Docket: 97-3731(IT)G

BETWEEN:

JOHN H. DANIELS,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on March 6, 2007 at Toronto, Ontario

Before: The Honourable Justice J.E. Hershfield

Appearances:

Counsel for the Appellant:	Sheldon Silver, Q.C. Glenn Ernst
Counsel for the Respondent:	Luther P. Chambers Pascal Tétrault

---

JUDGMENT

The appeals from the reassessments made under the *Income Tax Act* for the 1992, 1993 and 1995 taxation years are allowed and the reassessments are referred back to the Minister of National Revenue for reconsideration and reassessment in accordance with and for the reasons set out in the attached Reasons for Judgment.

Signed at Ottawa, Canada this 23rd day of May of 2007.

"J.E. Hershfield"

Hershfield J.

Citation: 2007TCC179
Date: 20070523
Docket: 97-3731(IT)G

BETWEEN:

JOHN H. DANIELS,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Hershfield J.

[1] The Appellant appeals reassessments of his 1992, 1993 and 1995 taxation years whereby the Minister of National Revenue (the "Minister") denied the Appellant an allowable business investment loss ("ABIL") deduction of $3,000,000 in computing his income for 1992. The appeals in respect of the 1993 and 1995 taxation years turn on whether there is an ABIL carry forward deduction available from the 1992 taxation year.

[2] The loss claimed by the Appellant arose in respect of a $4,000,000 debenture of Shoppers Trust Company ("Shoppers Trust Co") which had been pledged by the Appellant's brother (Phillip) as security for a bank loan. That debenture ("Debenture" or "Phillip's Debenture") was eventually acquired by the Appellant as a consequence of a series of events that followed Shoppers Trust Co being put into receivership. After acquiring the Debenture, the Appellant elected in respect of his 1992 taxation year to have subsection 50(1) of the *Income Tax Act*[1] ("*Act*") apply. That subsection deems the taxpayer to have disposed of the Debenture for nil proceeds. It is the application of this subsection, in part at least, that gave rise to the $4,000,000 loss.

---

[1] R.S.C. 1985, c.1 (5th Supp.), as amended.

[3] The sole issue is whether subparagraph 40(2)(g)(ii) of the *Act* applies to deny the loss claimed by the Appellant when he elected under subsection 50(1) of the *Act* to treat the Debenture as having been disposed of for nil proceeds. Subparagraph 40(2)(g)(ii) denies that loss unless the asset giving rise to the loss (the Debenture) was acquired for the purpose of gaining or producing income. The Respondent asserts that the Appellant failed to meet this requirement when the Debenture was acquired from his brother.

[4] The relevant facts are set out in the Statement of Agreed Facts attached to these Reasons as Appendix "A".

[5] Briefly, background facts to the end of 1991 may be summarized as follows:

a) The Appellant and his brother Phillip invested in Shoppers Trust Co in the early 1980's. It was engaged in the mortgage lending business and at all relevant times qualified as a Canadian controlled private corporation (CCPC) and as a small business corporation (SBC) as those terms are defined in the *Act*. Phillip held 75% of the shares of Shoppers Trust Co directly and the Appellant held the remaining 25% share interest through a holding company controlled by him;

b) Prior to 1988, each of the Appellant and Phillip also owned Shoppers Trust Co debentures with a face amount of $1,500,000 and Phillip was indebted to the Toronto Dominion Bank (the "TD Bank") in the amount of $3,000,000 (the "TD Debt");

c) In 1988, the Appellant and Phillip borrowed $8,000,000.00 from the Royal Bank of Canada on a joint and several basis (the "RBC Loans"). The loan to Phillip was in the amount of $5,500,000 and the loan to the Appellant was in the amount of $2,500,000.[2] Phillip used his loan proceeds to repay the TD Debt and the balance ($2,500,000) to acquire a further debenture from Shoppers Trust Co.[3] The Appellant used his

[2] The loan agreement and paragraph 6 of the Statement of Agreed Facts refer to this as a single loan. However, during the course of the hearing both parties referred to the loan as two distinct loans. Paragraph 11 of the Statement of Agreed Facts suggests the loan was made in distinct amounts to each of the debtors. Accordingly, following the lead of both parties these Reasons refer to the RBC loan as if they were two loans.

[3] The total debentures issued to Phillip were $4,000,000. It is this aggregate amount that is referred to in these Reasons as the "Debenture" or "Phillip's Debenture".

proceeds from the RBC Loan ($2,500,000) to purchase a further debenture from Shoppers Trust Co. Thereafter, the Appellant and his brother each owned $4,000,000 of Shoppers Trust Co debentures. The debentures bore interest at a rate of 12 per cent;

d) It is admitted that the Appellant had an income earning purpose when he became jointly and severally liable to the Royal Bank in respect of the RBC Loans made to him and Phillip;

e) The Appellant and Phillip each pledged their respective $4,000,000 Shoppers Trust Co Debentures and common shares in Shoppers Trust Co (collectively, the “Shoppers’ Securities”) as security for the RBC Loan; and,

f) As a result of a regulatory audit by the Office of Financial Savings Institutions in December 1991, Shoppers Trust Co was put into receivership in March of 1992.

[6] In computing his income for his 1991 taxation year, both the Appellant and Phillip determined that at December 31, 1991, the Shoppers’ Securities had become worthless. This gave rise to a business investment loss of $4,000,000 to each of the Appellant and his brother in respect of the debentures. Accordingly, they each claimed an ABIL of $3,000,000. These deductions were allowed by the Minister in computing income for the 1991 taxation year.

