Federal Court of Appeal Cour d'appel fédérale

**Date: 20180629**

**Docket: A-281-17**

**Citation: 2018 FCA 128**

**CORAM:** **NOËL C.J.**
**PELLETIER J.A.**
**DE MONTIGNY J.A.**

**BETWEEN:**

**HER MAJESTY THE QUEEN**

**Appellant**

**and**

**JAMES S.A. MACDONALD**

**Respondent**

Heard at Toronto, Ontario, on May 8, 2018.

Judgment delivered at Ottawa, Ontario, on June 29, 2018.

REASONS FOR JUDGMENT BY: NOËL C.J.

CONCURRED IN BY: PELLETIER J.A.
DE MONTIGNY J.A.

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## REASONS FOR JUDGMENT

**NOËL C.J.**

[1] This is an appeal by Her Majesty the Queen (the Crown or the appellant) from a decision rendered by Lafleur J. of the Tax Court of Canada (the Tax Court judge) in which she allowed the appeal brought by James S.A. MacDonald (Mr. MacDonald or the respondent) against reassessments issued with respect to his 2004, 2005, 2006 and 2007 taxation years. By these reassessments, the Minister of National Revenue (the Minister) determined that cash settlement

payments totalling $9,936,149 made by Mr. MacDonald pursuant to a derivative contract during the years in issue gave rise to capital losses rather than business losses.

[2] In support of her appeal, the Crown argues amongst other things that the Tax Court judge did not adopt the proper framework of analysis in disposing of the matter before her and failed to give effect to the recent decision of the Tax Court in *George Weston Limited v. The Queen,* 2015 TCC 42 [*George Weston*].

[3] The respondent for his part takes the position that none of the alleged errors has been established and essentially stands by the reasons given by the Tax Court judge in support of the conclusion that she reached.

[4] In my view, *George Weston* was determinative of the issue before the Tax Court judge and ought to have been followed. I therefore propose that the appeal be allowed.

**FACTS**

[5] The facts for the most part are set out in the Partial Statement of Agreed Facts which was annexed to the decision under appeal. The following reflects a brief summary which incorporates Mr. MacDonald’s *viva voce* evidence and tracks the facts as they unfolded in chronological order.

[6] Mr. MacDonald has over 40 years of capital markets and corporate finance experience. During his career, he has served on the board of numerous public companies. He worked with

McLeod Young Weir in various capacities until 1988 when the brokerage firm was acquired by the Bank of Nova Scotia, and became Scotia McLeod. As a result of this acquisition, Mr. MacDonald became the owner of 183,333 common shares of the Bank of Nova Scotia (the BNS shares).

[7] By 1997, Mr. MacDonald came to the view that certain world events would lead to a decline in the value of his BNS shares in the short term but nevertheless remained optimistic that they would perform well in the long term.

[8] Also around this time, Mr. MacDonald became interested in obtaining a loan in order to finance various investments. On June 6, 1997, Mr. MacDonald was offered a credit facility by the TD Bank. The offer envisaged that Mr. MacDonald would pledge a certain number of his BNS shares and assign any payment he could become entitled to receive pursuant to a forward contract (the Forward Contract) between himself and TD Securities Inc. (TDSI) to be entered into as collateral for the loan. The offer also contemplated that the Forward Contract would be maintained while the loan was in place and that Mr. MacDonald would provide TD Bank with a net worth statement on an annual basis.

[9] Mr. MacDonald entered into the Forward Contract as planned on June 26, 1997 with TDSI. It could only be cash settled – *i.e.*: no shares were thereby to be acquired or sold. Based on its terms, TDSI would pay Mr. MacDonald the amount by which the Reference Price (the closing price of the BNS shares on the Toronto Stock Exchange on the Forward Date) fell below the Forward Price ($68.43) multiplied by the 165,000 shares which were subject to the Forward

Contract (the Reference Shares). In the event the Reference Price was to exceed the Forward Price, Mr. MacDonald would be required to make payments to TDSI.

[10] The Forward Contract was to terminate on its Forward Date, initially June 26, 2002 and later extended to March 26, 2006. Mr. MacDonald also had the option to make settlement payments on the number of Reference Shares of his choice before the Forward Date, in which case the Forward Contract would be partially terminated with respect to the number of Reference Shares covered by the payments. Mr. MacDonald availed himself of this option on twelve occasions between 2003 and 2006.

[11] Thus, the number of the Reference Shares that were subject to the Forward Contract varied downwards due to settlement payments made by Mr. MacDonald. It also varied upwards due to the issuance of a stock dividend and a stock split which took place while the Forward Contract was in force. However, at no time was the number of Reference Shares under the Forward Contract greater than the total number of BNS shares owned by Mr. MacDonald.

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

[13] Mr. MacDonald accepted the credit facility offer on July 2, 1997. Pursuant to its terms, Mr. MacDonald undertook to maintain in place the Forward Contract for the number of Reference Shares corresponding to the 165,000 shares which had been pledged.

[14] Although this credit facility authorized Mr. MacDonald to borrow up to $10,477,485, he only availed himself of part of this credit – $4,899,000 – which he used for the purpose of investing in other ventures. These borrowed funds were fully repaid prior to the close of Mr. MacDonald's 2004 taxation year.

