



SUPREME COURT OF CANADA

CITATION: MacDonald v. Canada, 2020 SCC 6

APPEAL HEARD: October 17, 2019

JUDGMENT RENDERED: March 13, 2020

DOCKET: 38320

BETWEEN:

James S. A. MacDonald
Appellant

and

Her Majesty The Queen
Respondent

CORAM: Wagner C.J. and Abella, Moldaver, Karakatsanis, Côté, Brown, Rowe, Martin and Kasirer JJ.

REASONS FOR JUDGMENT:
(paras. 1 to 45)

Abella J. (Wagner C.J. and Moldaver, Karakatsanis, Brown, Rowe, Martin and Kasirer JJ. concurring)

DISSENTING REASONS:
(paras. 46 to 88)

Côté J.

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MACDONALD v. CANADA

James S. A. MacDonald

Appellant

v.

Her Majesty The Queen

Respondent

Indexed as: MacDonald v. Canada

2020 SCC 6

File No.: 38320.

2019: October 17; 2020: March 13.

Present: Wagner C.J. and Abella, Moldaver, Karakatsanis, Côté, Brown, Rowe, Martin and Kasirer JJ.

ON APPEAL FROM THE FEDERAL COURT OF APPEAL

Taxation — Derivative contracts — Hedging — Subjective and objective intention — Linkage — Taxpayer entering into derivative contract — Taxpayer pledging cash settlement payments and underlying asset from derivative contract as collateral for loan — Whether derivative contract should be characterized as hedge

or speculation — Whether gains or losses arising from derivative contract are taxable on income or capital account.

In 1988, M became the owner of 183,333 common shares of the Bank of Nova Scotia. In 1997, the Toronto-Dominion Bank offered M a loan for up to \$10.5 million. The loan also contemplated and required the existence of a forward contract as part of the pledge. A forward contract is a type of derivative contract that creates an obligation for one party to sell, and another party to buy, an underlying asset at a pre-determined future date and at a pre-determined price.

Shortly before signing the loan and pledge agreements to gain access to the loan, M entered into the forward contract with TD Securities Inc. The assets underlying the forward contract were 165,000 Bank of Nova Scotia shares, the same number of shares M eventually pledged as collateral for the loan. The forward contract was to be cash settled and was structured so that M would make money if the Bank of Nova Scotia stock price decreased. M was required to pledge Bank of Nova Scotia shares and any cash settlement payments he was entitled to receive from the forward contract as security for the loan. M entered into the forward contract with TD Securities Inc. on June 26, 1997.

During the life of the forward contract, the price of Bank of Nova Scotia shares increased and M made cash settlement payments totaling approximately \$10 million. In computing his income for the 2004, 2005 and 2006 taxation years, M characterized the cash settlement payments as income losses deductible against

income from other sources. The Minister of National Revenue reassessed M and characterized the cash settlement payments as capital losses on the basis that the forward contract was a hedge of the Bank of Nova Scotia shares. M filed notices of objection based on the position that he used the forward contract for speculation, not hedging. The Tax Court concluded that the forward contract was a speculative instrument such that the cash settlement payments were properly characterized as losses on account of income. The Federal Court of Appeal unanimously allowed the Crown's appeal, holding that the forward contract was a hedge of M's Bank of Nova Scotia shares and, therefore, the cash settlement payments were capital losses.

Held (Côté J. dissenting): The appeal should be dismissed.

Per Wagner C.J. and **Abella**, Moldaver, Karakatsanis, Brown, Rowe, Martin and Kasirer JJ.: Whether gains and losses from derivative contracts are to be characterized as on income account or on capital account depends on whether the contract is considered a hedge or speculation. A hedge is generally a transaction which mitigates risk, while speculation is the taking on of risk with a view to earning a profit. Gains and losses arising from hedging derivative contracts take on the character of the underlying asset, liability or transaction being hedged.

The characterization of a derivative contract turns on the contract's purpose. While subjective manifestations of purpose may sometimes be relevant, the taxpayer's stated intention is not determinative. The primary source of ascertaining a

derivative contract's purpose is the linkage between the derivative contract and any underlying asset, liability or transaction purportedly hedged.

The linkage analysis begins with the identification of an underlying asset, liability or transaction which exposes the taxpayer to a particular financial risk, and then requires consideration of the extent to which the derivative contract mitigates or neutralizes the identified risk. The more effective the derivative contract is at mitigating or neutralizing the identified risk and the more closely connected the derivative contract is to the item purportedly hedged, the stronger the inference that the purpose of the derivative contract was to hedge. Perfect linkage is not required to conclude that the purpose of a derivative contract was to hedge and the method by which a derivative contract is settled is not determinative of linkage or, ultimately, purpose. The relationship between the derivative contract and transactions or assets outside of the derivative contract will very often be relevant.

While M did not immediately sell his Bank of Nova Scotia shares to offset his losses under the forward contract, the absence of a synchronous transaction used to offset gains or losses arising from a derivative contract is not equivalent to the absence of risk and is not, by itself, determinative of the characterization of a derivative contract. In this case, the substantial linkage between the forward contract and the Bank of Nova Scotia shares fully supports the conclusion that the forward contract was a hedge. The forward contract had the effect of nearly perfectly

neutralizing fluctuations in the price of Bank of Nova Scotia shares, pointing to the necessary linkage.

The purpose of the forward contract as a hedging instrument is most apparent when one considers the forward contract alongside the loan and pledge agreements. The loan and pledge agreements are part of the context relevant to ascertaining the purpose of the forward contract. They gave M access to a large credit facility but required him to maintain the forward contract and to pledge, as collateral, Bank of Nova Scotia shares and all cash settlement payments owed to him pursuant to the forward contract. The credit available to M could not exceed 95% of the value of his pledged Bank of Nova Scotia shares, and the shares pledged as collateral matched the shares contemplated by the forward contract. This arrangement allowed M access to a large credit facility on attractive terms. It also allowed Toronto-Dominion Bank to provide the credit facility with the guarantee of collateral that was free from market fluctuation risk, since if the price of Bank of Nova Scotia shares increased, the value of M's pledged shares would increase proportionally, but if the price decreased, M would be entitled to an offsetting cash settlement payment which would automatically be pledged as collateral. This arrangement reveals the necessary linkage between M's Bank of Nova Scotia shares and the forward contract to indicate a hedging purpose.

The cash settlement payments arising from the forward contract derive their income tax treatment from the underlying Bank of Nova Scotia shares, which the parties agree were held by M on account of capital. When considered in its full

and proper context, it is clear that the purpose of the forward contract was to hedge against market price fluctuations that M's Bank of Nova Scotia shares were exposed to.

Per Côté J. (dissenting): The appeal should be allowed and the trial judge's order restored. There is disagreement with the majority regarding the meaning of intent, the majority's interference with the trial judge's findings of fact and the relationship between the forward contract and M's arrangements with other entities. There is no basis for intervening in the trial judge's finding that M intended to speculate and not to hedge.

The tax characterization of the forward contract turns on the taxpayer's intent, which is determined by reviewing the taxpayer's subjective statements of intent and objective manifestations of intent. Neither the objective nor the subjective element is determinative on its own. A hedge may exist for tax purposes despite the absence of a synchronous transaction used to offset gains or losses arising from a derivative contract due to ownership risk. Ownership risk is a concept which recognizes that the owner of an asset is exposed to risks arising from fluctuations in the value of the asset, notwithstanding that the owner does not intend to sell the asset (and thereby incur a transactional risk).

The majority adopts a test which purports to be similarly anchored on a taxpayer's subjective statements and objective manifestations of intent. However, its analysis looks only to the economic effects of the derivative instrument in order to

ascertain its tax character. The majority's test will introduce a significant degree of uncertainty into the tax treatment of derivative instruments, because a test which is in effect based solely on risk mitigation will have extensive repercussions for the taxation of financial derivatives.

There is disagreement with the majority on its treatment of the forward contract between M and TD Securities Inc. as an indistinguishable component of the credit facility and the securities pledge agreement between M and Toronto-Dominion Bank. It is not a court's role to prevent taxpayers from relying on the sophisticated structure of their transactions by imposing tax according to the transactions true economic and commercial effects. The tax character of the losses from the forward contract is not affected by M's arrangements with other entities. The forward contract must be considered separately from the credit facility and the securities pledge agreement. Further, in tax characterization cases, it is the intention of the taxpayer which the court is concerned with, not the intention of other entities on the other side of the taxpayer's transaction. Therefore, Toronto-Dominion Bank's interest in mitigating the risk of the Bank of Nova Scotia shares is not relevant. In order for the forward contract to constitute a hedge, it and M's ownership risk in the Bank of Nova Scotia shares must stand on their own.

