The Taxation of Securities Transactions — II: Recent Legislation

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Two recent amendments to the *Income Tax Act*² affect the taxation of securities transactions. Capital losses on certain securities can now be set off against ordinary income,² and certain taxpayers can elect to treat all ordinary gains and losses on securities as capital gains and losses.³ Neither device is completely original, for there are well-known statutory precedents for each in the United States.⁴ They are challenging provisions to analyze in the Canadian context because their authors departed from the American models in intriguing ways, and these deviations promise to attract litigation or further amendment of the Act.

I. Operation of the provisions

A. Business investment losses

Section 3(d) permits taxpayers to deduct from ordinary income allowable capital losses on the shares or debt of Canadian controlled private corporations,⁵ instead of restricting their application

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1 S.C. 1970-71-72, c. 63 as am. [Unless otherwise noted, all references to the *Income Tax Act* are to this version.]

2 *Income Tax Act*, s. 3(d), added by S.C. 1977-78, c. 42, s. 1(2), applicable from the calendar year 1978 onward: s. 3(d) must be read with the amendments in ss. 38(c) and 39(1)(c), which were added by S.C. 1977-78, c. 42, ss. 2, 3. The allowable capital losses that may be off-set against ordinary income are "business investment losses" [hereinafter also "BIL"].


4 I.R.C. §1244 permits incorporators of small businesses to treat all gains and losses on that corporation's stock as ordinary income and losses, if such an election is made at the time of incorporation. I.R.C. §1221 deems all gains and losses on transactions in securities to be capital gains and losses for all taxpayers except dealers in securities.

5 *Income Tax Act*, ss. 39(1)(c)(i)(A), (B). "Canadian controlled private corporation" is defined in s. 125(6)(a) and will be alternatively referred to herein as "CCPC".
to capital gains. If a loss on CCPC shares is generated by a business transaction or an adventure, the full amount of the loss may be offset against ordinary income, but if the loss is a business investment loss only half of it may be applied to ordinary income. The BIL rules do not attempt to clarify the distinction between capital and income transactions, and so eligibility will rest on tests devised by the courts.6

The provisions governing business investment losses are found in three statutory fragments: sections 39(1)(c), 38(c) and 3(d). Section 39(1)(c) is the starting point, defining “business investment loss” as non-income losses from dispositions of CCPC shares or debt:

loss for the year determined under this subdivision (to the extent of the amount thereof that would not, if section 3 were read [without reference to the expression “other than a taxable capital gain from the disposition of a property” in paragraph (a) thereof and without reference to paragraph (b) thereof], be deductible in computing his income for the year or any other taxation year) from the disposition after 1977 of any property . . . .

Section 38(c) then provides that half of that business investment loss is an “allowable” business investment loss, and section 3(d) instructs the taxpayer to deduct allowable business investment losses at the time that income losses are taken into account.

The most important effect of this provision is that it takes some of the sting out of forming a corporation which is so unsuccessful that its shares are sold at a loss. Previously, tax advisers could offer only partnership organization to entrepreneurs who foresaw the possibility of losses: now the limited liability that flows from incorporation can be acquired while sacrificing only half the tax benefit of eventual losses, although application of the losses will be postponed until the actual disposition of the shares.7

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7 Quaere whether the “BIL” rules have any effect on the non-recognition by s. 85(4) of loss on the non-arms-length disposition of shares to a controlled corporation. Also, s. 54(c) gives an elaborate definition for the “disposition” of property, but does not allow the taxpayer to recognize loss in a year in which the obligations become worthless, even if the formal steps of redemption, cancellation and so forth have not been taken. If the American experience with stock is any guide, as contemplated in I.R.C. § 1244, tax administrators may prove receptive to such a position: see e.g., I.R.C. Regs. §§ 1.1244(a)-1(a) which state that § 1244 extends to a loss on a sale or exchange, “including a transaction treated as a sale or exchange, such as worthlessness”.