[7] In January of 1992, after some payments by each of the Appellant and his brother toward their respective obligations under the RBC Loans, Royal Bank was owed $4,500,000 by Phillip ($1,000,000 having been repaid by Phillip) and $750,000 by the Appellant ($1,750,000) having been repaid by the Appellant). As noted, both the Appellant and Phillip were jointly and severally liable in respect of the entire remaining indebtedness of $5,250,000 – a liability admitted to have been incurred by the Appellant for an income earning purpose at the time the RBC Loans were made.

[8] The Royal Bank then called for repayment of the RBC Loans. Phillip was unable to repay any part of the outstanding balance of the RBC Loans. Consequently, the Appellant was required to repay the full amount of $5,250,000 owing to the Royal Bank pursuant to his joint and several obligation. Such amount was paid in June 1992.

[9] In the aggregate, the Appellant repaid $7,000,000 of the $8,000,000 RBC Loan ($2,500,000 to pay off his loan and $4,500,000 on account of his brother's loan).

[10] In a letter addressed to Phillip dated November 18, 1992, the Appellant demanded that Phillip pay him the $4,500,000 that the Appellant was required to pay the Royal Bank in respect of Phillip's loan. Failing such payment the Appellant stated he would obtain an assignment of the Shoppers' Securities from the Royal Bank and would take steps to recover payment of the $4,500,000 amount in full.

[11] The Appellant obtained an assignment of Phillip's Debenture on December 1, 1992. On December 4, 1992, the Appellant gave Phillip written notice pursuant to *The Personal Property Security Act of Ontario* (PPSA) that the Appellant intended to dispose of Phillip's Debenture unless Phillip paid the Appellant $4,500,000, but if that amount was not paid, the Appellant accepted Phillip's Debenture in satisfaction of Phillip's obligation to the Appellant.[4]

[12] Phillip was unable to repay any amount to the Appellant due to serious financial difficulties. The Appellant therefore acquired Phillip's Debenture (and common shares) without attempting to collect the $4,500,000 from Phillip.

[13] Shoppers Trust Co remains in receivership to this day. It is agreed that on December 31, 1992, the Debenture acquired by the Appellant from his brother had no value. As the owner of this newly acquired Debenture and electing under subsection 50(1), the Appellant claimed a $4,000,000 business investment loss and an ABIL of $3,000,000. This loss was denied by the Respondent.

[14] The loss claimed relies on the Appellant having an adjusted cost base of $4,000,000 in respect of the Debenture acquired from his brother. The Appellant relies on section 79 as it read at the relevant time in 1992 to support his assertion in this regard. Respondent's counsel conceded this at trial and made no argument as to a different construction of section 79. Accordingly, having a $4,000,000 adjusted

[4] Although the Agreed Statement of Facts (paragraphs 20 and 21) refer only to the Appellant accepting Phillip's Debenture in full satisfaction of the $4,500,000, it seems apparent that the parties accept that the common shares which formed part of the Shoppers' Securities were assigned to the Appellant and accepted as well as part of the consideration for Phillip being released from his debt to the Appellant. That is, it seems apparent that the parties accept that $4,000,000 was the debt amount released in respect of Phillips's Debenture with the $500,000 balance being attributed to the common shares.

cost base and nil proceeds of disposition under subsection 50(1), the Appellant had a capital loss of $4,000,000 and claimed an ABIL of $3,000,000.

[15] Subject to the application of subparagraph 40(2)(g)(ii), the Respondent agreed at the hearing that paragraphs 79(f) and (g), subsection 50(1), and paragraphs 39(1)(c) and 38(c) of the *Act*, permitted the Appellant to deduct the ABIL claimed in respect of the Debenture acquired from Phillip. Therefore, the only matter to be decided is whether the Appellant acquired Phillip's Debenture for the purpose of gaining or producing income from a business or property within the meaning of subparagraph 40(2)(g)(ii) of the *Act.*

[16] Before turning to consider that question, I note that in addition to the Statement of Agreed Facts, the Appellant gave evidence at the hearing. He testified that when he seized Phillip's Debenture, he believed in its eventual value and did not sue his brother for contribution because Phillip already had severe financial troubles and no assets. While reluctant to acknowledge knowledge of certain correspondence from tax advisers relating to his acquiring his brother's Debenture, he did acknowledge that he knew of the tax advantage and followed the advice of his advisers to best ensure his loss position in respect of his obligations under the joint and several RBC Loans.

[17] I turn now to the arguments made by the parties.

ARGUMENT

Appellant

[18] The Appellant's principal argument is that I must accept the uncontradicted testimony of the Appellant that he had in mind that the ownership of Phillip's Debenture might one day have value. That that may only have been a faint hope and not the predominant reason for acquiring the Debenture, cannot dissuade me of accepting his income producing purpose. The Appellant relies on *Larry W. Rich v. Her Majesty the Queen.*[5]

[19] The Appellant's alternative argument is that the time to consider the purpose of acquiring Phillip's Debenture is not the time of acquisition of the worthless

[5] 2003 DTC 5115 (F.C.A.).

subrogated debt, but rather the time to consider purpose should be determined by looking to the event that eventually gave rise to the acquisition. It is the Appellant's position that his seizure of Phillip's Debenture is a direct result of the income earning purpose that motivated him to effectively guarantee Phillip's debt and invest in Shoppers Trust Co originally.