[15] Upon Mr. MacDonald's repayment of the loan, the Forward Contract remained in place. However, contrary to what Mr. MacDonald anticipated, the value of the Reference Shares did not decrease and remained above their Reference Price. As a result, between 2004 and 2006, Mr. MacDonald was required to make cash settlement payments totalling $9,966,149.

[16] At trial, Mr. MacDonald testified that he intended to profit from the anticipated decline in the value of the BNS shares but nevertheless retain ownership of the shares based on his belief that they would perform well in the long term and he entered into the Forward Contract as it allowed him to achieve both objectives. While he did sell some of his BNS shares during the years when the Forward Contract was in place, he explained that this was done in order to rebalance his portfolio and to reduce his overall exposure to Canadian financial institutions which had increased when, in the context of another take-over, he became the owner of a substantial number of shares issued by the TD Bank.

[17] In computing his income for his 2004, 2005 and 2006 taxation years, Mr. MacDonald took the position that the cash settlement payments totalling $9,966,149 made during those years gave rise to business losses that were deductible against income from other sources.

[18] The Minister took issue with this characterization and denied the losses for the years in which they were claimed on the basis that the cash settlement payments gave rise to capital losses. The 2007 reassessment denies a minimum tax carry forward credit to which Mr. MacDonald became entitled by reason of the business loss claimed for his 2005 taxation year.

[19] Notices of objection were filed by Mr. MacDonald and the appeal to the Tax Court of Canada ensued.

**DECISION OF THE TAX COURT OF CANADA**

[20] The Tax Court judge first identified the approach to be used in determining whether the cash settlement payments made by the respondent were on account of income or capital in nature. She chose to address the issue using the two-step analysis suggested by the respondent: she first focused on the Forward Contract "in and of itself" – *i.e.*: independently of any connection with the BNS shares – and considered whether it was entered into in the course of an adventure or concern in the nature of a trade so that any loss derived therefrom was to be treated on an income account under paragraph 3*a*) of the *Income Tax Act*, R.S.C. 1985, c.1 (5th Suppl.) (the Act) (Reasons, para. 35). As a second step, she considered whether the Forward Contract was linked to capital assets – *i.e.*: the BNS shares owned by the respondent – in which case the

Forward Contract would be a hedging instrument and losses reflected by the cash settlement payments would be capital in nature.

[21] Turning to the first step, the Tax Court judge, citing *Canada Safeway Limited v. Canada,* 2008 FCA 24, [2008] D.T.C. 6074, noted that the most important factor in determining whether a transaction is an adventure in the nature of a trade is the intent of the taxpayer and whether it reveals a scheme for profit making (Reasons, para. 52). She also noted that an adventure in the nature of a trade is a speculative undertaking which typically involves great risk (Reasons, paras. 53 and 54).

[22] Based on the testimony of Mr. MacDonald which she accepted as “credible and reliable”, the Tax Court judge found that his “sole purpose and intention” when he entered into the Forward Contract was to speculate and profit from the decrease in the value of the BNS shares he foresaw and that this intention remained in place throughout (Reasons, para. 59). Moreover, the Forward Contract exposed Mr. MacDonald to great risks as it was uncertain whether he would make or receive payments thereunder (Reasons, paras. 60 and 61). She therefore rejected the Crown’s contention that Mr. Macdonald’s “primary intention” was to “lock-in an economic gain on the BNS shares pledged and the Forward Contract, and to protect the value of the BNS shares” (Reasons, para. 58).

[23] The Tax Court judge later reinforced this finding in various ways (Reasons, paras. 60 to 65). She noted the “very important fact” that Mr. MacDonald “did not intend to ever sell his BNS shares” (Reasons, para. 66). Although he did in fact sell slightly over 50% of his BNS

shares while the Forward Contract was in place and in the few months following the last cash settlement payment, these sales could all be explained by special circumstances, such that Mr. MacDonald's stated intent to never sell his BNS shares could not be doubted or questioned (*Ibidem*).

[24] After rejecting a series of other arguments advanced by the Crown (Reasons, paras. 68 to 79), the Tax Court judge reaffirmed her finding that the respondent had, by entering into the Forward Contract, engaged in an adventure in the nature of a trade.

[25] The Tax Court judge then turned to the issue whether the Forward Contract hedged a capital asset. She explained that if this were the case, the effect would be to "convert" the cash settlement payments from income into capital as "it is clear from the evidence […] that the BNS shares held by Mr. MacDonald are the capital assets to be considered" in determining the tax treatment (Reasons, para. 80).

[26] The Tax Court judge, noting that the term "hedge" is not defined in the Act, first considered the testimony of both expert witnesses called upon to opine on its commercial definition and found that the essential feature is a strategy to offset investment risk (Reasons, paras. 81 and 85).

