 19, 23, 25, 28

PART VII – STATUTES RELIED ON

None.