There is further disagreement with the majority's three purported legal errors which they impute to the trial judge. Regarding the first error, the majority's critique amounts to a difference of opinion as to the weight to be ascribed to the

forward contract's mode of settlement and to M's evidence. The trial judge correctly identified and applied the relevant legal principles. She did not treat the mode of settlement as determinative. She did not treat M's statements of intent as determinative. There is no basis for the Court to intervene. The second of the purported errors is based on a flawed reading of the trial judge's reasons. The trial judge did not deny that the law recognizes the concept of ownership risk. Rather, she found as a matter of fact that a short-term ownership risk was not a material concern to M and did not therefore inform his conduct or his intentions. With respect to the final purported error, the trial judge's reasons must be considered as a whole. She did not focus solely on the absence of ownership risk. Rather, she considered a number of objective factors and made findings of credibility and reliability which are owed deference on appeal. Absent an extricable legal error, her factual findings that M had intended to speculate and that he had objectively manifested that intent are findings of fact that can be reviewed only for a palpable and overriding error.

Turning to the question of linkage, while the timing connection and quantum connections are imperfect, during its existence the forward contract achieved a theoretical partial economic hedge of M's ownership risk in the Bank of Nova Scotia shares. However, economic realities are not the end of the analysis. M's conduct was more consistent with that of a speculator than of a hedger, because the forward contract was cash-settled and the forward contract was an isolated transaction. On balance, the trial judge's findings of fact should not be overturned on the application of a deferential standard of review, because, while some of the

objective economic indicators are consistent with an intent to hedge, there are also objective circumstances that suggest an intent to speculate.

In the final analysis, the Court should not disregard a unanimous precedent, applicable standards of review, findings of fact and a trial judge's assessment of credibility in order to square a theoretical economic hedge into the round hole of an intention-based test.

Cases Cited

By Abella J.

Considered: *Placer Dome Canada Ltd. v. Ontario (Minister of Finance)*, 2006 SCC 20, [2006] 1 S.C.R. 715; *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622; *A.-G. of Man. v. A.-G. of Can.*, [1925] 2 D.L.R. 691; *Atlantic Sugar Refineries Ltd. v. Minister of National Revenue*, [1949] S.C.R. 706; *Salada Foods Ltd. v. The Queen*, [1974] C.T.C. 201; *Echo Bay Mines Ltd. v. Canada (T.D.)*, [1992] 3 F.C. 707; *George Weston Ltd. v. R.*, 2015 TCC 42, [2015] 4 C.T.C. 2010; **referred to:** *Friesen v. Canada*, [1995] 3 S.C.R. 103; *Ludco Enterprises Ltd. v. Canada*, 2001 SCC 62, [2001] 2 S.C.R. 1082.

By Côté J. (dissenting)

Underwood v. Ocean City Realty Ltd. (1987), 12 B.C.L.R. (2d) 199; *Housen v. Nikolaisen*, 2002 SCC 33, [2002] 2 S.C.R. 235; *Symes v. Canada*, [1993] 4 S.C.R. 695; *Ludco Enterprises Ltd. v. Canada*, 2001 SCC 62, [2001] 2 S.C.R. 1082; *George Weston Ltd. v. R.*, 2015 TCC 42, [2015] 4 C.T.C. 2010; *Barrick Gold Corp. v. R.*, 2017 TCC 18, [2017] 3 C.T.C. 2103; *Echo Bay Mines Ltd. v. Canada (T.D.)*, [1992] 3 F.C. 707; *Atlantic Sugar Refineries Ltd. v. Minister of National Revenue*, [1949] S.C.R. 706; *Salada Foods Ltd. v. The Queen*, [1974] C.T.C. 201; *Canada Safeway Ltd. v. R.*, 2008 FCA 24, [2008] 2 C.T.C. 149; *Friesen v. Canada*, [1995] 3 S.C.R. 103; *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622; *Canada v. Shell Canada Ltd. (C.A.)*, [1998] 3 F.C. 64; *R. v. Javanmardi*, 2019 SCC 54; *Placer Dome Canada Ltd. v. Ontario (Minister of Finance)*, 2006 SCC 20, [2006] 1 S.C.R. 715.

Statutes and Regulations Cited

Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.), s. 3.

Authors Cited

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Grottenthaler, Margaret E., and Philip J. Henderson. *The Law of Financial Derivatives in Canada*. Toronto: Thomson Reuters, 2019 (loose-leaf updated 2019, release 2).

Balmer, Alexandra G. *Regulating Financial Derivatives: Clearing and Central Counterparties*. Northampton, Mass.: Edward Elgar Publishing, 2018.

Krishna, Vern. *Income Tax Law*, 2nd ed. Toronto: Irwin Law, 2012.

Hogg, Peter W., Joanne E. Magee, and Jinyan Li. *Principles of Canadian Income Tax Law*, 7th ed. Toronto: Carswell, 2010.

Li, Jinyan, Joanne Magee, and J. Scott Wilkie. *Principles of Canadian Income Tax Law*, 9th ed. Toronto: Thomson Reuters, 2017.

APPEAL from a judgment of the Federal Court of Appeal (Noël C.J. and Pelletier and de Montigny JJ.A.), 2018 FCA 128, [2019] 2 F.C.R. 302, 2018 D.T.C. 5077, [2019] 3 C.T.C. 79, [2018] F.C.J. No. 680 (QL), 2018 CarswellNat 3400 (WL Can.), setting aside a decision of Lafleur J., 2017 TCC 157, [2018] 1 C.T.C. 2239, 2017 D.T.C. 1104, [2017] T.C.J. No. 121 (QL), 2017 CarswellNat 3934 (WL Can.). Appeal dismissed, Côté J. dissenting.

Matthew Milne-Smith, Elie S. Roth, Stephen S. Ruby and Chenyang Li,
for the appellant.

Daniel Bourgeois and Eric Noble, for the respondent.

The judgment of Wagner C.J. and Abella, Moldaver, Karakatsanis, Brown, Rowe, Martin and Kasirer JJ. was delivered by

ABELLA J. —

[1] This appeal deals with what are known as derivative contracts. Whether gains and losses from these contracts are to be characterized as on income account or on capital account depends on whether the contract is considered a hedge or

speculation. A hedge is generally a transaction which mitigates risk, while speculation is the taking on of risk with a view to earning a profit.

[2] James S. A. MacDonald has over 40 years of capital markets and corporate finance experience. He was the head of mergers and acquisitions at McLeod Young Weir, a brokerage firm engaged in various aspects of corporate finance, when the firm was acquired by the Bank of Nova Scotia in 1988. As a result of this acquisition, Mr. MacDonald became the owner of 183,333 common shares of the Bank of Nova Scotia. He continued his career as an executive at the Bank until March 1997 when he left to start another company.

[3] Shortly after he left the Bank of Nova Scotia, the Toronto-Dominion Bank offered Mr. MacDonald a credit facility for up to \$10.5 million. Under the terms of the offer, Mr. MacDonald was required to pledge Bank of Nova Scotia shares as partial security for the credit facility and the credit available to him would not exceed 95% of the value of these pledged shares. The credit offer also contemplated and required the existence of a “forward contract” as part of the pledge.

[4] A forward contract is an agreement for the purchase/sale of an asset at an agreed future date. More technically, a forward contract is a type of derivative contract that creates an obligation for one party to sell, and another party to buy, an underlying asset (“Reference Asset”) at a pre-determined future date (“Forward Date”) and at a pre-determined price (“Forward Price”) (*Placer Dome Canada Ltd. v. Ontario (Minister of Finance)*, [2006] 1 S.C.R. 715, at para. 30; Margaret E.

Grottenthaler and Philip J. Henderson, *The Law of Financial Derivatives in Canada* (loose-leaf), at p. 1-5).

[5] Forward contracts can be settled by physical delivery of the underlying asset, or “cash settled” by one party paying the other based on whether the Forward Price is higher or lower than the market price on the Forward Date (*Placer Dome*, at para. 31; Grottenthaler and Henderson, at p. 11-18). In either case, forward contracts essentially function to “remove uncertainties relating to future price changes” of the Reference Asset (Alexandra G. Balmer, *Regulating Financial Derivatives: Clearing and Central Counterparties* (2018), at p. 24).

[6] Mr. MacDonald entered into the forward contract with TD Securities Inc. on June 26, 1997. The Reference Assets underlying the forward contract were 165,000 Bank of Nova Scotia shares. The forward contract was to be cash settled and was structured so that Mr. MacDonald would make money if the Bank of Nova Scotia stock price decreased. Specifically,

(a) if the 165,000 Bank of Nova Scotia shares decreased in value, TD Securities would pay Mr. MacDonald the full amount of the decrease (i.e., the amount by which the Forward Price exceeded the actual market price on the Forward Date multiplied by the number of Bank of Nova Scotia shares (165,000));

and

(b) if the 165,000 Bank of Nova Scotia shares increased in value, Mr. MacDonald would pay TD Securities the full amount of the increase (i.e., the amount by which the Forward Price fell below the actual market price on the Forward Date, multiplied by the number of Bank of Nova Scotia shares (165,000)).

[7] Payments made pursuant to the forward contract were known as “Cash Settlement Payments”. Mr. MacDonald had the option of terminating the contract early by making appropriate Cash Settlement Payments. He did so on several occasions with respect to a number of shares, which had the effect of correspondingly reducing the number of shares included under the forward contract.

[8] On July 2, 1997, Mr. MacDonald signed a pledge agreement, whereby he pledged 165,000 of his Bank of Nova Scotia shares and any Cash Settlement Payments he was entitled to receive from the forward contract as security for the credit facility. He formally accepted the credit offer shortly after on July 7, 1997.