[27] She then turned to the case law and found that, for income tax purposes, a hedge exists where: i) a taxpayer has an intent to hedge and ii) the hedging instrument is directly or symmetrically linked to an underlying asset in terms of quantum and timing citing *Reference re:*

*Grain Futures Taxation Act (Manitoba),* [1925] JCJ No. 4 (QL), [1925] 2 WWR 60 [*Grain Futures*], confirmed in *Echo Bay Mines Ltd v Canada (TD*), [1992] 3 F.C. 707, 92 D.T.C. 6437 [*Echo Bay Mines*], *Placer Dome Canada Ltd. v. Ontario (Minister of Finance),* 2006 SCC 20 [*Placer Dome*], and *Salada Foods Ltd v. The Queen,* [1974] C.T.C. 201, 74 D.T.C. 6171 (FCTD) (Reasons, paras. 86 to 90).

[28] The Tax Court judge also found that *George Weston* was consistent with the established jurisprudence and confirmed that both the intent to hedge and the link between the instrument and the underlying asset must be present before hedging can be said to have occurred (Reasons, para. 95).

[29] Turning to the first requirement, the Tax Court judge framed the issue as whether Mr. MacDonald had “a clear intention to hedge against his BNS shares” (Reasons, para. 96). After referring to her initial finding that Mr. MacDonald’s intention was to speculate, she found that the requisite intent to hedge was lacking (*Ibidem*). Given her holding that both intent and linkage must be present in order for hedging to take place, the analysis could have ended there.

[30] However, the Tax Court judge went on to address what she understood to be the “linkage principle” (Reasons, para. 97). The Crown took the position that the relevant link was between the Forward Contract and Mr. MacDonald’s ownership of the BNS shares. According to the Crown, this link was clear: the Forward Contract reduced Mr. MacDonald’s exposure to market fluctuations which affected the share value. This was also the view of the Crown’s expert witness, Dr. Klein (Reasons, paras. 97 and 98).

[31] The Tax Court judge rejected this contention. She agreed with the expert called by Mr. MacDonald, Dr. Kurgan, who explained that the BNS shares were the “Reference Shares” under the Forward Contract but not the “Delivery Assets” as the Forward Contract does not contemplate settlements other than by way of cash payments. She therefore found that “the Forward Contract cannot be described for income tax purposes as a partial same asset hedge of the BNS shares” (Reasons, para. 99).

[32] Moreover, the Tax Court judge rejected the Crown’s contention that Mr. MacDonald was exposed to risk by simply owning the shares. Specifically, she did not accept that price fluctuations could have affected him since he did not intend to ever sell his BNS shares except for the “small number” that he did sell (Reasons, paras. 103 and 104). It followed, in her view, that the only risk that could have been hedged is a transactional risk (Reasons, para. 105).

[33] However, the Tax Court judge held that any such transaction would have to be made “at the same time or in close proximity” to the cash settlement payments made under the Forward Contract (Reasons, para. 112) As the cash settlement payments “arose at different times from the realized gains on the sales of the BNS shares”, the Tax Court judge found that the linkage principle was not satisfied and there was no hedge for tax purposes (Reasons, para. 113).

[34] The Tax Court judge therefore held that the Forward Contract was not a hedging instrument because it was neither linked to Mr. MacDonald’s ownership of his BNS shares nor to any disposition of these shares.

**POSITION OF THE PARTIES**

- *The Crown*

[35] The Crown submits that the Tax Court judge erred in law by failing to apply the proper legal test in determining whether the Forward Contract was a hedging instrument. The Tax Court judge is also alleged to have adopted a flawed two-stage analysis in addressing the issue and to have placed too much weight on Mr. MacDonald's "subjective statement of intention" (Memorandum of the Crown, para. 56).

[36] In order to qualify as a hedge, a financial instrument must be linked to an underlying asset exposed to risk. As established by the case law, this condition will be met where a person has assets or liabilities exposed to market fluctuations and the commercial purpose for entering into the contract was to mitigate such risks (Memorandum of the Crown, para. 38). As such, the link between the Forward Contract and Mr. MacDonald's pledged shares was obvious: "changes in the value of the Forward Contract always offset changes in the value of the underlying pledged shares so that the respondent's net asset value remained the same even as the market price for BNS shares fluctuated". This allowed Mr. MacDonald to offer the shares as risk-free collateral to the TD Bank (Memorandum of the Crown, para. 36).

[37] The Crown also submits that the Tax Court judge further erred by adopting a strict approach to linkage (Memorandum of the Crown, para. 39). The Tax Court judge found that a link between an offsetting transaction – such as the sale of BNS shares – was required. In doing so, the Tax Court judge disregarded the established jurisprudence, specifically, the Tax Court

decision in *George Weston* which established that a derivative instrument can be linked to an underlying asset where no transaction is contemplated (Memorandum of the Crown, para. 41). As a result, the two most recent cases of the Tax Court of Canada concerning hedging are irreconcilable.

[38] Mr. MacDonald's ownership of the pledged shares resulted in him having assets and liabilities exposed to market fluctuations (Memorandum of the Crown, para. 44). Ownership has risks. Even if he never intended to sell his shares, Mr. MacDonald's continued ownership of the shares exposed him to risk (Memorandum of the Crown, para. 45).

[39] Moreover, in order for there to be a hedge, there must be an objective reason for doing so (Memorandum of the Crown, para. 46). In *Saskferco Products ULC v. Canada*, 2008 FCA 297, this Court focused on the surrounding commercial purposes of the transaction rather that the taxpayer's subjective intent.

