SUPREME COURT OF CANADA

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Case in Brief: *MacDonald v. Canada*

Judgment of March 13, 2020 | On appeal from the Federal Court of Appeal
Neutral citation: 2020 SCC 6

How a taxpayer uses a "derivative contract" determines how it is treated for tax purposes, the Supreme Court has ruled.

Mr. MacDonald had worked in finance and owned a large number of shares. He started a business. He got a loan from his bank. He used some shares to "secure" part of the loan. If he couldn't pay back what he borrowed, the bank could take the shares as "security." He could borrow up to 95% of the value of the shares. This was over $10 million.

Mr. MacDonald and his bank also signed a "forward contract" covering the shares. A forward contract is an agreement to buy (or sell) something at a specific price on a future date. It is a kind of "derivative contract," which is a contract based on an "underlying asset" (in this case, the shares). These kinds of contracts are common in the financial world. Forward contracts can be for "speculation" or for "hedging." "Speculation" is when someone invests in something that increases their risk, hoping for a high return. It is more like gambling. "Hedging" is when someone invests in something to reduce risks of price changes in something else. It is more like insurance.

In this case, if the value of the shares went up, Mr. MacDonald agreed to pay the difference between the new price and the price in the forward contract. If the value of the shares went down, the bank would pay him. The money Mr. MacDonald got would be used as extra security for the loan.

The price of the shares increased. Mr. MacDonald paid his bank about $10 million. These payments were "cash settlement payments" under the forward contract.

The issue in this case was how Mr. MacDonald claimed the cash settlement payments on his income tax. Under the *Income Tax Act*, there are two basic categories of earnings. The first category is ordinary income from things like employment and business. The second is capital gains or losses, which are the profits (or losses) you get from selling something for more (or less) than you paid for it. How gains and losses are treated can make a big financial difference for a taxpayer. Whether the payments from the forward contract were income losses or capital losses depended on whether the forward contract was a hedge or speculation.

Mr. MacDonald said he was using the forward contract to speculate. This meant the payments he made should be deducted from his business income. Canada Revenue Agency said he was using the forward contract to hedge. This meant the payments were capital losses.

The Tax Court said the forward contract was speculation. The Federal Court of Appeal said it was a hedge.

The majority of judges at the Supreme Court said the purpose of a derivative contract determines whether it is a hedge or speculation. They said the purpose of Mr. MacDonald's contract was hedging. This meant the payments were capital losses. To find the purpose of the forward contract, the majority looked at how closely it was tied to the shares (the "underlying asset"). The more closely a derivative contract is tied to the underlying asset, and the better it is at lowering risk, the more likely it is to be a hedge. Otherwise, it's more likely to be speculation.

Shares can go up or down in value over time. But in this case, the majority noted the forward contract protected Mr. MacDonald from this risk and uncertainty. This protection was almost perfect. The loan agreement and the agreement to use the shares as security weren't part of the forward contract. But the majority said they were important context for determining the purpose of the forward contract. Mr. MacDonald had to provide the bank with shares and with any payments from the forward contract as security for the loan. The amount of money he could borrow was tied to the value of his shares. The amount of shares he provided as security for the loan were the same number of shares covered by the forward contract. This allowed the bank to give Mr. MacDonald a good deal because it faced very little risk if he didn't pay back his loan. This arrangement showed enough of a connection between the contract and the shares to indicate a hedging purpose.

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This case started as a disagreement with Canada Revenue Agency. Tax disagreements can be appealed to the Tax Court of Canada, which focuses on tax cases.

Breakdown of the decision: ***Majority:*** Justice Rosalie Silberman Abella dismissed the appeal (Chief Justice Wagner and Justices Moldaver, Karakatsanis, Brown, Rowe, Martin, and Kasirer agreed) | ***Dissenting:*** Justice Suzanne Côté said whether a forward contract was characterized as on income or on capital depended on the taxpayer's intent, as confirmed by objective facts, and would have allowed the appeal

More information (case # 38320): Decision | Case information | Webcast of hearing

Lower court rulings: appeal from reassessments (Tax Court of Canada) | appeal (Federal Court of Appeal)