[9] The parties originally set a Forward Date of June 26, 2002, but the contract was extended and amended several times before it was terminated on March 29, 2006.

[10] During the life of the forward contract, the price of Bank of Nova Scotia shares increased and Mr. MacDonald made Cash Settlement Payments totaling approximately \$10 million.

[11] In computing his income for his 2004, 2005 and 2006 taxation years, Mr. MacDonald took the position that he used the forward contract for speculation, not hedging and, on this basis, characterized the Cash Settlement Payments as income losses deductible against income from other sources. The Minister of National Revenue reassessed Mr. MacDonald and characterized the Cash Settlement Payments as capital losses — which could only be deducted against capital gains — on the basis that the forward contract was a hedge of the Bank of Nova Scotia shares Mr. MacDonald held on account of capital.

[12] Mr. MacDonald filed notices of objection and appealed the reassessments to the Tax Court of Canada ([2018] 1 C.T.C. 2239).

[13] The trial judge held that Mr. MacDonald's sole intention in entering into the forward contract was to speculate, not hedge and that there was no linkage between the forward contract and Mr. MacDonald's Bank of Nova Scotia shares. On this basis, she concluded that the forward contract was a speculative instrument and the Cash Settlement Payments were properly characterized as losses on account of income.

[14] Writing for a unanimous court, Noël C.J. allowed the Crown's appeal ([2019] 2 F.C.R. 302). In his view, intention is not a condition precedent to hedging: a derivative contract will be a hedging instrument if the party entering into the contract owns assets exposed to risk from market fluctuation, the contract neutralizes or mitigates this risk, and the party entering into the contract understands the contract's

nature. These requirements were met in this case since Mr. MacDonald owned Bank of Nova Scotia shares exposed to risk from market fluctuation, the forward contract had the effect of neutralizing that risk, and Mr. MacDonald understood that it had this effect. Mr. MacDonald's testimony regarding his intentions could not overwhelm these facts. For these reasons, Noël C.J. concluded that the forward contract was a hedge of Mr. MacDonald's Bank of Nova Scotia shares and, therefore, the Cash Settlement Payments were capital losses.

[15] For the following reasons, I would dismiss the appeal.

Analysis

[16] The basis for determining the income of a taxpayer is found in s. 3 of the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.):

3. The income of a taxpayer for a taxation year for the purposes of this Part is the taxpayer's income for the year determined by the following rules:

(a) determine the total of all amounts each of which is the taxpayer's income for the year (other than a taxable capital gain from the disposition of a property) from a source inside or outside Canada, including, without restricting the generality of the foregoing, the taxpayer's income for the year from each office, employment, business and property,

(b) determine the amount, if any, by which

(i) the total of

(A) all of the taxpayer's taxable capital gains for the year from dispositions of property other than listed personal property, and

(B) the taxpayer's taxable net gain for the year from dispositions of listed personal property,

exceeds

(ii) the amount, if any, by which the taxpayer's allowable capital losses for the year from dispositions of property other than listed personal property exceed the taxpayer's allowable business investment losses for the year,

...

(d) determine the amount, if any, by which the amount determined under paragraph (c) exceeds the total of all amounts each of which is the taxpayer's loss for the year from an office, employment, business or property or the taxpayer's allowable business investment loss for the year[.]

[17] In *Friesen v. Canada*, [1995] 3 S.C.R. 103, Major J. explained that s. 3 of the *Income Tax Act*

recognizes two basic categories of income: "ordinary income" from office, employment, business and property, all of which are included in s. 3(a), and income from a capital source, or capital gains which are covered by s. 3(b). The whole structure of the *Income Tax Act* reflects the basic distinction recognized in the Canadian tax system between income and capital gain. [p. 111]

[18] Financial derivatives are "contracts whose value is based on the value of an underlying asset, reference rate, or index" (*Placer Dome*, at para. 29). Depending on the circumstances, gains and losses arising from derivative contracts may be taxable either as income or capital. There are two basic types of derivative contracts which form the building blocks for more complex structures: forward contracts and options. Though both forward contracts and options are about the future purchase/sale

of assets, forward contracts create a mutual obligation to buy/sell, while options provide one party the right, but not the obligation, to purchase/sell the asset (*Placer Dome*, at para. 30; Grottenthaler and Henderson, at p. 1-4).

[19] Regardless of the type, derivative contracts are used for two purposes:

- “to speculate on the movement of the underlying asset, reference rate or index”;

or

- “to hedge exposure to a particular financial risk such as the risk posed by volatility in the prices of commodities” (*Placer Dome*, at para. 29).

[20] The income tax treatment of gains and losses arising from derivative contracts depends on whether the derivative contract is characterized as a hedge or speculation. Gains and losses arising from hedging derivative contracts take on the character of the underlying asset, liability or transaction being hedged (*Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622, at paras. 68-70). In contrast, speculative derivative contracts are characterized on their own terms, independent of an underlying asset or transaction.

[21] In this case, there is no dispute that Mr. MacDonald’s Bank of Nova Scotia shares are a capital asset and that if the forward contract was a hedge of those shares, the Cash Settlement Payments will be characterized as capital losses. There is

also no dispute that if the forward contract was not a hedge of Mr. MacDonald's Bank of Nova Scotia shares, the Cash Settlement Payments will be characterized as income losses.

[22] A long line of jurisprudence supports the conclusion that the characterization of a derivative contract as a hedge turns on the contract's purpose. Purpose is ascertained objectively (*Ludco Enterprises Ltd. v. Canada*, [2001] 2 S.C.R. 1082, at para. 54). While subjective manifestations of purpose may sometimes be relevant, the taxpayer's stated intention, as Noël C.J. noted, is not determinative. The taxpayer's conduct is generally more revealing than "ex post facto declarations" of the taxpayer (Vern Krishna, *Income Tax Law* (2nd ed. 2012), at p. 161; see also Jinyan Li, Joanne Magee and J. Scott Wilkie, *Principles of Canadian Income Tax Law* (9th ed. 2017), at p. 296). As the cases demonstrate, the primary source of ascertaining a derivative contract's purpose is the linkage between the derivative contract and any underlying asset, liability or transaction purportedly hedged. The more closely the derivative contract is linked to the item it is said to hedge, the stronger the inference that the purpose of the derivative contract was hedging.

[23] *A.-G. of Man. v. A.-G. of Can.*, [1925] 2 D.L.R. 691 (P.C.), provides an early description of hedging and of the importance "purpose" and "linkage" play in defining a derivative contract as a hedge. In that case, the Judicial Committee of the Privy Council reviewed the Manitoba legislature's authority to enact the *Grain Futures Taxation Act*, S.M. 1923, c. 17, which imposed a tax on gains arising from

grain futures (a type of derivative instrument similar to a forward contract). In finding the statute *ultra vires*, Viscount Haldane described the use of grain futures as “hedges”, noting that grain sellers use grain futures to “guard against” and “avoid possible loss from a drop in market-price” while waiting to sell their grain on the market (p. 694). He observed that the grain seller does this by buying and selling grain futures equivalent to the quantity of grain actually held with an “aim . . . to eliminate the risk which he runs from fluctuations in the general market-price *while waiting to sell what he actually possesses*” (p. 694 (emphasis added)). As Viscount Haldane’s description implies, the linkage between the underlying asset (the grain possessed) and the derivative contract (the grain futures) is central in defining the contract’s purpose.

[24] A similar understanding of hedging was applied in *Atlantic Sugar Refineries Ltd. v. Minister of National Revenue*, [1949] S.C.R. 706, where this Court explored the bounds of linkage. The issue was how to characterize a sugar refinery’s earnings arising from entering into sugar futures under the *Income War Tax Act*, R.S.C. 1927, c. 97. In concluding that the futures were a hedge, Kerwin J. observed that the subject of the derivative contract was the same as the taxpayer’s business (raw sugar) and found that the purpose of the sugar futures was “to offset losses either actual or feared” from the taxpayer’s purchase of higher-than-normal quantities of raw sugar during wartime conditions (p. 707). He concluded that the profits from these futures were sufficiently connected to the taxpayer’s business operations such that they should be treated the same way as its other business earnings. It was added

by Locke J., in concurring reasons, that although the futures were not entered into at the exact time the raw sugar was purchased, this lack of synchronized timing did not change the essential nature of the futures as a hedge. Locke J. concluded that the futures were a hedge despite testimony of the president of the taxpayer company that the sales “were not in the nature of hedges but speculative transactions” (p. 710).

[25] *Salada Foods Ltd. v. The Queen*, [1974] C.T.C. 201 (F.C.T.D.), provides an example of how an insufficient connection will lead to the conclusion that the derivative contract was entered into for speculation, not hedging purposes. In that case, Salada Foods entered into a forward sale contract for £500,000 with the Canadian Imperial Bank of Commerce, from which it realized a substantial profit. Salada Foods argued that the contract was entered into with the sole purpose of protecting the value of its investment in its U.K. subsidiaries (which it considered capital assets). It submitted, therefore, that gains arising from this contract should be taxed as capital gains. Urie J. rejected the argument, noting that the value of the forward sale contract did not align with the value of Salada Food’s investments into its subsidiaries, and that there was “little or no relationship between the gain received by [Salada Foods] on its forward sale contract and its actual investment loss occurring as a result of the devaluation of the pound” (p. 206). As a result, notwithstanding Salada Food’s stated intentions, Urie J. found that the purpose of the forward sale contract was speculative, and concluded that gains arising from it were taxable on account of income.