[40] The Crown also takes the position that the Tax Court judge's two-step approach caused her to err in her analysis of the linkage between the Forward Contract and the BNS shares; she ought to have undertaken the hedging analysis at the outset (Memorandum of the Crown, paras. 49 to 51).

- *The respondent*

[41] The respondent submits that the Tax Court judge correctly held that intent and a sufficient link between the instrument and the underlying asset are required in order for a hedge

to exist. These central elements of a hedge were established by the Privy Council in *Grain Futures* and continue to inform the jurisprudence (Memorandum of the Crown, paras. 49 to 52). The Crown's failure to challenge the Tax Court judge's finding that Mr. MacDonald did not intend to hedge is fatal to her appeal (Memorandum of the respondent, paras. 47 and 48). Moreover, the Tax Court judge's conclusion that Mr. MacDonald did not have this requisite intent is based on a careful assessment of the evidence. The Crown' position – that Mr. MacDonald's BNS shares were hedged because the TD Bank was able to protect the value of its collateral – disregards Mr. MacDonald's intent and the Tax Court judge's finding that the loan had no bearing on the hedging issue (Memorandum of the respondent, paras. 33, 53).

[42] According to the respondent, the decision under appeal is not inconsistent with *George Weston.* In that case, George Weston had a clear intent to hedge and the swaps (the hedging instrument) matched the value of the assets and were entered into at the same time they were acquired, thus exhibiting the necessary linkage in terms of both quantum and timing (Memorandum of the respondent, para. 62). The Crown's position, if accepted, would give rise to an "accidental hedge" whereby a taxpayer would become a hedger regardless of his intent to do so (Memorandum of the respondent, para. 66).

[43] In addition, the Tax Court judge did not err in her application of the linkage principle. The Tax Court judge correctly concluded that the Forward Contract neither mitigated risk nor locked in any gain on Mr. MacDonald's BNS shares (Memorandum of the respondent, para. 70).

[44] The respondent also asserts that the Tax Court judge adopted the correct two-step approach. In any event, proceeding in a different manner would not alter the fact that Mr. MacDonald did not intend to hedge nor create the requisite linkage (Memorandum of the respondent, para. 80).

[45] The respondent also takes the position that the Tax Court judge did not commit any of the factual errors that the Crown alleges. Her conclusion that Mr. MacDonald was not exposed to risk by reason of his ownership of the BNS shares was based on his intent to never sell the shares as well as the expert evidence. As she was entitled to do, the Tax Court judge rejected the evidence of the Crown's expert witness and accepted that a transaction was required as price fluctuations would have no effect on Mr. MacDonald (Memorandum of the respondent, para. 88).

[46] Moreover, the Tax Court judge did not err in finding that the loan bore no relationship to the Forward Contract and that it did not establish a link between the Forward Contract and the BNS shares (Memorandum of the respondent, paras. 90 to 92). In coming to this conclusion, the Tax Court judge relied on the testimony of Mr. MacDonald, the testimony of both experts and the fact that Mr. MacDonald was affluent and could repay the loan (Memorandum of the respondent, para. 93).

**ANALYSIS AND DISPOSITION**

- *Standard of review*

[47] The issue to be decided in this appeal turns on the definition of a hedge for tax purposes and whether the Forward Contract is a hedging instrument when this definition is applied to the facts at hand. Ascertaining the meaning of a hedge gives rise to a question of law, reviewable on the standard of correctness (*Housen v. Nikolaisen*, 2002 SCC 33, [2002] 2 S.C.R. 235, at para. 8). The application of this definition to the facts at hand gives rise to a question of mixed fact and law which, in the absence of an extricable legal error, cannot be interfered with unless an overriding and palpable error can be demonstrated (*Ibidem* at paras. 36 and 37).

- *The analytical approach*

[48] This appeal does not turn on whether the Tax Court judge chose the proper analytical approach in addressing the issue before her because regardless of the approach taken, the matter must ultimately be resolved by ascertaining whether the Forward Contract is a hedging instrument. The Tax Court judge recognized as much at paragraph 80 of her reasons. It remains however that the hedging issue, if decided in favour of the Minister, stood to resolve the matter whereas the trading issue, however decided, could not. Given this, the analysis should have begun with the hedging issue.

[49] The Tax Court judge explained that addressing the trading issue first was in accordance with the structure of the Act (Section 3) and “the principles for ascertaining profits under

subsection 9(1) of the Act developed by the Supreme Court of Canada in *Canderel Ltd v Canada*, [1998] 1 SCR 147, [1998] SCJ No 13 (QL) [*Canderel*] […]" (Reasons, para. 35). However, no issue of profit computation arises if the Forward Contract is a hedging instrument. The Tax Court judge also suggested, relying on *Friesen v. Canada*, [1995] 3 S.C.R. 103, [1995] 2 C.T.C. 369 [*Friesen*], that income from a source (paragraph 3*a*) of the Act) should be considered prior to income derived from the taxable portion of capital gains (paragraph 3*b*)). While *Friesen* speaks of this distinction, no particular hierarchy is proposed.