[20] The Appellant relies on the Reasons for Judgment of Justice Bowman of this Court (now Chief Justice) in *The Cadillac Fairview Corporation Limited v. Her Majesty the Queen*,[6] where he states, at pages 406-407:

> To arrive at the conclusion that a capital loss has been sustained for the purposes of the Act it is clear from sections 3, 38 and 39 that there must have been an actual or deemed *disposition* of property. The mere making of a capital payment does not, of itself, give rise to a capital loss. Where a guarantee of a primary debtor's obligation is given and the guarantor is required under the guarantee to pay and does pay to the creditor the primary debtor's obligation, <u>the guarantor is in the normal course subrogated to the position of the creditor unless it has explicitly or implicitly waived those rights of subrogation or other circumstances prevent such rights from arising. Absent such a factual or legal impediment, by operation of law a debtor-creditor relationship arises between the guarantor and the primary debtor. The guarantor's cost of the debt would normally be the amount that it paid under the guarantee.</u> (emphasis added)
>
> If, as is frequently the case, the principal debtor cannot pay, the debt may be regarded as having become bad. Section 50 of the Act deems the debt to have been disposed of by the guarantor at the end of the taxation year in which it became bad and to have been reacquired at a cost of nil immediately thereafter. Thus, through the combined operation of the law of subrogation and section 50 of the Act the disposition necessary to support the claim for a capital loss is achieved.

[21] Chief Justice Bowman then dealt specifically with how subparagraph 40(2)(g)(ii) should be interpreted and stated as follows at page 407:

> In many cases if a guarantor is obliged to make good under a guarantee it is because the principal debtor is unable to pay the obligation. From this, it follows that the guarantor's right of subrogation against the principal debtor is, at the time of acquisition, likely to be, in many instances, worthless or virtually worthless. <u>A narrow and mechanical reading of subparagraph 40(2)(g)(ii)</u> would lead one to conclude that on the payment of the guaranteed amount the guarantor's acquisition of the worthless subrogated debt could not possibly have as its

[6] 97 DTC 405 (T.C.C.), aff'd 99 DTC 5121 (F.C.A.).

> purpose the gaining or producing of income from a business or property. Such an interpretation in my view lacks commercial sense. A functional and more commercially realistic interpretation would subsume in the purpose of the acquisition of the subrogated debt the purpose for which the guarantee was originally given. (emphasis added)

[22] Relying on this passage, the Appellant argues that it is clear that the Court would not accept a "narrow and mechanical reading" of subparagraph 40(2)(g)(ii) and insist that a taxpayer satisfy a condition that could likely not be satisfied in most cases once a debt has gone into default. If it is only after the default that the purpose of acquiring the worthless subrogated debt is examined, the test of gaining or producing income from a business or property could, in almost every case not be satisfied.

[23] In *Harry Gordon v. Her Majesty the Queen*,[7] Justice McArthur applied Chief Justice Bowman's test in *Cadillac Fairview* and said at page 1558:

> Common sense and commercial reality leads to the obvious conclusion that the appropriate time to consider whether the Appellant had an income earning purpose was at the time that the guarantee was given, *and not at the time the guaranteed debt was in fact paid.* (emphasis added)

[24] In *National Developments Ltd. v. Her Majesty the Queen,*[8] Justice Bell held that the taxpayer's right to receive an amount from a subsidiary by way of subrogation (following the taxpayer's payment of that amount to the subsidiary's creditor) related back to the time when the amount was pledged to the creditor.

---

[7] 96 DTC 1554 (T.C.C.).

[8] 94 DTC 1061 (T.C.C.).

At page 1067 he found:

> (b) the debt or right to receive the sum of $951,177 from K-Tel arising on the banks' calling on the Appellant's pledge *related back to the time when the amount of that pledge was deposited in a collateral account as security for payment to the banks of K-Tel's obligations*. Although it may be suggested that technically the reference to "debt or other right to receive an amount" being acquired must refer only to the date upon which the banks called K-Tel's loan and applied the monies in the Collateral Accounts to K-Tel's obligation to the banks, *such construction, in my opinion would be inconsistent with the object and spirit of subparagraph 40(2)(g)(ii), would not be in harmony with the evident purpose of that provision, would lack common sense and would cast a blind eye to the commercial and economic realities of business transactions*; (emphasis added)

[25] In *Estate of the Late Fabian Aylward v. Her Majesty the Queen*,[9] Justice Mogan referred to the *National Developments* and said, at page 643:

> By parallel reasoning, I conclude that the payments to General Tire and Toyo Tire, made by Mr. Aylward in 1994, relate back to the time when two guarantees were first given and the later time when those two creditors demanded payment from Provincial Tire (as debtor) and from Aylward's Limited (as guarantor). The capital loss incurred by Mr. Aylward in 1994 upon his payment of the $305,000 was not reduced to nil by subparagraph 40(2)(g)(ii).

[26] In *Xavier v. Fernandez v. M.N.R.*,[10] Mogan, J. said at page 184:

> In my oral Reasons for Judgment, I erred in looking at the retaining of the net proceeds of sale by the financial institutions as an investment by the Appellant and his co-owners at the time of the forced sale. Instead, I should have related the investment of those proceeds back to the date when the property was pledged. I regret that I have not had the benefit of hearing legal argument on this issue of "relating back".

[27] All these authorities are argued to support the Appellant's position that the test of whether a debt or security was acquired for the purpose of gaining or producing income from a business or property must be applied at the time the guarantee or, in this case, the obligation to pay, was originally given or created, not at the time when the debt or the security are likely worthless.

---

[9] 2001 DTC 638 (T.C.C.).

[10] 91 DTC 182 (T.C.C.).

Respondent

[28] The Respondent challenges the Appellant's testimony that he thought Phillip's Debenture might have value one day and argues that releasing his brother from his indebtedness and acquiring an admittedly worthless Debenture is not consistent with a reasonable objective conclusion that the Debenture was acquired for the purpose of gaining or producing income. The Debenture had been worthless for a year when he acquired it; it was unsecured; and had no prospect of having any value. Discharging Phillip was forgoing a better prospect for financial recovery and all documentary evidence shows that the only considerations for the acquisition and discharge were income tax considerations.