[26] The definition of hedging and the required sufficiency of linkage were further discussed in *Echo Bay Mines Ltd. v. Canada (T.D.)*, [1992] 3 F.C. 707. The issue was whether income from the settlement of forward sales contracts for the delivery of silver counted as “resource profits” within the meaning s. 1204(1) of the *Income Tax Regulations*, C.R.C., c. 945. MacKay J. found that the resolution of the case required a determination as to whether the forward sales contracts were a hedge of the mine’s silver production. This in turn required consideration of the following:

[U]nder generally accepted accounting principles [GAAP], a producer’s gain or loss from its execution of forward sales contracts may be considered a “hedge” and therefore matched against the production of the goods produced, if four conditions are met

1. The item to be hedged exposes the enterprise to price (or interest rate) risk.
2. The futures contract reduces that exposure and is designated as a hedge.
3. The significant characteristics and expected terms of the anticipated transactions are identified.
4. It is probable that the anticipated transaction will occur. [pp. 715-16]

[27] MacKay J. concluded that despite imperfect symmetry between the quantum of the forward contracts and the actual production from the mine, and between the timing of production sales and the settlement of the forward contracts, “[e]xact matching was not feasible from a practical point of view, nor is it required in order to constitute hedging” (p. 731). He held that the linkage between the forward contracts and the mine’s production was sufficient to support the conclusion that the

purpose of the forward contracts was to hedge against price fluctuations in silver. On this basis, he concluded that earnings and losses from the forward contracts were to be treated as part of the price received for the silver produced by the mine and included as “resource profits” (p.732).

[28] In *Shell Canada*, a case where the derivative contract in question was agreed to be a hedge, this Court considered the tax treatment of a complex corporate finance arrangement involving several debenture purchase agreements and a forward exchange contract. Under this arrangement, Shell was effectively given access to a US\$100 million loan at a lower-than-normal financing cost by obtaining the loan indirectly through the purchase and sale of New Zealand currency. One of the issues before the Court was the proper income tax treatment of Shell’s gains on the forward exchange contract entered into as part of the loan arrangement. In answering this question, McLachlin J. concluded:

Whether a foreign exchange gain arising from a hedging contract should be characterized as being on income or capital account depends on the characterization of the debt obligation to which the hedge relates. As noted, Shell entered into the Forward Exchange Contract in order to hedge with US\$ the market risk on the Debenture Agreements, which were denominated in NZ\$. Indeed, Shell would not have entered into the Debenture Agreements in the absence of the Forward Exchange Contract. The gain on the Debenture Agreements was characterized as being earned on capital account and so therefore should the gain on the Forward Exchange Contract. [para. 70]

[29] The most recent decision from this Court addressing hedging in the context of derivative contracts is *Placer Dome*. At issue was whether cash settled

derivative contracts qualified as “hedging” transactions under Ontario’s *Mining Tax Act*, R.S.O. 1990, c. M.15. The Minister had previously excluded these contracts from the definition of “hedging” on the basis that cash settled derivative contracts were speculative and did not result in the physical delivery of output from a mine. LeBel J. noted that “[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’” (para. 29, citing Brent W. Kraus, “The Use and Regulation of Derivative Financial Products in Canada” (1999), 9 *W.R.L.S.I.* 31, at p. 38). He concluded that the derivative contracts at issue were “part of a comprehensive program designed to manage the risk associated with fluctuations in the [market] price of gold” and that, under Generally Accepted Accounting Principles (GAAP), “the way in which a derivative contract functions as a ‘hedge’ is unaffected by the method by which the contract is settled” (paras. 5 and 31). He endorsed the test used by the trial judge that, for a derivative contract not settled by physical delivery of a mine’s output to fit within the definition of “hedging” under the *Mining Tax Act*, there must be “some link” or “nexus” between the derivative contract and the output of the mine (para. 14). LeBel J. concluded that the definition of “hedging” under the *Mining Tax Act* included cash settled forward contracts.

[30] *Placer Dome* was considered by the Tax Court in *George Weston Ltd. v. R.*, [2015] 4 C.T.C. 2010, where Lamarre A.C.J. further refined the bounds of sufficient linkage. In *George Weston*, the issue was the proper income tax

characterization of gains from currency-exchange-based swap contracts, a type of derivative contract. The taxpayer, George Weston Ltd., argued that the swaps were entered into to hedge against foreign exchange rate fluctuation associated with its U.S. subsidiaries. The Crown argued that to constitute a hedge, the derivative contract must be associated with an underlying *transaction* and there was no underlying transaction because George Weston did not sell its U.S. subsidiaries.

[31] Lamarre A.C.J. rejected this argument, holding that it is possible for a derivative contract to be used for hedging even if “there is no sale or proposed sale of the underlying item being hedged” (para. 97). She observed that the swaps, though “not linked to the purchase or sale of commodities”, allowed George Weston “to stabilize the value of the USD assets exposed to currency risk on the balance sheet” (para. 77). On the facts of the case, Lamarre A.C.J. concluded that George Weston’s internal policies and the timing and quantum links between the swaps and George Weston’s net investment in its U.S. subsidiaries supported the finding that the swaps were used to hedge, not speculate.

[32] As these cases demonstrate, the characterization of a derivative contract as a hedge turns on its purpose. The primary source for ascertaining a derivative contract’s purpose is the extent of the linkage between the derivative contract and an underlying asset, liability, or transaction. The linkage analysis begins with the identification of an underlying asset, liability or transaction which exposes the taxpayer to a particular financial risk, and then requires consideration of the extent to

which the derivative contract mitigates or neutralizes the identified risk. The more effective the derivative contract is at mitigating or neutralizing the identified risk and the more closely connected the derivative contract is to the item purportedly hedged, the stronger the inference that the purpose of the derivative contract was to hedge. However, as noted, perfect linkage is not required to conclude that the purpose of a derivative contract was to hedge (see e.g. *Atlantic Sugar*, at p. 711; *Echo Bay Mines*, at pp. 22-23; *Placer Dome*, at para. 49; *George Weston*, at paras. 96-98).

[33] In this case, the substantial linkage between the forward contract and Mr. MacDonald's Bank of Nova Scotia shares fully supports Noël C.J.'s conclusion that the forward contract was a hedge.

[34] Based on his testimony, the trial judge found that Mr. MacDonald intended to hold his Bank of Nova Scotia shares indefinitely. On this basis, she concluded that "Mr. MacDonald was exposed to no risk by holding the [Bank of Nova Scotia] shares" and that, as a result, he had increased rather than mitigated his risk exposure by entering into the forward contract (para. 68). I agree with Noël C.J. that this conclusion amounted to an error of law. The absence of a synchronous transaction used to offset gains or losses arising from a derivative contract is not equivalent to the absence of risk and is not, by itself, determinative of the characterization of a derivative contract (see e.g., *George Weston*, at para. 97; *Echo Bay Mines*, at pp. 22-23; *Atlantic Sugar*, at p. 711).

[35] The trial judge's error in concluding that Mr. MacDonald faced no risk from holding his Bank of Nova Scotia shares necessarily led her to conclude that he entered into the forward contract with the intention of speculating. She also allowed Mr. MacDonald's *ex post facto* testimony and the fact that the forward contract was settled by cash, not physical delivery of the Bank of Nova Scotia shares, to overwhelm her analysis. In *Placer Dome*, LeBel J. noted that:

Derivative transactions may be settled in a number of different ways: physical delivery of the underlying asset, cash settlement or offsetting contract. Most derivative contracts, however, are not settled by physical delivery. The most important point about settlement is that, at least for the purposes of GAAP, the way in which a derivative contract functions as a "hedge" is unaffected by the method by which the contract is settled. [para. 31]

[36] Though this statement was made in the context of explaining GAAP, later in his reasons LeBel J. adopted the position of Professors Grottenthaler and Henderson endorsing the holding in *Echo Bay Mines* that cash settled forward contracts and forward contracts settled by physical delivery are economically equivalent and treating them differently for tax purposes would create "an unjustified artificial distinction" (*Placer Dome*, at para. 34, citing Grottenthaler and Henderson, at pp. 11-8 and 11-9). As a result, the method by which a derivative contract is settled is not determinative of linkage or, ultimately, purpose.

[37] The forward contract had the effect of nearly perfectly neutralizing fluctuations in the price of Bank of Nova Scotia shares held by Mr. MacDonald, pointing to a close linkage. The purpose of the forward contract as a hedging

instrument is most apparent when one considers the forward contract alongside the loan and pledge agreements between Mr. MacDonald and TD Bank. Seen in this light, there was considerable linkage between the forward contract and Mr. MacDonald's Bank of Nova Scotia shares.