This improved loss relief is designed to increase the rate of investment in business operations. However, considering that operating losses of a partnership are fully allowable, this partial allowance for dissolution losses to holders of corporate obligations may not eliminate the disadvantage of early incorporation. Instead, it may simply reduce present disincentives to incorporation of existing businesses. An entrepreneur can operate an unincorporated business during the initial loss period, incorporate when the enterprise becomes profitable and enjoy the reduced rate of taxation until the total business limit is exceeded, and then take advantage of the limited protection provided by the BIL rules if the shares are disposed of at a capital loss in the future. A similar scheme is to be found in the United States, but the Canadian approach is less generous by comparison. A noteworthy feature of the Canadian scheme is that losses on holding-company shares qualify for the special business investment loss relief even if their operations did not qualify for the small business credit.

Since section 38(c) qualifies only half of a business investment loss for treatment as an ordinary loss, the only real benefit to the taxpayer is its greater scope of application, because the quantum of loss relief available is the same in both cases. An inevitable question is whether a taxpayer may choose to forego the "benefit" conferred by the new rules, due to hardship or any other cause, or whether the business investment loss relief is mandatory in all cases. Circumstances in which this desire will arise may be un-

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8 *Income Tax Act*, s. 125(2)(b), as am. by S.C. 1976-77, c. 4, s. 49(1), raised the total business limit to $750,000 for 1976 and subsequent tax years.

9 Note that under s. 125(6)(b) of the *Income Tax Act* a net loss does not reduce the cumulative deduction account; it can be reduced only by the payment of taxable dividends. A corporation which has a significant net operating loss will not ordinarily be able to distribute enough taxable dividends to requalify itself for the credit in anticipation of re-establishing a profit; hence no tax purpose is served in postponing disposition of shares.

10 See I.R.C. § 1371 (sub-chapter "S" corporations, which consist largely of "active business" corporations, are mere conduits for shareholders, as net profits or losses flow through to the shareholder each year), and § 1244 (losses on dispositions of small active business corporation shares are treated as ordinary losses, not capital losses, and thus are fully allowable up to $25,000 each year).

11 Cf. I.R.C. § 1244(c)(1)(E), which denies special relief if the corporation derived 50% or more of its income from "royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities". See also §1244(c)(2), which defines the small business corporation for purposes of the stock rules in §1244.
common, but they are not unimaginable. Section 39(1) (b) is not coordinated with the new 39(1) (c), nor do sections 38(b) and (c) complement each other. One may argue that the taxpayer can compute both the allowable capital loss and the allowable business investment loss with respect to the same disposition, but section 3(b) (ii) limits recognition of allowable capital losses in the computation of income for the year to non-business investment losses. It will be interesting to see whether the courts recognize that section 39(1) (c) is permissive and that a mandatory construction would thwart one purpose of the provision, namely, improved loss relief. This provision continues the trend of favouring incorporated businesses in the expectation that this will stimulate the overall rate of business investment. As a consequence, the rate at which new corporations are formed will probably continue to increase even if the rate of formation of business entities remains stable. 

B. Lifetime election

The election provided in section 39(4) permits all individuals to treat all their securities transactions as capital transactions, provided that they are not dealers or traders in securities. In effect, the controversy over capital/income classification will now focus on the determination of who is a dealer or trader in securities.

The lifetime election operates by a deeming mechanism. In the year in which the election is made, "every Canadian security owned by him in that year", as well as Canadian securities owned by the taxpayer in "any subsequent taxation year", are deemed to have been capital property "in those years". For good measure, every disposition of those deemed capital properties is deemed to be a disposition of a capital property. The election may be made in

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12 E.g., excess allowable business investment losses will go to make up non-capital loss carry-over accounts, and not all taxpayers will prefer to have non-capital loss carry-overs with their limited viability when net capital loss carry-overs exist indefinitely; see Income Tax Act, ss. 111(1)(a) and (b).