[29] With respect to the Appellant's alternative argument, the Respondent does not take issue with the Appellant taking an assignment of Phillip's Debenture from the Royal Bank which gave the Appellant a security interest in the Debenture. The Respondent recognizes that under the law of guaranty as set out in the province of Ontario under the scheme of the *Mercantile Law Amendment Act* ("MLAA") and the PPSA, upon assignment from the creditor, the surety for a debt is entitled to stand in place of the creditor and use all the remedies available to the creditor to recover the loss from the original debtor. However, the Respondent contends that the Appellant therefore had three possible recourses for recovery of his payment for Phillip's liability to the Royal Bank:

a. He could have pursued Phillip on his liability;
b. He could have sold the Debentures and pursued Phillip for the deficiency pursuant to subsection 64(3) of the PPSA; or
c. He could have accepted the Debentures in satisfaction of Phillip's indebtedness to him.

[30] The Respondent argues then that the acquisition of the ownership interest in the Debenture was not a necessary consequence of holding the security interest. It was the consequence of a choice made by the Appellant. By choosing to seize Phillip's Debenture, the Appellant entered into a fresh transaction, distinct and separate from the guarantee. It had legal effect as a separate transaction. New rights came into existence (he became beneficial owner of the Debenture) and obligations were extinguished. This was a substantive transaction that must, according to the principle laid down by the Supreme Court of Canada in *Her Majesty the Queen v.*

John R. Singleton,[11] be viewed independently - not as part of a chain of related interdependent transactions.

[31] In *Singleton* the issue was to determine if the use of borrowed funds by the taxpayer was an eligible use. In that case the taxpayer essentially refinanced a partnership interest (in the sense that financing from a borrowed source replaced the taxpayer's own investment in an income earning partnership) and used his freed up equity to acquire a personal residence. The transactions were clearly related and were part of an uninterrupted interdependent chain of transactions that were completed with each step done in contemplation of the preceding step.

[32] Even with such a direct connection between the transactions, the majority judgment in *Singleton* found that each transaction should be viewed as a separate transaction. At the point in time that the money was borrowed by the taxpayer, it was borrowed to finance a capital contribution to his partnership - a contribution made necessary by a prior withdrawal from his capital account. The loan was applied to an income producing asset which was held for that purpose. Accordingly, the money was used for the purpose of earning income, and this was an eligible use of the borrowed money.

[33] The Respondent argues that the reasoning in *Singleton* is clear authority requiring that the seizure of Phillip's Debenture be isolated as a separate step, the purpose of which could not objectively be found to have been an acquisition made for the purpose of earning income. That a related earlier transaction – the incurrence of a debt under a joint and several liability covenant made for the purpose of earning income – had a qualifying purpose, is not relevant in determining the purpose of the ultimate acquisition. Even if the chain between these events was unbroken – as were the events in *Singleton* – the acquisition itself is a separate step, the purpose of which must be determined in isolation of earlier connected transactions. If the chain between these events can be broken, then the argument to treat the acquisition of the Debenture as a separate transaction, in terms of determining its purpose, is all the more compelling. The Respondent argues that the Appellant had a choice as to what action he could take after acquiring the security interest in Phillip's Debenture. The exercise of that choice is a break in the chain of events. Such a break makes it all the more clear that the acquisition of the Debenture was a distinct step, the purpose of which must be determined in isolation of prior events.

---

[11] 2001 DTC 5533 at page 5538.

[34] I also note that Respondent's counsel saw a lack of symmetry in the operation of the provisions of the *Act,* or tax slippage in this case, that might warrant my attention. The same Debenture was claimed as an ABIL by two taxpayers (by Phillip in 1991 and by the Appellant in 1992) and that the total amount of business loss claimed between the two brothers was $12,000,000 in respect of an $8,000,000 debt issue.

[35] While this is the result, I note that any tax slippage flows from the provisions of the *Act.* The operation of section 79 ensures that Phillip, who has properly taken his ABIL, is deemed to have a $4,000,000 gain in 1992 on the disposition of the Debenture. As to the symmetry that one might expect, one can see *that* gain as offsetting the loss claimed in 1992 by Phillip. That the loss was an ABIL and the gain is an ordinary capital gain is irrelevant. That Phillip may have had capital losses to consume this gain is also irrelevant. From this perspective, there has been $12,000,000 of losses claimed, $4,000,000 of gains declared – leaving $8,000,000 of losses to be declared. That is what has occurred. There is no need for me to give this argument my further attention.

ANALYSIS

[36] As acknowledged by the Respondent, subject to subparagraph 40(2)(g)(ii), the requirements of paragraph 39(1)(c) have been satisfied to permit the Appellant to realize an ABIL of $3,000,000 upon the deemed disposition, by the Appellant, of the Debenture at December 31, 1992, pursuant to subsection 50(1). Subparagraph 40(2)(g)(ii) reads as follows:

> **(2) Limitations - Notwithstanding subsection (1)**,
>
> …
>
> (g) a taxpayer's loss, if any, from the disposition of a property, to the extent that it is
>
> …
>
> (ii) a loss from the disposition of a debt or other right to receive an amount, unless the debt or right, as the case may be, was acquired by the taxpayer for the purpose of gaining or producing income from a business or property (other than exempt income) or as consideration for the disposition of capital property to a person with whom the taxpayer was dealing at arm's length,
>
> …
>
> is nil;

[37] I will deal firstly with the threshold issue as to the Appellant's purpose for seizing Phillip's Debenture as an isolated event.