[38] In *Shell Canada*, McLachlin J. cautioned that “the economic realities” of a situation cannot be used to “recharacterize a taxpayer’s *bona fide* legal relationships” (para. 39). This does not mean that contextual factors outside the four corners of the derivative contract will never be relevant in ascertaining its purpose. McLachlin J.’s statement was made in the context of this Court rejecting an argument that two related transactions between different parties should effectively be treated as a single collective transaction for the purpose of tax characterization. This is very different from considering multiple related agreements to help determine why a particular agreement was entered into.

[39] When assessing whether a derivative contract is a hedge or speculation, the relationship between the derivative contract and transactions or assets outside of the derivative contract will very often be relevant. By definition, a hedging derivative contract is aimed at reducing the risk associated with some asset, liability or transaction. In this case, the loan and pledge agreements are part of the context relevant to ascertaining the purpose of the forward contract. Considering these agreements will in no way recharacterize Mr. MacDonald’s *bona fide* legal relationships.

[40] As Noël C.J. observed, the combined effect of the forward contract, the loan agreement and the pledge agreement allowed for credit backed by collateral that was free from market fluctuation risk. The loan and pledge agreements gave Mr. MacDonald access to a large credit facility but required him to maintain the forward contract and to pledge, as collateral, Bank of Nova Scotia shares and all Cash Settlement Payments owed to him pursuant to the forward contract. The credit available to him could not exceed 95% of the value of his pledged Bank of Nova Scotia shares. The shares pledged as collateral matched the shares contemplated by the forward contract. As the number of shares covered by the forward contract decreased due to settlement, the same number of shares were released from being collateral under the loan and pledge agreements.

[41] From the perspective of TD Bank, this meant that the value of the collateral was perfectly protected from market fluctuations: if the price of Bank of Nova Scotia shares increased, the value of Mr. MacDonald's pledged shares would increase proportionally; if the price decreased, Mr. MacDonald would be entitled to an offsetting Cash Settlement Payment which would automatically be pledged as collateral. This arrangement allowed Mr. MacDonald to gain access to a large credit facility on attractive terms and allowed TD Bank to provide the credit facility with the guarantee of protected collateral.

[42] In my view, this arrangement reveals the necessary linkage between Mr. MacDonald's Bank of Nova Scotia shares and the forward contract to indicate a

hedging purpose. The fact that Mr. MacDonald did not sell his Bank of Nova Scotia shares immediately to offset his losses under the forward contract does not sever this connection. Although the loan and pledge agreements form part of the context in this case and shed light on the purpose of the forward contract as a hedge, the forward contract, considered independently, perfectly sheltered the large bulk of Mr. MacDonald's Bank of Nova Scotia shares from market price fluctuations. A good argument can be made, therefore, that even without the loan agreement, the contract was still a hedge.

[43] Mr. MacDonald's *ex-post facto* testimony regarding his intentions cannot overwhelm the manifestations of a different purpose objectively ascertainable from the record.

[44] The Cash Settlement Payments arising from the forward contract derive their income tax treatment from the underlying Bank of Nova Scotia shares, which the parties agree were held by Mr. MacDonald on account of capital. When considered in its full and proper context, it is clear that the purpose of the forward contract was to hedge against market price fluctuations that Mr. MacDonald's Bank of Nova Scotia shares were exposed to.

[45] I would therefore dismiss the appeal with costs.

The following are the reasons delivered by

CÔTÉ J. —

I. Introduction

[46] The issue before this Court is whether losses resulting from a cash-settled forward contract (“Forward Contract”) between James S. A. MacDonald and TD Securities Inc. (“TDSI”) are deductible on Mr. MacDonald’s income account or on his capital account. The appeal turns on whether the Forward Contract should be characterized as an adventure in the nature of trade or as a hedge of Mr. MacDonald’s Bank of Nova Scotia shares (“BNS Shares”). If it was an adventure in the nature of trade, the losses are deductible on Mr. MacDonald’s income account. If it was a hedge, they take on the tax character of the underlying asset, in this case the BNS Shares, which are deductible on his capital account.

[47] Contrary to the Federal Court of Appeal, I would, with great respect, hold that the tax characterization of the Forward Contract turns on the taxpayer’s intent, which is determined by reviewing the taxpayer’s subjective statements of intent and objective manifestations of intent. I part ways with my colleague Abella J. on the meaning of intent, on her interference with the trial judge’s findings of fact, and on the relationship between the Forward Contract and Mr. MacDonald’s arrangements with other entities. I see no basis for intervening in the trial judge’s finding that, given all of the relevant circumstances, Mr. MacDonald intended to speculate and not to hedge. I would therefore allow the appeal.

II. Summary of the Relevant Facts

[48] I do not propose to duplicate the facts recited by my colleague in her reasons. However, I wish to highlight some important details in how Mr. MacDonald arranged his affairs.

[49] Mr. MacDonald and the Toronto-Dominion Bank (“TDB”) were the parties to a credit facility agreement entered into on July 7, 1997 (“Credit Facility”), which required Mr. MacDonald to maintain the Forward Contract, and to a securities pledge agreement (“Securities Pledge Agreement”), in which he pledged to TDB all amounts which might become payable to Mr. MacDonald from TDSI under the Forward Contract. Mr. MacDonald and TDSI — a separate entity from TDB — were the parties to the Forward Contract. Further, whereas the terms of the Credit Facility contemplated the Forward Contract, the terms of the Forward Contract did not contemplate the Credit Facility.

[50] In addition, although the Credit Facility entitled Mr. MacDonald to draw on up to \$10,477,480, he only borrowed a total of \$4,899,000. By November 5, 2004, he had repaid the entire balance under the Credit Facility. However, the Forward Contract continued in effect until March 29, 2006. The losses for which Mr. MacDonald is claiming a deduction are for taxation years 2004, 2005 and 2006.

III. Trial Judge’s Factual Findings and Standard of Review

[51] The trial judge, Lafleur J., made a number of important findings which have not been challenged on appeal (2017 TCC 157, [2018] 1 C.T.C. 2239):

- Mr. MacDonald's evidence was "credible and reliable, and he was himself a very credible witness" (para. 59);
- Mr. MacDonald's "sole purpose and intention in entering into the Forward Contract was to speculate on and profit from, an anticipated decline in the trading price of the BNS shares" (para. 59);
- Mr. MacDonald's "intention at the time of entering into the Forward Contract was to gain a profit by speculating that the market price of the BNS shares would drop in value" (para. 63);
- Mr. MacDonald "did not have a clear intention to hedge when he entered into the Forward Contract" (para. 80);
- Mr. MacDonald "did not consider the [Credit Facility] as being part of the Forward Contract" (para. 62);
- there was no "connection between the amount borrowed under the [Credit Facility] and the entering into, and the settlement of, the Forward Contract" (para. 106); and

- Mr. MacDonald was not interested in selling the BNS Shares in the short term, and he continued to hold a substantial portion of the shares in BNS he had been holding when he entered into the Forward Contract (paras. 66, 104 and 107).

[52] An appeal, even to the Supreme Court of Canada, does not involve a retrial of the case. This Court's power to substitute its own view of the facts for that of the trial judge is circumscribed by its role as an appellate court: *Underwood v. Ocean City Realty Ltd.* (1987), 12 B.C.L.R. (2d) 199 (C.A.), at p. 204, quoted with approval in *Housen v. Nikolaisen*, 2002 SCC 33, [2002] 2 S.C.R. 235, at para. 3. Given this institutional limitation, the standard of review for findings of fact is palpable and overriding error: *Housen*, at para. 10. The standard for questions of mixed fact and law is also palpable and overriding error unless it is clear that the trial judge made an extricable error in principle amounting to an error of law: para. 37. Finally, the standard of review for questions of law is correctness: para. 8.

[53] In this appeal, whether intent is required in order to find that the Forward Contract was a hedge is a question of law, and is therefore reviewable on the correctness standard. The trial judge's finding that Mr. MacDonald's sole intent was to speculate, and not to hedge, is a finding of fact reviewable for palpable and overriding error, absent an extricable error of law: *Symes v. Canada*, [1993] 4 S.C.R. 695, at p. 736.

IV. Meaning of Intent

[54] Before explaining why intent is necessary in order to find that the Forward Contract was a hedge, I believe that it would be useful to first discuss what I mean by “intent”. This Court has previously considered how to determine a taxpayer’s intention. In *Symes*, at p. 736, Iacobucci J. noted that the issue before the Court was whether Ms. Symes had incurred child care expenses with the intention of gaining or producing income from a business. He went on to explain that, where a taxpayer’s intention must be ascertained, the court must look beyond the taxpayer’s subjective statements to identify objective manifestations of intent:

As in other areas of law where purpose or intention behind actions is to be ascertained, it must not be supposed that in responding to this question, courts will be guided only by a taxpayer’s statements, *ex post facto* or otherwise, as to the subjective purpose of a particular expenditure. Courts will, instead, look for objective manifestations of purpose, and purpose is ultimately a question of fact to be decided with due regard for all of the circumstances. [p. 736]

[55] Iacobucci J. returned to this point in *Ludco Enterprises Ltd. v. Canada*, 2001 SCC 62, [2001] 2 S.C.R. 1082, at para. 54, in which this Court had to determine a taxpayer’s intention in using borrowed money in order to decide whether interest charges were deductible from income under the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (“ITA”):

In the interpretation of the [ITA], as in other areas of law, where purpose or intention behind actions is to be ascertained, courts should objectively determine the nature of the purpose, guided by both subjective and objective manifestations of purpose. In the result, the requisite test to determine the purpose for interest deductibility under s. 20(1)(c)(i) is whether, considering all the circumstances, the taxpayer had a reasonable

expectation of income at the time the investment was made. [Emphasis added; citations omitted.]