14 Income Tax Act, s. 39(4). “Capital property” is defined in s. 54(b)(ii) as: "... any property ..., any gain or loss from the disposition of which would, if the property were disposed of, be a capital gain or a capital loss .... Since s. 39(1) defines a capital gain as excluding pre-1972 ordinary income, it is difficult to see exactly how deeming shares as capital property forces
respect of any tax year after 1976,\textsuperscript{15} and once it is made it is effectively a lifetime election which controls the character of all dispositions of securities as long as the taxpayer continues to possess legal personality under tax law. There is at present no mechanism for revoking the election, although its operation can be suspended by disqualification. The limitations on the election refer to the taxpayer and to the subject-matter of the disposition. If the taxpayer is "a trader or dealer in securities", or is a corporation that carries on the business of lending money or of factoring commercial obligations, or falls into narrow prohibited categories, the election is inoperative with respect to a year in which the taxpayer has that disability.\textsuperscript{16} The subject-matter limitation provides that the election applies only to securities which are "issued by a person resident in Canada".\textsuperscript{17} This phrase can be construed broadly as indicating all obligations which fit within the notion of a security and are Canadian issues, or it may be construed narrowly as meaning only the types of securities mentioned in the provision, with the additional requirement that they be issued by a "person"\textsuperscript{18} resident in Canada.

C. Timing considerations of the election

The nature of the election raises some problems in timing which the taxpayer should consider carefully. These include: (1) when the decision must be made, relative to the tax year in which the election is made; (2) factors that should affect the decision; (3) avoiding the disadvantages of an early election by the use of a holding company, and (4) using an early election to protect against future disqualification.

1. When the decision must be made

The election is made in the taxpayer’s return for the year, which allows time for reflection. The legal character of the taxpayer does not affect the election itself, and once the election is made, all of the shares owned by the taxpayer in the year to which the election gains to be classed as capital gains. The problem with the scope of "business" has been that the character of the transaction, and not the type of property, determined the treatment of the proceeds, so that s. 54(b)(ii) would not seem to achieve the desired result.

\textsuperscript{15}Income Tax Act, s. 39(4).
\textsuperscript{16}Ibid., s. 39(5).
\textsuperscript{17}Ibid., s. 39(6).
\textsuperscript{18}See s. 248(1) of the Income Tax Act for the definition of "person".
relates and any securities owned in subsequent years are deemed to be capital property, beginning with the year of the election. However, under section 39(5), “an election under sub-section 4 does not apply to a disposition of a Canadian security by a taxpayer who, at the time the security is disposed of”, falls into one of the enumerated classes. Only the deemed capital aspect of section 39(4) is nullified, and thus a taxpayer could intermittently treat gains and losses as capital rather than as income amounts, depending on his or her current occupation. During the years in which the dispositions are unprotected by the election, the tax treatment of a sale would be governed by the traditional concepts of adventure, business and capital gains.

2. Factors to consider in making the election

As the election is effectively permanent, it will always apply to a taxpayer's dispositions unless the taxpayer falls into one of the disqualifying categories set out in section 39(5). But the election applies equally to gains and losses, so that valuable losses in future years may be lost if there are no off-setting capital gains available at the right time. Taxpayers and their advisers should be cautious in making the election. It should never be made by a taxpayer anticipating losses, and taxpayers should assure themselves that their gains actually will be treated as ordinary income before committing themselves to this irrevocable decision.

3. Electing through a holding company

The most serious shortcoming of the scheme is that it does not contemplate the taxpayer who deals or trades in securities but who engages in investment transactions in a personal or private capacity: the benefit of the election is denied to such taxpayers.

It is suggested that disqualified taxpayers who wish to employ the election could form controlled corporations which can then elect. Provided that the corporate formalities are observed, the subsequent transactions are bona fide and do not involve any off-market valuations or breaches of fiduciary duties, the corporation would certainly have the right to elect as an independent legal person. Taking this approach one step further, it would seem reasonable for all taxpayers to use the election through controlled corporations, as long as all of the above precautions are taken. The legal personality of the corporation is terminable at will; that of a human being is not, at least in a commercial sense. If this approach to tax planning is unacceptable to the legislature, a battery
of anti-avoidance rules will undoubtedly be appended to what is now a relatively uncomplicated provision.\textsuperscript{10}

4. Advantages of an early election

The effect of the election is that all of the taxpayer's Canadian securities in the year of election, and in subsequent years, are deemed to be capital property.\textsuperscript{20} Thus if the election applies to a disposition it is deemed to be a disposition of capital property.\textsuperscript{21} Whether the election applies to a disposition is determined by section 39(5), which provides that the election does not apply to a disposition by a taxpayer who, at the time the security is disposed of, falls into the class enumerated in section 39(5). Thus a taxpayer who becomes a dealer or trader in securities, or "tainted" in some other way, may elect to treat all securities as capital property (by disposing of some security and making the election) before being disqualified. The taxpayer can then wait until he or she loses the disability under section 39(5) before disposing of any securities held or acquired during that time. Presumably section 39(4)(a) would operate to deem such securities to have been capital property during the holding period, even if dispositions during that period would not have been protected by the election.