[38] It might be helpful to re-state the context in which the Appellant's acquisition of Phillip's Debenture occurred. The Debenture (and shares) replaced the $4,500,000 debt that Phillip owed the Appellant by operation of the law of guaranty and the right of contribution. Having repaid $4,500,000 of Phillip's indebtedness to the Royal Bank, the Appellant obtained a right of contribution for that amount from Phillip. As well, the Appellant had a right to an assignment of the Royal Bank's security interest in the Debenture - a right he exercised. He then seized or took ownership of the Debenture in satisfaction of his brother's indebtedness to him.

[39] The Appellant contends that he seized the $4,000,000 Debenture from Phillip in satisfaction of Phillip's debt, instead of pursuing Phillip on the debt for three reasons:

a. It was unlikely that any amount could be recovered in a claim against Phillip;
b. The Appellant believed the Debentures could have value in the future; and
c. The Appellant had been advised of a tax advantage in seizing Phillip's Debentures rather than pursuing Phillip.

[40] If I believe that the Appellant seized the Debenture because he believed it could have value in the future, that would be sufficient to dispose of the appeal in favour of the Appellant. In such case, applying the reasons in *Rich,* there would be no need to question the weight of the income-earning purpose, even if his belief in the future value of the Debenture was only a faint hope and subordinate to the tax advantage he sought. While every case must be considered in its overall context, I see no reason in the case at bar to distinguish it from the Federal Court of Appeal decision in *Rich*.

[41] *Rich* was also a case involving the taxpayer's claim for an ABIL. The trial judge had found that the predominant purpose of the share purchase that gave rise to the ABIL claim was to assist the taxpayer's son and that the commercial purpose normally associated with such purchase, namely to earn dividends, was a faint hope. While the trial judge found that fact to be fatal, the Federal Court of Appeal did not agree. The Court of Appeal allowed that the purpose test in subparagraph 40(2)(g)(ii) had been met, accepting that even a faint hope of income as a subordinate reason to acquire shares was sufficient.

[42] Recalling that the purpose of the ABIL is to encourage investment in small Canadian businesses, it is little wonder to me that a Court would accept a faint

hope as sufficient to meet the requisite purpose test. When a family business experiences financial difficulty, the objective rationality of rescue motives might always be questionable with hindsight. Considerable tolerance seems essential. In my view *Rich* stands for such principle.

[43] Still, the Respondent relies on the difference between a faint hope and the assertion that the Appellant's testimony, when viewed objectively, is not credible. The Respondent essentially wants me to find that on a balance of probability, the Appellant never considered that the worthless Debenture might someday yield a return. His self-interested testimony should be disregarded.

[44] Objectively, the Respondent's position is not without merit. The Appellant need not have released Phillip to maintain a faint hope of recovery under his security interest in Phillip's Debenture. The acquisition was not necessary for him to claim a loss on the bad debt. It was only necessary to obtain ABIL treatment.

[45] It is hard not to accept on a balance of probability that the Respondent's assertions are true in this case in spite of the Appellant's testimony. Self-interested recollections of doubtful thought processes going through one's mind years ago are not reliable. While corroborative evidence of intent or purpose may be difficult to find in cases such as this, there is a greater likelihood that such evidence might exist if the stated purpose was genuinely present. For example, evidence that he did an analysis of the Receiver's report might have warranted an inference of some faint hope being present. The absence of anything corroborative leads to an opposite inference. The only evidence the Appellant gave was that the Receiver was not patient enough to make the best of real estate cycles and that some of Shoppers Trust Co's property interests escalated in value sufficiently in recent years to give more than faint hope of recovery, had such property interests been kept. But that evidence seems only to underline that he understood that Receivers liquidate and in that environment at that time, his tax motivation for exchanging his right of contribution for the Debenture objectively appears not only to be his predominant reason for the exchange but seems likely to be the only reason. That is, the evidence tends to support a finding that the release of one debt in exchange for another was nothing other than a step taken on the advice of tax advisers in order to secure not only a capital loss for tax purposes but an ABIL.

[46] On the other hand, taking the assignment of Phillip's Debenture from the Royal Bank strikes me as a routine step anchored, objectively, in the hope of recovery. Collection of Phillip's indebtedness to the Appellant would only be

enhanced by the Appellant taking any security interest in any asset as per his entitlements. Even the Respondent does not take issue with that.

[47] If the Respondent does not take issue with the fact or likelihood that the Appellant had *recovery* options in mind when he took the security interest, it seems to me that the Respondent is hard pressed to attack the Appellant's oral testimony that he thought the Debenture may have potential value. Taking action to gain recovery options necessarily implies a belief that the Debenture itself had potential value. The Respondent's own argument focuses on the recovery options afforded by the assignment of the security interest in the Debenture without condemning the motive for obtaining the assignment. The Respondent just condemns the option chosen once the assignment was made and in doing so reliance is placed on the fact that the security interest assigned to the Appellant by the bank gave the Appellant a right to realize any value the Debenture might have without actually owning the Debenture and on the fact that the Appellant lost an additional avenue for recovery by discharging his brother without gaining any advantage.

[48] These objective realities do not, in my view, entirely distract from the corroborative inference that might properly be drawn if one accepts that the security interest assigned to the Appellant by the bank could reasonably be considered as having been acquired because it represented some potential value as a security interest. Any value perceived in a security interest in the Debenture reflects value perceived in the Debenture. On this basis, I might be inclined to give the Appellant the benefit of the doubt as to his purpose. However, such finding is not necessary as the Appellant's alternative argument prevails in any event.