[56] We are bound to follow *Symes*' and *Ludco*'s authoritative statements that intent is a question that requires an assessment both of the taxpayer's subjective intention and of the presence or absence of objective manifestations of that intention. Neither the objective nor the subjective element is determinative on its own.

V. Intent Is Necessary in Order to Find That the Forward Contract Was a Hedge

[57] I am of the opinion that the tax characterization of the Forward Contract turns on the taxpayer's intent and that this is determined by reviewing the taxpayer's subjective statements and objective manifestations of intent. Based on my reading of the jurisprudence, a hedge exists for tax law purposes if the taxpayer *intended to hedge* using the derivative instrument and that intention was objectively manifested by a sufficient connection between the derivative instrument and the underlying asset or liability ("linkage"), or by integration of the derivative transaction into the taxpayer's profit-making activities: *George Weston Ltd. v. R.*, 2015 TCC 42, [2015] 4 C.T.C. 2010; *Barrick Gold Corp. v. R.*, 2017 TCC 18, [2017] 3 C.T.C. 2103; *Echo Bay Mines Ltd. v. Canada (T.D.)*, [1992] 3 F.C. 707; *Atlantic Sugar Refineries Ltd. v. Minister of National Revenue*, [1949] S.C.R. 706. By contrast, an adventure in the nature of trade exists if the taxpayer *intended to speculate* using the derivative instrument and that intention was objectively manifested by indications that the transaction was a scheme for profit-making: *Salada Foods Ltd. v. The Queen*, [1974]

C.T.C. 201 (F.C.T.D.); M. E. Grottenthaler and P. J. Henderson, *The Law of Financial Derivatives in Canada* (loose-leaf), at p. 11-5. With respect, I find as a logical consequence that the Federal Court of Appeal (2018 FCA 128, [2019] 2 F.C.R. 302) erred in law in holding that an intention to hedge is not a requirement for a finding that a transaction constitutes a hedge.

[58] Moreover, disregarding the taxpayer's intent to hedge in characterization cases would be artificial, because intent to speculate is "the most determinative factor" in the decision as to whether a transaction of any kind is an adventure in the nature of trade: *Canada Safeway Ltd. v. R.*, 2008 FCA 24, [2008] 2 C.T.C. 149, at para. 43; see also *Friesen v. Canada*, [1995] 3 S.C.R. 103, at para. 16. Given that intent is clearly relevant to that analysis, adopting a rule that intent is to be disregarded in determining whether a derivative constitutes a hedge would only cause confusion. Further, eliminating the taxpayer's intent as an important factor to be applied in determining the tax characterization of a derivative transaction would turn the taxation of such transactions into a judicially created "carve-out" from the general tax characterization jurisprudence, and such a distinction would not be justified by the text of the ITA as it was enacted at the relevant time. Taxpayers deserve to be taxed on the basis of known legal rules, and not on the basis of judicial decisions made after the fact.

[59] My colleague adopts a test which purports to be similarly anchored on a taxpayer's subjective statements and objective manifestations of intent. At first

glance, her test appears inconsistent with the Federal Court of Appeal's holding that intent is not required for a finding that a transaction constitutes a hedge. As I explain below, my colleague's application of her test to the facts of this appeal illustrates that the difference between her test and that of the Federal Court of Appeal is one more of style than of substance. Unlike the Federal Court of Appeal, she refers to intention in her analysis, but, like the Federal Court of Appeal, her analysis looks only to the economic effects of the derivative instrument in order to ascertain its tax character.

[60] I would also point out that a test which is in effect based solely on risk mitigation will have extensive repercussions for the taxation of financial derivatives. For example, the fact that there is often a high correlation between the values of two investments of the same type, such as bank stocks, means that — because of the risk mitigation effect — my colleague's test would lead to the conclusion that a derivative instrument that shorted shares in TDB was a hedge of the BNS Shares regardless of the taxpayer's intentions. Therefore, this test will introduce a significant degree of uncertainty into the tax treatment of derivative instruments: see J. Beitel, "Hedging Transactions — MacDonald Reversed" (2018), 66 *Can. Tax J.* 919, at p. 923.

[61] Below, I review the trial judge's decision and my colleague's critique of that decision. The bottom line, however, is that the test used by the trial judge and her finding that Mr. MacDonald intended to speculate and not to hedge was within the line of existing jurisprudence on the taxation of financial derivatives and should not be disturbed. I conclude this section by reiterating that taxpayers deserve to be taxed

on the basis of the legal rules that are known to apply at the time they enter into a transaction.

VI. The Credit Facility and the Securities Pledge Are Irrelevant

[62] I part ways with my colleague on her treatment of the Forward Contract between Mr. MacDonald and TDSI as an indistinguishable component of the Credit Facility and the Securities Pledge Agreement between Mr. MacDonald and TDB. This Court must respect the legal form of the Forward Contract, which, on its own terms, is unrelated to the Credit Facility and was entered into between Mr. MacDonald and TDSI, a separate entity from TDB. To hold otherwise would be inconsistent with this Court's unanimous decision in *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622.

[63] In *Shell*, the taxpayer had embarked on a complex financing arrangement to gain access to 100 million US dollars ("USD") for its business operations, first entering into debenture agreements with three foreign lenders in order to borrow 150 million New Zealand dollars ("NZD") at 15.4 percent interest, and then entering into a forward exchange contract with Sumitomo Bank Ltd. in order to purchase 100 million USD with the money borrowed under the debenture agreements. The forward exchange contract also allowed the taxpayer to exchange USD for NZD in an amount matching the interest payments under the debenture agreements, and to exchange USD for the principal amount under those agreements. This arrangement was designed to enable the taxpayer to realize a foreign exchange gain on the forward

exchange contract, as it was to repay the amounts under the debenture agreements in NZD. When computing its income for the years of this financing arrangement, the taxpayer deducted the interest it had paid under the debenture agreements and reported the foreign exchange gain as a capital gain. The Minister of National Revenue disputed these claims because, he argued, the effect of the financing scheme was to allow the taxpayer to obtain USD at a superficially higher interest rate which was, in reality, lower than the rate it would have paid had it simply contracted for a straightforward loan for 100 million USD. The claimed capital gain was also reassessed as being on income account. The Federal Court of Appeal held that it was not constrained by the legal form of the taxpayer's arrangement, and it considered the debenture agreements and the forward exchange contract together in order to determine whether the amounts the taxpayer sought to deduct could be considered interest.

[64] This Court unanimously allowed the taxpayer's appeal, holding that it was an error of law to recharacterize the taxpayer's transactions by considering the taxpayer's forward exchange contract with Sumitomo alongside the former's debenture agreements with the foreign lenders. This Court stated that the Federal Court of Appeal had erred by paying insufficient attention to certain "very important principles" in disregarding the fact that Sumitomo was not a party to the taxpayer's debenture agreements with the foreign lenders: para. 41. This Court elaborated as follows on what some of those "very important principles" are:

This Court has repeatedly held that courts must be sensitive to the economic realities of a particular transaction, rather than being bound to what first appears to be its legal form. But there are at least two *caveats* to this rule. First, this Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer's *bona fide* legal relationships. To the contrary, we have held that, absent a specific provision of the [ITA] to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases. Recharacterization is only permissible if the label attached by the taxpayer to the particular transaction does not properly reflect its actual legal effect. [Citations omitted; para. 39.]

This Court unanimously held that the payments the taxpayer had received under the debenture agreements could not be recharacterized for tax purposes on the basis of other agreements the taxpayer had entered into with other legal entities. In addition, this Court unanimously stated that it is not a court's role to prevent taxpayers from relying on the sophisticated structure of their transactions by imposing tax according to the transactions' "true economic and commercial effects": paras. 44-45. The transactions must be considered separately for tax purposes.

[65] Although *Shell* did not concern exactly the same issue under the ITA as the one in the case at bar, I, like the trial judge, would not be too quick to narrowly construe broad statements of "very important principles" from a unanimous decision of this Court. In this case, the tax character of the losses from the Forward Contract between TDSI and Mr. MacDonald is not affected by Mr. MacDonald's arrangements with TDB. TDSI was not a party to the Credit Facility or the Securities Pledge Agreement. There has been no finding of a sham, nor does the ITA require that these agreements be considered to be one.

[66] As the Federal Court of Appeal did in *Canada v. Shell Canada Ltd.* (C.A.), [1998] 3 F.C. 64, my colleague relies on Mr. MacDonald's arrangements with TDB in order to recharacterize the tax treatment of his arrangements with TDSI. By failing to respect Mr. MacDonald's legal relationships with separate entities, my colleague adopts an economic realities approach which this Court has in principle unanimously rejected: *Shell*, at paras. 39-45. Mr. MacDonald's legal relationships with separate entities should be respected; their separate legal personalities cannot simply be ignored. The Forward Contract must be considered separately from the Credit Facility and the Securities Pledge Agreement.