[50] I therefore begin by considering the hedging issue.

- *The hedging issue*

[51] It is well established that for income tax purposes, the treatment of any gain or loss derived from a hedging instrument is determined by the character of the asset being hedged (*Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622, [*Shell*] paras. 68 and 70, citing *Tip Top Tailors Ltd. v. Minister of National Revenue*, 1957 CanLII 71 (SCC), [1957] S.C.R. 703, [*Tip Top Tailors*], at p. 707; *Alberta Gas Trunk Line Co. v. M.N.R.*, 1971 CanLII 179 (SCC), [1972] S.C.R. 498; *Columbia Records of Canada Ltd. v. M.N.R.*, [1971] C.T.C. 839 (F.C.T.D.). In the present case, the BNS shares held by the respondent during the period when the Forward Contract was in place were capital property in his hands so that if the Forward Contract had the effect of hedging risk linked to these shares, the losses incurred by the respondent as a result of having been required to make cash settlement payments will be treated as capital losses.

[52] The leading authority as to what constitutes hedging under Canadian law is the decision of the Supreme Court in *Placer Dome.* The issue in that case was whether "hedging" as defined under the *Mining Tax Act*, R.S.O. 1990, c. M.15 was restricted to transactions that result in physical delivery of the output of a mine or include profits derived from "hedging" programs in respect of mining operations (*Placer Dome*, para. 1).

[53] In order to answer this question, the Supreme Court identified the act of "hedging" on the basis of its commonly understood meaning under Generally Accepted Accounting Principles (GAAP). It explained that "financial derivatives are contracts whose value is based on the value of an underlying asset, reference rate, or index." (*Placer Dome*, para. 29). It further identified the distinction between speculation and hedging as follows (*Ibidem*):

> A transaction is a hedge where the party to it genuinely has assets or liabilities exposed to market fluctuations, while speculation is "the degree to which a hedger engages in derivatives transactions with a notional value in excess of its actual risk exposure."[…] (reference omitted)

[54] As the derivative contracts in that case did not exceed the output of the mine, they were held to be hedging instruments rather than speculative instruments. Specifically, these instruments had the effect of fixing a price for the output of a mine before delivery by forward sale thereby eliminating the risk inherent in the fluctuation in price of the gold output (*Placer Dome*, para. 52).

[55] Applying this approach to the case at hand, the number of BNS shares held by Mr. MacDonald throughout the period during which the Forward Contract was in place exceeded the number of Reference Shares covered under the Forward Contract, so that market fluctuation risk

was effectively neutralized or mitigated with respect to the corresponding number of BNS shares owned by Mr. MacDonald during this period. Stated differently, the amount of any cash settlement payment which Mr. MacDonald could become entitled to receive or be required to make under the Forward Contract was inversely proportional to the loss or gain on the corresponding number of shares that he held computed on the basis of the Reference Price at the time.

[56] Although the BNS shares held by the respondent were fungible, the Forward Contract at the outset had the effect of neutralizing or mitigating risk on the specific block of shares which was pledged by Mr. MacDonald while the credit facility offered by the TD Bank was in place. As the loan was repaid and shares were released to Mr. MacDonald under the Securities Pledge Agreement, the Forward Contract continued to have that effect on the BNS shares that he held, up to the remaining number of Reference Shares covered by the Forward Contract.

[57] The Supreme Court in *Placer Dome* also explained that forward contracts may be settled by physical delivery of the underlying asset or by cash settlements. It observed that most derivative contracts are not settled by physical delivery. Of particular significance for present purposes is the holding that "the way in which a derivative contract functions as a 'hedge' is unaffected by the method by which the contract is settled." (*Placer Dome*, para. 31).

[58] The Tax Court judge did not apply *Placer Dome* in addressing the issue before her. She explained that *Placer Dome* is based on GAAP and cited another decision of the Supreme Court

– *Canderel* – for the proposition that GAAP is not determinative of the manner in which income is computed under the Act (Reasons, para. 70).

[59] As noted earlier, the issue to be decided in this case is not one of income computation and although GAAP is not determinative in addressing issues arising under the Act, it is often helpful (*Canderel*, para. 35). Notably, the definition of a hedge under GAAP was relied upon in *Echo Bay Mines*, a case involving the computation of income under the Act. *Echo Bay Mines* bears many similarities with *Placer Dome*. The specific issue being addressed in that case was whether receipts from the settlement of forward sales contracts entered into in order to neutralize price fluctuation of the output of a mine were part of "resource profits" under the Act.

[60] The Supreme Court in *Placer Dome* endorsed the conclusion reached in *Echo Bay Mines*. After noting that under GAAP, no distinction is to be made between cash settled and delivery settled contracts (*Placer Dome*, para. 34), the Court said (*Ibidem*, para. 35):

> Although I am mindful that *Echo Bay Mines* concerned a different statute, one in which "hedging" is not a defined term, I conclude that the general principles articulated in that case have some relevance here. The central issue in *Echo Bay Mines* was whether gains and losses from hedging were sufficiently linked to the underlying transactions, namely the production and sale of silver, to constitute "resource profits" within the meaning of the Regulations under the *Income Tax Act*. In essence, the court in *Echo Bay Mines* was grappling with the same question that is raised in the present case: Can synthetic derivative transactions be said to "fix the price" for the underlying commodity even where those transactions do not result in the delivery of the underlying commodity?