[49] The Appellant's alternative argument is that the time to consider purpose is not the time of acquiring (seizing) the Debenture. If that was the time to apply the test of a purpose to gain or produce income, the test could never be satisfied. It is the Appellant's position that his seizing Phillip's Debenture was a direct result of the income earning purpose that motivated him to effectively guarantee Phillip's debt and invest in Shoppers Trust Co originally. The Appellant relies on the *Cadillac Fairview* line of authorities that rejects a narrow and mechanical reading of subparagraph 40(2)(g)(ii). As Chief Justice Bowman said in his Reasons for Judgment in *Cadillac Fairview*:

> A functional and more commercially realistic interpretation would subsume in the purpose of the acquisition of the subrogated debt the purpose for which the guarantee was originally given.

[50] However, in that case and the other cases relied on by the Appellant, the debt referred to is the debt arising as a consequence of the right of contribution. In the case at bar that debt is Phillip's personal debt to the Appellant. That personal indebtedness of Phillip was acquired at law when the Appellant paid Phillip's debt to the Royal Bank. If the indebtedness to the Appellant remained Phillip's, the authorities relied on would be on all fours and I would not hesitate to apply them and relate back to the earlier transaction in determining the Appellant's purpose in respect of his acquiring the debt that arose from his right of contribution. However, in the case at bar the relevant indebtedness to the Appellant did not remain Phillip's; instead it was replaced with the indebtedness of Shoppers Trust Co in the form of the Debenture.

[51] Without this "exchange", the Appellant would be entitled to a capital loss in respect of the bad debt owed to him by his brother. It was a bad debt to which section 50 would apply. This would be the case even though the debt was created well after the transactions that led up to and eventually gave rise to its creation. However, in that case he would not be entitled to an ABIL. The Respondent sees this extra "exchange" step, affected by seizing Phillip's ownership interest in the Debenture and releasing Phillip, as a step that distinguishes the line of cases relied on by the Appellant. That step, as an isolated step that affords the Appellant better tax treatment, is argued by the Respondent not to be governed by the authorities relied on by the Appellant but rather is one that must be governed by the principles set out by the Supreme Court of Canada in *Singleton*.

[52] In considering how this extra step fits into the analysis, it is necessary to consider the provisions of the *Act* that govern it. The governing provision is section 79 of the *Act*.[12] At the relevant time that section provided that where beneficial ownership of a property (the Debenture) is acquired by a person (the Appellant) from a debtor (Phillip) as a consequence of the failure of the debtor (Phillip) to pay the debt owed (Phillip's debt arising from the Appellant's right to contribution), the creditor's (the Appellant's) adjusted cost base of the debt owed is deemed to be nil. Since the value of the extinguished unpaid debt is nil, no gain or loss is triggered on its extinguishment. The cost of the property (the Debenture) acquired by the creditor (the Appellant) in satisfaction of the debt is then deemed to be the cost of the debt extinguished on the acquisition ($4,000,000).

---

[12] Section 79 as it read in 1992 is set out in Appendix B attached to these Reasons.

[53] In more general terms, section 79 transfers the loss associated with the bad debt to the newly acquired property. No immediate tax consequence is triggered in relation to the loss incurred as a result of the debtor's failure to pay. The loss is deferred and recalculated based on future events such as on the disposition of the newly acquired property. Where the newly acquired property is a debt instrument such as the Debenture in this case, such a future event would include the application of section 50 if the requirements of that section are met. In the case at bar, section 50 applies and the Appellant's loss is recognized unless, as argued by the Respondent, subparagraph 40(2)(g)(ii) applies to deny the loss.

[54] The Appellant argues, in effect, that the *Act* should not be read in a manner that would eliminate the loss that section 79 is intended to preserve. I agree. To preserve the loss, which is the purpose of section 79, an income earning intention acknowledged in respect of the original debt must flow through to the newly acquired property as worthless as it may be. Otherwise such an exchange of indebtedness involving a worthless Debenture in a non-SBC could result in the denial of a capital loss in respect of which an ABIL was not being sought. Even the Respondent has not suggested such a construction of the *Act*. The Respondent just objects to the effectiveness of a tax plan when the exchange of debt results in an ABIL. However, it is well established that taking advantage of sections of the *Act* that give rise to preferred tax treatment is not a reason to deny the advantage sought. That the newly acquired property, the Debenture, might afford the creditor a less restricted use of the loss is in this sense circumstantial and in any event, in respect of the tax advantage sought, there is a direct connection between the property acquired by the Appellant under section 79 (a debt instrument of a SBC) and the original indebtedness that arouse as a consequence of a guarantee given by the same taxpayer (the Appellant) to re-finance that same SBC. On that basis it follows that a functional and more commercially realistic interpretation of section 79 would be to subsume in the purpose of the acquisition, to which that section applies, the purpose for which the guarantee was originally given.

[55] As to the Respondent's reliance on *Singleton*, in my view, that case can readily be distinguished. It dealt with whether borrowed money was used for the purpose of earning income as required by paragraph 20(1)(c) of the *Act* to allow an interest deduction. No other provisions of the *Act* had to be considered in terms of aiding or dictating a particular construction of that provision in the circumstances of that case. That being the case, the Court found in favour of the taxpayer, relying on the direct link from the borrowed money to an eligible use. The loan proceeds were in that case found to be used for an income earning purpose because they were

directly applied to an income producing asset which was *held* (already held) for that purpose.