[67] Further, it is unclear what the Credit Facility and the Securities Pledge Agreement add to my colleague's analysis, given that she views the risk neutralized by the Forward Contract as a risk of "fluctuations in the price" of the BNS Shares: Abella J.'s reasons, at para. 37. Mr. MacDonald's exposure to fluctuations in the price of his shares is a risk that would exist without the Credit Facility and the Securities Pledge Agreement. What the Credit Facility and the Securities Pledge Agreement demonstrate is TDB's interest in mitigating the risk of the BNS Shares declining in value while the principal on the Credit Facility was outstanding. Therefore, it appears that my colleague is relying on the Credit Facility and the Securities Pledge Agreement to show how the Forward Contract hedged TDB's contingent risk of price fluctuations in the BNS Shares in the eventuality that they had to be called in as collateral for the Credit Facility. However, in tax characterization cases it is the intention of the *taxpayer* which this Court is concerned with, not the intention of

other entities on the other side of the taxpayer's transactions: P. W. Hogg, J. E. Magee and J. Li, *Principles of Canadian Income Tax Law* (7th ed. 2010), at p. 358. TDB's intention should not be relied on to show that the Forward Contract was a hedge against a risk which did not concern Mr. MacDonald. This Court should be concerned only with Mr. MacDonald's intention in entering into the Forward Contract, not with that of TDB.

[68] In order for the Forward Contract to constitute a hedge, it and Mr. MacDonald's ownership risk in the BNS Shares must stand on their own. The derivative transaction at issue must be considered independently of the taxpayer's arrangements with separate entities and the risks to which those separate entities are exposed.

[69] I pause here to explain what I mean by "ownership risk", and to note a point on which I agree with my colleague. Ownership risk is a concept which is based on a recognition that the owner of an asset is exposed to risks related to fluctuations in the value of the asset even if the owner does not intend to sell the asset (and thereby incur a transactional risk): see C.A. reasons, at paras. 78-82. As my colleague notes, the effect of the concept of ownership risk is that a hedge may exist for tax purposes despite the absence of a synchronous transaction used to offset gains or losses arising from a derivative contract.

VII. No Grounds to Interfere With the Trial Judge's Factual Findings

[70] I also part ways with my colleague on three errors she imputes to the trial judge: (1) that the trial judge placed undue significance on Mr. MacDonald's evidence and on the Forward Contract's mode of settlement; (2) that the trial judge failed to appreciate that the BNS Shares were exposed to risk despite the absence of a "synchronous transaction used to offset gains or losses"; and (3) that the second of these errors "necessarily" led the trial judge to conclude that Mr. MacDonald's intention had been to speculate (paras. 34-35). I also note that my colleague's treatment of the Credit Facility and the Securities Pledge Agreement is inconsistent with the trial judge's findings; as I have already discussed that issue, however, I will not address it further.

[71] With respect, none of these purported legal errors stands up to scrutiny.

[72] Regarding the first of the purported errors, my colleague's critique amounts to a difference of opinion as to the weight to be ascribed to the mode of settlement and to Mr. MacDonald's evidence. However, this Court's role as an appellate court is not to retry the case or reweigh the evidence. An appellate court is not free to interfere with a factual conclusion it disagrees with if its disagreement stems from a difference of opinion over the weight to be assigned to evidence: *Housen*, at para. 23. Nor is it appropriate for an appellate court to transform its "opposition to a trial judge's factual findings and inferences into attributed legal errors": *R. v. Javanmardi*, 2019 SCC 54, at para. 42.

[73] The trial judge considered Mr. MacDonald's evidence and specifically took the objective circumstances into account:

The Respondent argued that Mr. MacDonald's self-serving statements alone cannot be determinative of his intention. However, I am not guided solely by Mr. MacDonald's statements (i.e. by his subjective intention) and I must look for objective manifestations of purpose, which is a question of fact to be decided from all of the circumstances. As mentioned in the previous paragraph, the facts and surrounding circumstances showed that the testimony of Mr. MacDonald was credible and reliable. [Emphasis added; citations omitted; para. 65.]

[74] Further, the mode of settlement played only a secondary role in the trial judge's analysis as a circumstance which was consistent with the finding that Mr. MacDonald was acting as a speculator would:

My conclusion is reinforced by the cash settlement feature of the Forward Contract which, as expressed by Mr. Kurgan, is more likely to be used by a speculator. As mentioned above, Mr. MacDonald cannot settle the Forward Contract by transferring any BNS shares; the only method of settlement is by way of cash transfer. The sole source of income for Mr. MacDonald is the Forward Contract. However, Dr. Klein was of the opinion that the cash settlement feature of the Forward Contract was not determinative of a hedge or speculation as they are economically equivalent. At the hearing, Dr. Klein testified as to the economic equivalence between cash settled and a physically settled forward contract. I agree with him that he had made that demonstration. However, in tax cases, form matters and my goal is not to determine the economic equivalence between two different transactions but the tax consequences arising from a specific transaction and, to that end, I must try to obtain an accurate picture of the income of a taxpayer. [para. 69]

[75] Nowhere in her reasons did the trial judge treat the mode of settlement as determinative. Indeed, she cited the same passage from *Placer Dome Canada Ltd. v.*

Ontario (Minister of Finance), 2006 SCC 20, [2006] 1 S.C.R. 715, on which my colleague relies in support of her conclusion that the trial judge erred:

Nevertheless, I am also cognizant of the comments of the Supreme Court of Canada in *Placer Dome Canada Ltd.*, *supra*, “that, at least for the purposes of GAAP [generally accepted accounting principles], the way in which a derivative contract functions as a ‘hedge’ is unaffected by the method by which the contract is settled” However, as also stated by the Supreme Court in *Canderel Ltd.*, *supra*, GAAP is not determinative of tax treatment . . . [para. 70]

[76] The trial judge correctly identified and applied the relevant legal principles. She did not treat the mode of settlement as determinative. She did not treat Mr. MacDonald’s statements of intent as determinative. I see no basis for this Court to intervene. Appellate intervention would be justified only if the taxpayer’s statements of intent and the mode of settlement carried no legal significance at all. If that were the case, this Court might as well stop asserting that the test is based on “intention”, and acknowledge that the real test it is applying is based purely on the economic effects of the transaction.

[77] The second of the purported errors, that the trial judge failed to appreciate that the BNS Shares were exposed to risk despite the absence of a linking transaction, is based on a flawed reading of the trial judge’s reasons. The trial judge clearly understood that a hedge of a capital asset is legally possible, and in fact stated as much in summarizing *George Weston Ltd.*:

Associate Chief Justice Lamarre noted that the Supreme Court in *Shell Canada Ltd.*, *supra*, did not say that the gain or loss on a derivative must necessarily be linked to a gain or loss on another transaction and she opined that there is no legal basis to deny capital treatment to proceeds earned from a hedging contract if there is no sale or proposed sale of the underlying item being hedged. In finding that the swaps were entered into as a hedge of the investment in the USD operations, Lamarre ACJ. considered GWL's [George Weston Ltd.'s] intention, the amounts of the swaps and the amounts of the USD operations which were approximately equal as well as the timing of the acquisition of the swaps which was fairly close to the acquisition of the USD operations. [para. 94]

[78] In *George Weston Ltd.*, the ownership risk which the taxpayer was exposed to was material to its business operations, which prompted the taxpayer to respond by hedging against that risk:

. . . GWL was exposed to currency risk associated with an increasing debt to equity ratio as a result of its expanded indirect holdings in US assets. That risk led to tangible consequences as detailed by Ms. Frost and as evidenced by Standard & Poor's credit watch discussed above. This caused management to hedge the risk using swaps which were directly tied to the value of GWL's US assets. [para. 75]

[79] In this appeal, the trial judge distinguished *George Weston Ltd.* on its facts on the basis that the ownership risk Mr. MacDonald was exposed to was entirely theoretical and immaterial given his financial purposes:

Furthermore, I am of the view that the Respondent erred when she said that the risk for Mr. MacDonald rested with his ownership of BNS shares and the potential for price fluctuations, citing *George Weston Ltd.*, *supra*. The facts in *George Weston Ltd.*, *supra*, are clear: the swaps were entered into to protect GWL against a devaluation of the USD compared to the Canadian dollar which would have had a negative impact on GWL's financial statements and on GWL's debt to equity ratio. The risk in GWL was clear and, in the absence of the swaps, GWL would have had

suffered from the devaluation of the USD as it would have had a direct impact on GWL's financial statements and a direct impact on its shareholders. When the risk was no longer present, GWL terminated the swaps.

However, I am of the view that the situation I am faced with is entirely different as to the existence of a risk. In arguing as she did, the Respondent did not take into account the actual facts of this case. Mr. MacDonald testified that he wanted to keep the BNS shares for the very long term. He sold only a small number of BNS shares over the years to rebalance his portfolio. He owned the BNS shares for the past 30 years. He entered into the Forward Contract, which was cash settled, confirming his intention not to sell the BNS shares. I do not see how Mr. MacDonald could 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 and, in fact, he only sold a small number of 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. [paras. 103-4]

[80] In this passage, the trial judge did not deny that the law recognizes the concept of ownership risk. Rather, she found as a matter of fact, based on her assessment of the totality of the evidence and her finding that Mr. MacDonald was a credible and reliable witness, that a short-term ownership risk was not a material concern for Mr. MacDonald and did not therefore inform his conduct or his intentions. This is not an error of law, but a finding of fact that can be reviewed only for a palpable and overriding error. I see no such error and, consequently, no basis for this Court to intervene.