[61] I do not believe that it was open to the Tax Court judge to move away from the test set out in *Placer Dome* in determining whether the Forward Contract entered into by Mr.

MacDonald is a hedging instrument (Compare *George Weston*, paras. 68 and 69). Under that test, the Forward Contract is a hedging instrument if it neutralizes or mitigates risk to which the underlying asset is exposed, and there is no issue that this was the effect of the Forward Contract on Mr. MacDonald's BNS shares from the time when they were pledged and thereafter up to the time when the last cash settlement payment was made and the remaining Reference Shares were finally settled.

[62] The Tax Court judge was concerned that applying *Placer Dome* to Mr. MacDonald's situation would make it "impossible to ever speculate using a derivative instrument while maintaining a long position in an asset." (Reasons, para. 68). However, there is nothing untoward about this result as it is based on the inescapable logic that a person can neither gain nor lose by entering into a derivative instrument while owning assets whose value is protected by this instrument. *George Weston* reflects the latest reiteration of this rule albeit in the context of a risk arising from ownership of property rather than a transactional risk.

- *Intention to hedge*

[63] The Tax Court judge discounted the fact that Mr. MacDonald owned corresponding assets of equal value to the reference property covered by the Forward Contract. She did so on the basis that Mr. MacDonald's clear intent in entering into the Forward Contract was not to hedge but to speculate (Reasons, para. 96). She further explained at various points in her reasons that since Mr. MacDonald did not "intend to ever sell his BNS shares", there was no risk for him to hedge (Reasons, para. 66; see also paras. 68 and 104).

[64] This assumes both that intent is a condition precedent for hedging and that ownership of assets whose value is subject to market fluctuations does not carry a risk, a proposition that is contrary to the one established in *George Weston* (See paragraphs 77 to 90 below).

[65] The 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 between June 6 and July 2, 1997 (See paragraphs 8 to 14 above). However, nothing turns on the findings made by the Tax Court judge in this regard as intent is not a condition precedent for hedging.

[66] The question whether intent is a prerequisite for hedging was not the subject of extensive debate before the Tax Court judge as it appears that the Crown conceded, as it does here, that a commercial or business purpose for mitigating a risk must be present in order for hedging to take place (Memorandum of the Crown, para. 38). However, being one of law, the question whether an intent to hedge is a prerequisite for hedging is for the Court to decide.

[67] While the case law to which the Tax Court judge referred shows that foresight of an impending risk is a necessary element of a hedging exercise, I am aware of no case which makes an intent to hedge a condition precedent for hedging. The passage from the Privy Council decision in *Grain Futures* cited by Mr. MacDonald in support of the contrary proposition must be read in that light (Memorandum of the respondent, para. 49).

[68] Counsel for the respondent also referred to numerous paragraphs from the reasons of the Tax Court in *George Weston* where "intent to speculate" is used in contrast with "intent to

hedge". Again, persons who enter into derivative contracts which have the effect of hedging risk on assets that they own are taken to understand the consequences of their actions, and *George Weston* was argued on the basis that the appellant was either intent on speculating or engaged in hedging (See for instance *George Weston* at paragraphs 87, 88, 89). There is no basis for the Tax Court judge's conclusion that *George Weston* "confirmed" that an intent to hedge is a prerequisite for hedging (Reasons, para. 95). Indeed, the issue is not even discussed.

[69] When regard is had to the binding authority on point, what is required in order for hedging to take place is that "the party to [a derivative contract] genuinely has assets […] exposed to market fluctuations […]" and the contract neutralizes or mitigates the exposure to this risk on the assets owned by the party (*Placer Dome*, para. 29). Although, as noted, the person concerned must understand the nature of the contract being entered into, an intention to hedge has never been made a prerequisite for hedging.

[70] If this be the state of the law as I believe it is, counsel for the respondent invited the Court to alter it so as to make intention a prerequisite for hedging. According to counsel, failure to do so would give rise to an "accidental hedge" (Memorandum of the respondent, para. 66). He gave the example of a person who enters into a contract to sell forward 100 BNS shares while holding none, but who inherits 100 BNS shares before the forward date. The person would thereby become an "accidental hedger".

[71] At first glance, the so called "accidental hedger" would not be caught by the existing test as the person concerned could not possibly have understood that the contract entered into would

have the effect of mitigating risk. Mr. MacDonald, however, is not in that position as he owned assets covered by the Forward Contract at the time when it was entered into and was fully aware that the contract would mitigate risk on those assets. The Tax Court judge did not address this issue given her finding that Mr. MacDonald did not intend to hedge.