[56] The test in the case at bar is very different. Subparagraph 40(2)(g)(ii) looks to the purpose of the acquisition of the debt not the use to which money is put. The "purpose of acquisition" test has already been held by a strong line of thoughtful and compelling cases to relate back to the purpose of the transaction that ultimately gave rise to the acquisition of the debt where the acquisition occurs by virtue of a right of contribution. That is, the proper construction of the purpose test in such cases is impacted by its interaction with such related events. The acquisition of the Debenture is such a related event and that event calls even more for the purpose test to be related back. Otherwise section 79 will fail to accomplish its objective in a very penalizing way. Accordingly, I am satisfied that the reasoning in the *Cadillac Fairview* line of cases must apply equally to the case at bar. Section 79 deals with the acquisition of property (the Debenture) on the basis that the loss denied by that provision (in respect of the extinguishment of the contribution debt owed by Phillip) will be accounted for when a taxable event occurs in respect of that property. In such case one must subsume in the purpose of the acquisition governed by section 79, the purpose that relates back to the extinguished debt, which in turn relates back to the purpose of providing the guarantee in the first place.

[57] The debt in this case arose in respect of a financing arrangement made for a SBC. As a result of that arrangement the Appellant has incurred a loss. That that loss can only be categorized as an ABIL by taking an extra tax planned step is no reason to view that step, and the provisions of the *Act* applicable to it, in a way that leaves the Appellant on the outside of the tax expenditure provisions put in the *Act* to assist in the financing of SBCs. In these circumstances a functional and more commercially realistic interpretation of the subject provisions would be to subsume in the purpose of the acquisition to which section 79 applies, the purpose for which the guarantee in this case was originally given. Such construction, in my view is consistent with the object and spirit of the subject provisions. To find otherwise would not be in harmony with their evident purpose, would lack common sense and would cast a blind eye to the commercial and economic realities of business transactions. These were the comments of Justice Bell in *National Developments* at page 1067. While they referred singularly to subparagraph 40(2)(g)(ii), they apply equally in my view to the interaction among section 79, subparagraph 40(2)(g)(ii) and the provisions of the *Act* affording ABIL treatment to debt instruments of SBCs.

[58] For all these reasons the appeals are allowed.

Signed at Ottawa, Canada this 23rd day of May 2007.

"J.E. Hershfield"

Hershfield J.

APPENDIX A

97-3731(IT)G

TAX COURT OF CANADA

BETWEEN:

JOHN H. DANIELS

Appellant

-and-

HER MAJESTY THE QUEEN

Respondent

STATEMENT OF AGREED FACTS

The Appellant and the Respondent hereby each agree that for the purposes of this appeal, the following facts are admitted:

1. At all material times the Appellant and his brother, Phillip Daniels ("Phillip"), were residents of Canada.

2. At all material times Phillip owned 75% of the common shares of Shoppers Trust Company, ("Shoppers Trust"), and 547900 Ontario Limited, a company all of whose common shares were owned by the Appellant, owned 25% of the common shares of Shoppers Trust.

3. Shoppers Trust is a corporation incorporated under the *Loan and Corporations Trust Act* (Ontario). Shoppers Trust was a Canadian-controlled private corporation and a small business corporation within the meaning of the Act throughout the relevant period and carried on the business of lending money.

4. Prior to 1988, each of the Appellant and Phillip also owned Shoppers Trust debentures with a face amount of $1,500,000, and Phillip was indebted to the Toronto Dominion Bank (the "TD Bank") in the amount of $3,000,000 (the "TD Debt").

5. The Appellant had acquired his Shoppers Trust debentures in exchange for preference shares of Shoppers Trust for which he had paid $1,500,000.

6. In 1988, the Appellant and Phillip borrowed $8,000,000 (the "Royal Bank Loan") from the Royal Bank of Canada (the "Royal Bank") on a joint and several basis. Phillip received $5,500,000 of the proceeds of the Royal Bank Loan, and the Appellant received $2,500,000 of those proceeds.

7. The Appellant had an income earning purpose when he became jointly and severally liable to the Royal Bank in respect of the $8,000,000 Royal Bank Loan made to him and Phillip.

8. Phillip used the $5,500,000 proceeds of the Royal Bank Loan to repay the TD Debt (of $3,000,000), and purchased additional Shoppers Trust debentures for $2,500,000 with the remaining proceeds, and thereafter owned $4,000,000 of Shoppers Trust debentures ("Phillip's Debentures").

9. The Appellant used his share of the proceeds of the Royal Bank Loan of $2,500,000 to purchase additional Shoppers Trust debentures for $2,500,000, and thereafter owned $4,000,000 of Shoppers Trust debentures (the "Appellant's Debentures").

10. Each of the Appellant and Phillip pledged his respective $4,000,000 of Shoppers Trust debentures and his common shares in Shoppers Trust (collectively, the "Shoppers Securities") to the Royal Bank as security for the Royal Bank Loan.

11. Before 1992, Phillip repaid $1,000,000 of the Royal Bank Loan and the Appellant repaid $500,000 of the Royal Bank Loan. After these repayments, the Royal Bank was owed $4,500,000 by Phillip and $2,000,000 by the Appellant. Both the Appellant and Phillip were jointly and severally liable in respect of the entire indebtedness of $6,500,000.

12. In January of 1992, the Appellant repaid an additional $1,250,000 to the Royal Bank. After this repayment, the Royal Bank was owed $4,500,000 by Phillip and $750,000 by the Appellant. Both the Appellant and Phillip were jointly and severally liable in respect of the entire remaining indebtedness of $5,250,000.

13. The Office of Financial Savings Institutions, an Ontario regulatory authority, undertook an audit of Shoppers Trust in December, 1991. As a result, Shoppers Trust was put into receivership in March, 1992.

14. Each of the Appellant and Phillip determined that at December 31, 1991, the Shoppers Securities had become worthless.