It is not clear whether the election was intended to produce this result, but the policy of letting tainted taxpayers use the election to protect earlier acquisitions after leaving the tainting activity is consistent with the rationale for the capital gains preference: if such a taxpayer holds securities until after retirement from trading or financial business, the length of the holding period would rebut the presumption that the trader or financier intended to trade rather than invest in securities.

5. Relationship between section 39(1)(c) and section 39(4)

The provisions for the business investment loss and the capital gains election do not refer to each other. However, since both operated on the categorization of losses on CCPC shares, questions as to their ranking and interaction will arise in cases of conflict. There will be no such conflict unless the taxpayer has made the

\textsuperscript{10} Quaere the effect of incorporation on the formation of such corporations and the classification of investment income received by corporations. S. 129 tends to support the contention that the fact of incorporation is no longer relevant in classifying sources of income, but compare Birmount Holdings Ltd v. The Queen [1977] C.T.C. 34, 77 D.T.C. 5031 (F.C.T.D.) \textit{per} Sweet D.J., \textit{aff'd} [1978] C.T.C. 358, D.T.C. 6254 (F.C.A.) \textit{per} Heald J.

\textsuperscript{20} \textit{Income Tax Act}, s. 39(4)(a).

\textsuperscript{21} \textit{Ibid.}, s. 39(4)(b).
election under section 39(4): if the transaction is a capital transaction, the capital loss will be treated as a business investment loss, and if the transaction is an adventure in the nature of trade or an ordinary business transaction, the loss will be fully allowable as a business loss.

Conflict exists between the two provisions only when the following conditions are present: (1) the taxpayer has made an election under section 39(4), (2) the "securities" in question are CCPC obligations, and (3) the disposition of the securities generated a loss. If the transaction in question was in fact a capital transaction, and not a deemed capital transaction under section 39(4), the question is which provision will prevail — section 39(4), because any disposition of a security will be deemed to be a disposition of a capital property, or section 39(1)(c), because a business investment loss is any loss that is not an income loss under section 3(a). Section 39(1)(c) is more specific in its scope than section 39(4), and thus it may be argued that the loss should be classed as a business investment loss. This position is further supported by the argument that section 39(4) was not enacted in order to guarantee capital treatment for capital transactions but was intended to confer greater certainty on transactions that fall into the middle ground between business and capital transactions.

A more serious version of the same conflict arises when the taxpayer realizes a loss on CCPC obligations in a transaction which is characterized as an adventure by the jurisprudence, but which is deemed to be a capital disposition because an election has been made. Is the loss then to be treated as an allowable capital loss (allowing half to be off-set against taxable gains), or is it an allowable business investment loss (with half written off against all income, including taxable capital gains)? The conflict arises by virtue of the deeming mechanism in the election: is a loss that is generated by a deemed capital disposition the same as a loss determined [under the capital rules] (to the extent of the amount thereof that would not, if section 3 were read [without reference to the expression "other than a taxable capital gain from the disposition of a property" in paragraph [39(1)] (a) thereof and without reference to paragraph [39(1)] (b) thereof], be deductible in computing his income for the year ...) from the disposition ... of any property ?

The legislation does not attempt to resolve this conflict; but the traditional rules of interpretation, as well as the apparent intent of section 39(1)(c), suggest that business investment loss rules govern, even when the mandatory relief granted by the section is not particularly beneficial to the taxpayer.
Once the election has been made, the effect of the combined election-capital loss relief rules on business losses should alert the prudent taxpayer to careful consideration of the treatment of transactions at common law before making the election. A premature election can disallow half of the taxpayer’s business losses if they are losses on CCPC obligations, and will further reduce the scope of their application if they are losses on non-CCPC securities.