[81] The final purported error is that the trial judge's treatment of the ownership risk concept tainted her finding that Mr. MacDonald's "sole purpose and intention" in entering the Forward Contract had been to speculate. Here, the trial

judge's reasons must be considered as a whole, and not by means of a surgical analysis of specific isolated sentences. She did not, to ascertain Mr. MacDonald's intention, focus solely on the absence of risk of price fluctuations. Rather, she considered a number of objective factors and made findings of credibility and reliability which are owed deference on appeal:

I am of the view that Mr. MacDonald's sole purpose and intention in entering into the Forward Contract was to speculate on and profit from, an anticipated decline in the trading price of the BNS shares; his testimony was credible and reliable, and he was himself a very credible witness

. . . The facts showed that Mr. MacDonald had a legitimate intention of gaining a profit from the Forward Contract. When he entered into the Forward Contract, it was uncertain as to whether he would be required to make a payment to TDSI or whether he would receive an amount from TDSI. The Forward Contract afforded Mr. MacDonald an opportunity to speculate on the outcome that the price of the BNS Shares would drop in the short term and that he could profit from that anticipated drop. His testimony was uncontradicted and the surrounding facts supported his testimony.

I agree with the following arguments raised by the Appellant. Mr. MacDonald entered into a Forward Contract that could only be cash settled. Hence, the Forward Contract did not involve an exchange, sale or delivery of any BNS shares Furthermore, the Forward Contract itself stamps the transaction as a trading venture as it was highly speculative in nature, it involved great potential for risk and reward, it was isolated and non-recurring, and was not used to lock-in any gain in the BNS Shares

. . .

. . . I am of the view that, on balance, the evidence showed that Mr. MacDonald's intention at the time of entering into the Forward Contract was to gain a profit by speculating that the market price of the BNS shares would drop in value because of the storm clouds he foresaw coming in the financial markets and which he referred to in his testimony: the 1997 Asian Debt Crisis, the collapse of the Thai Bhat, the October 1997 mini-crash of the New York Stock Exchange, the Russian

Debt Crisis in 1998 and the 1998 collapse of the Long Term Capital Management hedge fund. In his own words, Mr. MacDonald's intention "was to achieve a profit on an anticipated decline in the value of Bank of Nova Scotia shares based on the storm clouds that [he] saw in the investment horizon". It is clear from Mr. MacDonald's testimony that his intention was to speculate — he wanted to profit from a potential decline in the value of the BNS shares in the light of the state of the financial market around the time he entered into the Forward Contract.

. . . According to Mr. MacDonald's testimony, which I found credible and reliable, his unfavourable short term outlook stemmed from concerns he had about these adverse developments in the international markets and because, in his view, BNS, of all of the Canadian banks was the most internationally exposed to such events. His belief was based on the vast experience he had gained during the numerous years he had worked in the financial market and the critical information he had of BNS specifically. Mr. MacDonald's testimony was clear as to what his intention was in entering into the Forward Contract. As a very well-informed person in the world of finance, he saw storm clouds on the horizon. Also, because he worked at a very high level position at the BNS for many years, he was able to reasonably conclude that the BNS was the most exposed of the Canadian banks to the foreign market turbulence.

. . .

Another very important fact to take into account in this particular case is that Mr. MacDonald did not intend to ever sell his BNS shares and he wanted to hold on to them for the very long term. The facts also supported his testimony in that respect as Mr. MacDonald only sold only a small number of BNS shares throughout the years to rebalance his portfolio. In 2003 and 2004, he did not sell any BNS shares (he donated 400 BNS shares in 2004). In 2005, as VFC [Inc., a company of which he was the chairman and a shareholder,] was becoming quite successful, Mr. MacDonald sold 273,000 BNS shares, representing 37% of his shareholding. The reason given by Mr. MacDonald for selling the BNS shares was credible: as he was one of the founders of VFC, it would not look good if he were to sell VFC shares. Also, in 2006, Mr. MacDonald acquired TD Bank shares in exchange for his shares of VFC and decided to sell some BNS shares and TD Bank shares to rebalance his portfolio. In 2006, Mr. MacDonald sold 10,000 BNS shares, representing only 2.2% of his shareholding. Mr. MacDonald's testimony was very clear: the BNS shares are the cornerstone of his investment portfolio, representing approximately 15% of the value of his portfolio at the date of the hearing. Accordingly, it is clear that Mr. MacDonald took an important financial risk by entering into the Forward Contract. If the market price of the BNS shares went up, he would have had to make a payment to TDSI. As he did

not want to sell the BNS shares and he did not, in fact, sell any BNS shares when he made payments under the Forward Contract, it is evident that making payments under the Forward Contract without selling any corresponding BNS shares put Mr. MacDonald in a disadvantageous financial position. Therefore, one cannot conclude that he had locked-in a gain by entering into the Forward Contract. Furthermore, keeping in mind the important fact that Mr. MacDonald testified that he wanted to keep the BNS shares for the very long term, I do not see why Mr. MacDonald would have entered into the Forward Contract with the intent of making a payment to TDSI, which would be to lose money. [Emphasis added; paras. 59-66.]

[82] Given all of the evidence and the objective circumstances reviewed by the trial judge, I cannot accept that her view with respect to the ownership risk concept necessarily led her to conclude that Mr. MacDonald had intended to speculate. As I have already concluded, the trial judge did not err in law by denying or misapplying the concept of ownership risk. Absent an extricable legal error, her factual findings that Mr. MacDonald had intended to speculate and that he had objectively manifested that intent are findings of fact that can be reviewed only for a palpable and overriding error. No such error has been demonstrated. I see no basis for this Court to intervene.

VIII. Linkage

[83] I turn now to the question of linkage, which is important when analyzing whether a taxpayer objectively manifested an intention to hedge. The timing connection between the Forward Contract and the BNS Shares is weak, because Mr. MacDonald owned the BNS Shares for approximately 10 years before entering into the Forward Contract, the Forward Contract was an isolated transaction and the Forward Contract remained in existence for 16 months after Mr. MacDonald had

repaid his outstanding balance under the Credit Facility. The quantum connection is also imperfect, because the number of BNS Shares to which the Forward Contract applied did not exactly match the number of shares in BNS owned by Mr. MacDonald at the material time. Nonetheless, I acknowledge that, while it was in existence, the Forward Contract achieved a theoretical partial economic hedge of Mr. MacDonald's ownership risk in the BNS Shares. However, economic realities are not the end of the analysis.

[84] Mr. MacDonald is entitled to be taxed based on what he actually did, not what he could have done: *Shell*, at para. 45. Because the Forward Contract was cash-settled, Mr. MacDonald could only offset his risk by selling a corresponding number of BNS Shares to cover his losses. However, he did not sell his shares at the same time or in close proximity with the losses he incurred. In addition, the Forward Contract was an isolated transaction. It was not a regular or systemic part of his financial or investment practices. His conduct was therefore more consistent with that of a speculator than of a hedger.

[85] Further, given that *Shell* requires this Court to consider the Forward Contract separately from the Credit Facility and the Securities Pledge Agreement for tax purposes, the trial judge was correct to disregard the various links between the Credit Facility and the Forward Contract proposed by the Respondent. As I noted above, the trial judge carefully reviewed the objective indicia that the Forward

Contract was speculative and accepted that evidence. Additionally, as previously mentioned, Mr. MacDonald was unconcerned with ownership risk.

[86] On balance, while some of the objective economic indicators are consistent with an intent to hedge, there are also objective circumstances that suggest an intent to speculate, and I am not persuaded that the trial judge's findings of fact should be overturned on the application of a deferential standard of review. As I mentioned above, this Court's role is not to retry the case or reweigh the evidence: *Housen*, at para. 23. Where the issue on appeal involves the trial judge's interpretation of the evidence as a whole, that interpretation should not be overturned absent a palpable and overriding error: para. 36. No such error has been demonstrated. I would therefore restore the trial judge's conclusion that Mr. MacDonald's losses from the Forward Contract resulted from an adventure in the nature of a trade and are taxable on Mr. MacDonald's income account.

IX. Conclusion

[87] In the final analysis, my colleague purports to adopt a test based on the taxpayer's intent. However, her application of the test to the facts of this appeal reveals that the test she is really applying is one anchored on the economic realities of Mr. MacDonald's arrangements with various entities. In *Shell*, this Court unanimously held that economic realities cannot be used to recharacterize *bona fide* legal relationships. This Court should not disregard a unanimous precedent, applicable standards of review, findings of fact and a trial judge's assessment of

credibility in order to square a theoretical economic hedge into the round hole of an intention-based test.

[88] For the foregoing reasons, I would allow the appeal and restore the trial judge's order.

Appeal dismissed with costs, CÔTÉ J. dissenting.

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