15. Each of the Appellant and Phillip, in computing his income for his 1991 taxation year, claimed an allowable business investment loss of $3,000,000 in respect of the loss each suffered in respect of the Shoppers Securities.

16. The deduction of the said allowable business investment losses was allowed by the Minister of National Revenue (the "Minister") in computing the income of the Appellant and Phillip for their respective 1991 taxation year.

17. The Royal Bank called for repayment of the Royal Bank Loan in 1992. Phillip could not repay any part of the outstanding balance of the Royal Bank Loan. Consequently, the Appellant, pursuant to his joint and several obligation, was required to repay the full amount of $5,250,000 owing to the Royal Bank. The Appellant borrowed this sum from the Royal Bank in June, 1992 and used the proceeds of that loan to repay the $5,250,000 joint and several indebtedness of the Appellant and Phillip to that bank.

18. In the aggregate, therefore, the Appellant repaid $7,000,000 of the Royal Bank Loan.

19. By letter dated November 18, 1992, addressed to Phillip, the Appellant demanded that Phillip pay to him Phillip's $4,500,000 share of the Royal Bank Loan which the Appellant had repaid, failing which the Appellant would obtain an assignment from the Royal Bank of the Shoppers Trust debentures which Phillip had pledged to that bank as security for the Royal Bank Loan, and would take steps to recover payment in full of that amount.

20. On December 1, 1992, the Appellant obtained from the Royal Bank an assignment of Phillip's Debentures.

21. On December 4, 1992, the Appellant gave Phillip written notice pursuant to section 63 of *The Personal Property Security Act* of Ontario that the Appellant intended to dispose of Phillip's Debentures, unless Phillip paid the Appellant $4,500,000, but that if that amount was not paid, the Appellant accepted Phillip's Debentures in satisfaction of Phillip's obligation to the Appellant.

22. As a result of Shoppers Trust having been put into receivership, Phillip got into serious financial difficulties which not only rendered him unable to pay the Appellant the $4,500,000 which the Appellant demanded, but even compelled him to sell his personal residence. The Appellant, therefore, made no attempt to collect the $4,500,000 from Phillip after March, 1992, but rather acquired Phillip's Debentures.

23. Shoppers Trust has continued to be in receivership until this day, and its debentures had no value at December 31, 1992.

24. In computing his income for his 1992 taxation year, the Appellant deducted an allowable business investment loss of $3,000,000 in respect of Phillip's Debentures. This deduction was disallowed by the Minister on reassessing the Appellant for that year.

25. In computing his income for his 1992 taxation year, Phillip included a capital gain of $4,500,000 in respect of the disposition of Phillip's Debentures and certain shares.

26. The Appellant and the Respondent acknowledge and agree that each of them may introduce additional evidence in this appeal that is not inconsistent with the facts admitted above.

SECTION 79: Mortgage foreclosures and conditional sales repossessions.

Where, at any time in a taxation year, a taxpayer who

(*a*) was a mortgagee or other creditor of another person who had previously acquired property, or

(*b*) had previously sold property to another person under a conditional sales agreement,

has acquired or reacquired the beneficial ownership of the property in consequence of the other person's failure to pay all or any part of an amount (in this section referred to as the "taxpayer's claim") owing by him to the taxpayer, the following rules apply:

(*c*) there shall be included, in computing the other person's proceeds of disposition of the property, the principal amount of the taxpayer's claim plus all amounts each of which is the principal amount of any debt that had been owing by the other person, to the extent that it has been extinguished by virtue of the acquisition or reacquisition, as the case may be;

(*d*) any amount paid by the other person after the acquisition or reacquisition, as the case may be, as, on account of or in satisfaction of the taxpayer's claim shall be deemed to be a loss of that person, for his taxation year in which payment of that amount was made, from the disposition of the property;

(*e*) in computing the income of the taxpayer for the year,

(i) the amount, if any, claimed by the taxpayer under subparagraph 40(1)(*a*)(iii) or 44(1)(*e*)(iii) in computing the taxpayer's gain for the immediately preceding taxation year from the disposition of the property, and

(ii) the amount, if any, deducted under paragraph 20(1)(*n*) in computing the income of the taxpayer for the immediately preceding year in respect of the property,

shall be deemed to be nil;

(*f*) the taxpayer shall be deemed to have acquired or reacquired, as the case may be, the property at the amount, if any, by which the cost at that time of the taxpayer's claim exceeds the amount described in subparagraph (*e*)(i) or (ii), as the case may be, in respect of the property;

(*g*) the adjusted cost base to the taxpayer of the taxpayer's claim shall be deemed to be nil; and

(*h*) in computing the taxpayer's income for the year or a subsequent year, no amount is deductible in respect of the taxpayer's claim by virtue of paragraph 20(1)(*l*) or (*p*).

CITATION:	2007TCC179
COURT FILE NO.:	97-3731(IT)G
STYLE OF CAUSE:	John H. Daniels and Her Majesty the Queen
DATE AND PLACE OF HEARING:	March 6, 2007 - Toronto, Ontario
REASONS FOR JUDGMENT BY:	The Honourable Justice J.E. Hershfield
DATE OF JUDGMENT:	May 23, 2007
APPEARANCES:	
Counsel for the Appellant:	Sheldon Silver, Q.C. Glenn Ernst
Counsel for the Respondent:	Luther P. Chambers Pascal Tétrault
COUNSEL OF RECORD:	
For the Appellant:	
Name:	Sheldon Silver, Q.C. Glenn Ernst
Firm:	Goodmans, LLP
For the Respondent:	John H. Sims, Q.C. Deputy Attorney General of Canada Ottawa, Canada