II. Qualifications for election

The principal reason for providing the election in section 39(4) is to enhance the certainty of tax treatment of securities transactions by persons who are active in the market. This is not the only taxation provision aimed at strengthening the ailing Canadian securities industry; and where it does not achieve its purpose directly, it may do so indirectly by making capital treatment of securities transactions available to a wider class of taxpayers.

The structure of the election is interesting when compared with the American approach to the taxation of securities gains. During

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An important impediment to venture capital investment is the tax uncertainty relating to investments in new enterprises. Under the existing rules, certain investors face the possibility that any gains on their investments will be taxed fully as ordinary income rather than as a capital gain. To remove this uncertainty, a taxpayer will be permitted to make a permanent lifetime election to have capital gains treatment in respect of his investments in most types of Canadian securities. This option will not be available to security dealers, banks, trust companies or similar financial institutions.

23 The amendments of 1977 greatly simplified the rules governing corporate transfers, but firmly locked capital and pre-1972 surpluses into corporations by eliminating tax-deferred dividend elections after 1978 (subsequently extended to 1991). This move has somewhat reduced the attractiveness of shares which previously yielded tax-deferred dividends. However, countervailing inducements are provided by the “disintegration of integration”, although the combined effect of these two developments is to draw equity investments from corporations with large capital or pre-1972 surpluses to those primarily engaged in property investments. Other tax measures designed to attract equity investment in incorporated businesses are the enriched dividend tax credit introduced in 1977 and 1978, the dividend and interest-received deductions, the elimination of the designated surplus rules and the small business tax credit.

24 The cohesiveness of the North American securities industry justifies a closer examination of the United States approach. Recognition of the need for greater uniformity governing the securities industry in Canada and the
the black days of the U.S. securities markets, section 1221 of the *Internal Revenue Code* was enacted to limit the widespread application of stock market losses to otherwise taxable incomes.\(^{25}\) That section limited ordinary loss (and gain) treatment to those who were "dealers", holding shares as inventory for sale to customers. Thus the active trader, who was previously denied capital treatment because of the frequency and organization of transactions,\(^{26}\) had "guaranteed" capital gains on all securities gains and losses.

The effect of the American approach is to lock in losses in a declining market, and in rising markets to give investor-traders the same tax concession that is used to encourage participation by more modest investors. The American distinction between dealer and trader is easier to administer than the Canadian distinction between trader and investor,\(^{27}\) as it turns on the capacity in which the taxpayer acts, while the Canadian distinction depends on the analysis of various facts, including the frequency of transactions, for which determining criteria cannot be precisely defined. When Parliament drafted an analogous provision for Canada, the notion of a "guarantee" took on a different aspect. "Traders" as well as "dealers" are now denied the benefit of the lifetime election, with the result that the only real guarantee exists for those whose activities do not constitute trading or dealing but who are too active to be treated as investors. With a potentially large class of traders unable to treat securities transactions as capital transactions by election, the lock-in of losses which is experienced in the United States is lost. The narrower scope of the guarantee also limits any impact that the provision may be expected to have on levels of equity investment.

United States dates back at least to the *Interim Report of the Ontario Committee on Company Law* (1967). Although the lifetime election does not go as far as I.R.C. § 1221 in guaranteeing traders the capital gains preference, at least it takes a small step in that direction and thereby lessens the overall discrepancy in the tax burden borne by speculative investors in the two countries.


\(^{26}\)As Bittker points out (ibid.), it is unlikely that the courts would have achieved a markedly different result in the absence of I.R.C. § 1221(1).

Over twenty years ago taxation specialists predicted that legislation which attempted to define capital gains, or that interfered with judicial approaches to the separation of capital and income, would be inadequate.\(^2\) In so far as the language of section 39(5) represents the first step in the codification of "capital", their prediction was correct. The language in that section is too vague to achieve the intended result.

A. "Trader" in securities

Despite the importance of the concept of "trader" in taxation law in the United Kingdom, the term has never carried precise meaning in Canada, having been superseded by "business". In legislation regarding the regulation of securities, a trader is one who is engaged as principal or agent in the "business of trading in securities"\(^2\) a definition which emphasizes that trading is a form of business, but that business does not necessarily constitute trading.\(^3\)

For purposes of section 39(5), tax jurisprudence can define "trader" narrowly or broadly. These are the possibilities: (1) a "trader" is any taxpayer whose gain is treated as ordinary income on basic principles established in decided case-law; (2) "trader" applies only to taxpayers who are carrying on the business of trading in securities, either as principal or agent; or (3) "trader" refers only to taxpayers who act as principal in carrying on the business of trading securities, whether using a broker as an agent or not. In this last alternative "dealer" is being reserved for taxpayers who trade as agents.