[72] The evidence which bears on this point requires consideration of the credit facility which was negotiated with the TD Bank when the Forward Contract was entered into. Mr. MacDonald entered into the Forward Contract on June 26, 1997 while the credit facility was in the process of being organized. The initial credit offer was made on June 6, 1997. Entering into and maintaining the Forward Contract in place was a condition precedent for the loan. Mr. MacDonald was also required to pledge a block of his BNS shares commensurate with the number of Reference Shares covered by the Forward Contract – *i.e.*: 165,000 BNS shares – and to assign to the TD Bank any payment to which he could become entitled thereunder. Finally, he was required to produce a net worth statement periodically in order to demonstrate that he had the ongoing financial capacity to make cash settlement payments under the Forward Contract should he be called upon to do so (Appeal Book, Vol. IV, pp. 945-946). The credit facility was advanced on July 7, 1997. It is common ground that as a result of these transactions, the BNS shares that were pledged by Mr. MacDonald were protected from market fluctuation risk throughout the period during which the Forward Contract was in place, thereby achieving a perfect hedge.

[73] When questioned about this outcome, counsel for Mr. MacDonald pointed out that it was the lender and not his client who wanted the value of the pledged shares to be protected from

market fluctuation risk. However, it was Mr. MacDonald who wanted the credit facility (Transcripts of Mr. MacDonald's cross-examination, p. 113, lines 4 to 8), and he took the steps proposed by the lender in order to obtain it. Although counsel insists that Mr. MacDonald had no personal interest in neutralizing market fluctuation risk on the shares that he pledged, it remains that he was fully aware that risk had to be neutralized for the benefit of the lender. This is not a case of hedging by accident.

[74] I now turn to the question whether the Forward Contract immunized Mr. MacDonald's BNS shares from risk.

- *Were Mr. MacDonald's shares immunized from risk?*

[75] The Tax Court judge answered this question in the negative. She explained that in addition to the criterion of intent, hedging requires the presence of a close link between the Forward Contract and the underlying asset or transaction giving rise to risk and that the link be closely proximate in terms of timing and quantum (Reasons, paras. 86 and 95). Applying this test, she held that the link in this case was insufficient to conclude that a transactional risk (Reasons, para. 112) or a risk arising from ownership (Reasons, para. 104) had been hedged.

[76] The Tax Court judge first considered whether the Forward Contract had been used to hedge a transactional risk, specifically whether the loss represented by the cash settlement payments were neutralized or mitigated by the offsetting gains realized by Mr. MacDonald on the sale of some of his BNS shares while the Forward Contract was in force. After a lengthy analysis, she found that the required linkage was not present.

[77] This, however, was not an issue which she had to decide as no transactional risk was alleged to have been hedged. The Crown's sole position throughout has been that Mr. MacDonald hedged the risk to which he was exposed by reason of owning his BNS shares (Reply to the Amended Notice of Appeal, paras. 14.33; Reasons, para. 97).

[78] The question surrounding ownership risk and whether such a risk is capable of being hedged for tax purposes was addressed by the Tax Court in *George Weston*. Until *George Weston*, the decided cases all dealt with derivative contracts which have the effect of neutralizing or mitigating a transactional risk – *i.e.*: the sale of the mining output in *Placer Dome* and *Echo Bay Mines*, the purchase of materials used in the course of business in *Atlantic Sugar Refineries v. Minister of National Revenue*, [1949] S.C.R. 706 at 711 and *Tip Top Tailors* or the repayment of a foreign currency loan in *Shell*. Thus, in all these instances, it was a transactional risk that was offset through the use of a hedging instrument.

[79] *George Weston* involved currency swaps entered into in order to neutralize the impact of currency fluctuations on George Weston's consolidated balance sheet. The risk was caused by its subsidiary's acquisition of a U.S. based business in U.S. dollars by way of debt financing. As a result, cross-currency fluctuations would impact on the equity section of the corporate group's consolidated balance sheet. George Weston therefore entered into currency swaps whose value varied inversely with the value of its U.S. investments thereby ensuring that its debt to equity ratio would be unaffected by these fluctuations. The currency swaps turned out to be a lucrative exercise for George Weston as it ended up being "in the money" by over 300 million Canadian dollars when the swaps were terminated.

[80] Lamarre A.C.J. held for the first time that risk associated with the fluctuating value of assets can be hedged for tax purposes. In so holding, she rejected the Crown's contention that the currency risk associated with George Weston's increasing debt to equity ratio as a result of its expanded indirect holdings in U.S. assets could not be hedged because the risk was not associated with a transaction (*George Weston*, paras. 52, 76 and 81). No appeal was taken from that decision.

[81] The risk in *George Weston* arose by reason of the cross-currency fluctuation between the Canadian dollar and U.S. dollar. This had the potential of impacting negatively on George Weston's balance sheet. This was a real risk which George Weston neutralized through the swaps. Lamarre A.C.J. held that protecting one's financial position against an identified risk over time is hedging and this is what George Weston achieved by the swaps which it entered into.

[82] Neither the Tax Court judge nor the parties took issue with *George Weston* and I have no reason to question its correctness. Although the situation is novel, none of the binding precedents, including *Shell*, requires that a derivative transaction be linked to a gain or loss resulting from a separate transaction (*George Weston*, para. 81). A risk arising from ownership is equally capable of being hedged and there is no reason why the established rule that hedging gains or losses are treated the same way as the assets being hedged for tax purposes, should not apply (*Ibidem*).