1. Technical knowledge of market behavior

Though dealers, like traders, are disqualified from the election, each category should be defined narrowly enough to permit the other to operate without ambiguity. Dealing implies the creation and maintenance of a market in which buyer and seller are brought together; thus a dealer acts as agent, although some trading may be done on his or her own account. Yet, even if "dealer" is reserved for those taxpayers who act as agents, the ambit of trading is difficult


\(^{2}\)E.g., *The Securities Act, 1978*, S.O. 1978, c. 47, s. 1(1)7, 42. See citations collected in (1977) I Canadian Securities Law Reporter §3035 for specific statutory references.

\(^{3}\)Litigation on the factual criteria of a "trade" in securities legislation falls back on the familiar frequency-and-organization formula, but with somewhat less precision than is found in tax decisions.
to ascertain because of the ambiguity among "adventure", "trading" and "business" in the Income Tax Act. The difference between an adventure in securities and the conduct of a professional securities trader is great, but the distinctions are factual and susceptible of varying interpretation in different contexts. The continuum of transactions on one's own account looks something like this:

1. Taxpayer infrequently purchases securities and holds them for long-term increase in value.

2. Taxpayer makes informal arrangements to get advice on securities, occasionally promoting purchases when feeling particularly confident of trends.

3. Taxpayer works hard at choosing and timing lucrative transactions, consulting brokers, investment analysts, conducting crude market studies — trading on primary trends and the knowledge of others. All transactions are made through brokers.

4. Taxpayer has some special knowledge of the issuer, the industry or the particular market, and this special knowledge is used to select and time transactions.

5. Taxpayer is a securities adviser, promoter or other participant in the securities industry who also applies knowledge to own account.

6. Taxpayer is a professionally trained or licensed securities expert who is the principal in all transactions and does not use the services of a broker agent.

7. In addition to the facts in (6), the taxpayer also acts as agent for other principals in the acquisition and disposition of securities.

Although the factual variations are infinite, this breakdown demonstrates that there are really only three important aspects of securities transactions: the number and frequency of the transactions, the quality and source of the taxpayer's knowledge, and the taxpayer's status in relation to securities professionals. The taxpayer described at stages (3), (4) and (5) is difficult to classify as trader. At stage (6) the taxpayer performs the normal functions of a trader in securities, while the taxpayers in (1) and (2) are investors. Where the taxpayer makes a considerable effort in his or her private and personal capacity, the courts have asked whether the level of the taxpayer's activity constitutes a business or a series of adventures and, though the use of special knowledge is involved, the tendency has been to classify the transaction as an adventure.

The term "trader" raises the same definitional problems as "adventure", and one may ask how it differs from the broader

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term "business". If it does, how should the difference be expressed? The courts have not conclusively resolved the ambiguity and review board members take conflicting views. Girard [No. 1] v. M.N.R. illustrates a broad concept of trading. The taxpayer in this case was an unlicensed stockbroker and promoter who was treated as a trader because of the volume and frequency of his transactions:

[N]ot only brokerage houses, licensed stock brokers, agents or sellers of securities or professional consultants in the field may carry on the business of trading in securities. The nature of the transactions, their frequency, volume and purpose are, in my opinion, valid criteria for distinguishing between investments per se and business transactions and, to my mind, can be applied to any taxpayer or transaction. I believe that, even though he may have neither a licence nor professional status in the field of securities, a taxpayer who, in the course of a single year, buys and resells a substantial volume of securities apparently for the purpose of realizing a profit from their short-term resale, is carrying on the business of trading in securities.

What Mr Cardin does not make clear is whether stock brokers, agents, sellers or consultants carry on the business of trading in securities by virtue of their status as participants in the securities industry, or whether they are classed as traders only with respect to their securities transactions. The passage above suggests that the actual purchase and sale of securities are the touchstones of the trading classification, but the facts of this case would also support the view that it was the taxpayer's status as a participant in the securities industry which justified the result.