[83] The Crown reiterates before us her position that *George Weston* was dispositive of the issue before the Tax Court judge and ought to have been followed. I agree. As was the case with

respect to George Weston's U.S. assets, the value of the shares which Mr. MacDonald pledged in order to obtain his credit facility, as well as the corresponding number of BNS shares that he continued to hold after making cash settlement payments, were immunized from market fluctuation risk while the Forward Contract was in place.

[84] The Tax Court judge declined to apply *George Weston* on two grounds. First, she held that the present situation "is entirely different" because (Reasons, para. 104):

> […] Mr. MacDonald could not have been exposed to a risk associated with the ownership of the BNS shares since he did not want to ever sell the BNS shares […] As long as he did not sell the BNS shares, he suffered no risk in holding the BNS shares and I do not see how price fluctuations could have affected him.

[85] In so holding, the Tax Court judge failed to appreciate the distinction between transactional risk and ownership risk. Although, the fact that Mr. MacDonald did not want to ever sell his BNS shares would foreclose the existence of a transactional risk, ownership risk can only exist if the underlying property is not sold. An intent to never sell is wholly consistent with the existence of ownership risk.

[86] This belief that Mr. MacDonald had no risk to hedge sealed the outcome from the Tax Court judge's perspective as Mr. MacDonald could not possibly have hedged a risk that he did not have (Reasons, para. 105). However, the reality is that Mr. MacDonald's BNS shares were exposed to market fluctuation risk the same way as George Weston's U.S. assets were exposed to cross-currency fluctuation risk, and in both cases, this risk could impact on their respective worth when measured in terms of the value of these assets in their hands. The respective derivative contracts neutralized this risk.

[87] The Tax Court judge also distinguished *George Weston* on the basis that the risk in that case arose by reason of a “triggering event” – *i.e.*: the U.S. acquisition – whereas no such event occurred here. She noted that in contrast, Mr. MacDonald has been the owner of his BNS shares for some thirty years (Reasons, para. 107).

[88] With respect, whether the assets which give rise to ownership risk have long been held or were recently acquired is immaterial. There is no inconsistency between long term ownership and hedging a risk associated with ownership. What matters is that Mr. MacDonald’s BNS shares were exposed to market fluctuation risk and that this risk was neutralized by the Forward Contract.

[89] Finally, nothing more needs be demonstrated in order to establish that ownership risk was hedged by the Forward Contract. In this respect, the Tax Court judge appeared to hold that the required “linkage” was not present because the BNS shares are not “Delivery Assets” under the Forward Contract but are “Reference Shares” or “Reference Assets” (Reasons, paras. 98 to 100). The suggestion, as I understand it, is that in order to qualify, the Forward Contract had to be a “same asset hedge of the BNS shares” and that the Forward Contract fell short of this description because the settlements had to be made by cash payments rather than by the delivery of shares (Reasons, para. 99).

[90] With respect, this linkage question, which arose from a debate between the experts, is irrelevant when regard is had to *Placer Dome*. As noted, the Supreme Court in that case considered the impact of the mode of settlement on the operation of a hedging instrument and

held that hedging is unaffected by the way in which the contract is settled. The logic behind this conclusion seems unassailable, and I see no basis on which the Tax Court judge could have held that the mode of settlement had any bearing on the issue before her.

[91] Had the Tax Court judge followed the reasoning set out in *George Weston*, she would have been bound to conclude that risk capable of being hedged did result from Mr. MacDonald's share ownership and that this risk was neutralized by the Forward Contract which he entered into.

- *Summary of conclusions*

[92] Based on the case law, an intention to hedge is not a condition precedent for hedging. 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.

[93] Mr. MacDonald was not an "accidental hedger". He was aware of the hedging effect which the Forward Contract would have on the BNS shares that he pledged to the TD Bank and that it would continue to have on the corresponding number of shares that he held thereafter while the Forward Contract was in force.

[94] The Tax Court judge's decision allows Mr. MacDonald to deduct the settlement payments as business losses even though the corresponding number of BNS shares that he held

while the Forward Contract was in place are capital property in his hands thereby failing to adhere to the linkage principle, as developed by the case law.

[95] The Tax Court judge erred in law in not following binding precedents, in particular the definition of a hedge given by the Supreme Court in *Placer Dome*. She further erred in distinguishing *George Weston* on the basis that Mr. MacDonald had no ownership risk to hedge. Had she appreciated that Mr. MacDonald's BNS shares were exposed to risk and followed the case law, she would have been bound to conclude that this risk was mitigated by the Forward Contract that he entered into.

- *Disposition*

[96] For these reasons, I would allow the appeal with costs, set aside the decision of the Tax Court judge and giving the judgment which she ought to have given, I would confirm the validity of the reassessments issued against Mr. MacDonald, with costs.

"Marc Noël"
Chief Justice

"I agree
Pelletier J.A."

"I agree
de Montigny J.A."

# FEDERAL COURT OF APPEAL

## NAMES OF COUNSEL AND SOLICITORS OF RECORD

| | |
|---|---|
| **DOCKET:** | A-281-17 |
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| **DATED:** | JUNE 29, 2018 |

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