Mr Frost took a narrower view of trading in Donata Investment Ltd v. M.N.R., in which the taxpayer engaged in a number of activities, including land investment, some business enterprises and security transactions. In ruling that share transactions which yielded a $161,000 loss and a $132,000 gain were capital transactions, Mr Frost stated that a taxpayer must carry on the sort of trading activity ordinarily conducted by traders employed by brokerage houses in order to be considered a trader for tax purposes. He considered expert testimony which left no doubt as to the technical aspects of trading in securities, and he deduced from this evidence

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33 Ibid., 2160.
“three badges of trade” exhibited by those who are “in the business of buying and selling securities”:

1. *Constantly watching the ticker tape* to take advantage of short-term market trends.

2. *Cutting losses* (the witness suggested a maximum of 20%) and *maximizing short-term profits* to maintain high liquidity.

3. Trading over a stock exchange is for the most part *a full-time job.*

Mr Frost elaborated this view in *Geddes v. M.N.R.,* which involved the characterization of gains on commodity futures. While he did not deny that a non-professional could “trade”, he stipulated that such a person would have to exhibit the same technical knowledge as possessed by the professional, “a knowledge of the significance of trend lines, odd lots, volume, short interest ratios, breadth, Elliott theory, Dow theory and all the other tools or approaches which professional people use to interpret market trends . . .”.

The view expressed by Mr Frost is not unduly restrictive. A taxpayer who trades as a licensed professional and as principal will of course be classified as a trader. An unlicensed taxpayer who brings the requisite degree of technical market knowledge to the transaction will also be treated as a trader. There is little support for the proposition that the employment of a broker insulates the taxpayer from classification as a trader. *Ladin v. M.N.R.* takes the opposite view, citing the payment of $15,000 in broker fees as evidence of trading.

The only positive authority for the proposition that use of a broker is evidence of investor status is Mr Weldon’s ruling in *McLaws v. M.N.R.* The appellant was the lawyer who had represented Irrigation Industries Ltd in its tax appeals. Relying on

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36 *Ibid.*, 2290 [emphasis added]. Mr Frost lists fifteen additional criteria which he gleaned from the testimony, but they merely elaborate on the three major tests set out in the text.


> [The purchase and sale of treasury shares through brokers] is not the sort of trading which would be carried on ordinarily by those engaged in the business of trading in securities. The appellant’s purchase was not an underwriting, nor was it a participation in an underwriting syndicate with respect to an issue of securities for the purpose of effecting their sale to the public, and did not have the characteristics of that kind of a venture.

the "volume and frequency of transactions" test of carrying on business, he had convinced himself that his stock market transactions amounted to a business and accordingly sought to deduct a $5,000 loss. Mr Weldon ruled that the loans were generated neither by trading nor by a series of adventures in the nature of trade. In rejecting the trading argument, Mr Weldon referred to *The Shorter Oxford English Dictionary* definition of trading and commented:

"trading" [is] the carrying on of trade; buying and selling; commerce, trade and traffic. It is hard to see how Mr. McLaws did any stock trading in his 1960 taxation year as he dealt with a broker in the same way any other customer would do. The broker is the trader in each transaction. He is the one who brings a seller and a purchaser together, and completes the transaction. When a person buys or sells stocks solely for himself, he would not appear to be engaged in trading within the usual meaning of that term.\footnote{Ibid., 137-8.}

Mr Weldon made special note of the items that defeated the taxpayer's contention: he was not a promoter or an underwriter, he did not spend much time in studying market behaviour, and he did not attempt to attract customers.

2. Special knowledge concerning securities

Not all knowledge which is brought to bear on securities transactions is technical knowledge of market trends. As discussed in the first of these articles, special knowledge relating to the performance of a particular issue or of a sector of industry can form the basis for including securities gains in ordinary income.\footnote{Supra, note 6, 487 et seq.}

Where such special knowledge or ability falls short of the technical knowledge the trader possesses, it can still form the basis for including such gains in business income. For example, in *Ladin v. M.N.R.*\footnote{Supra, note 38.} a taxpayer employed as a cattle purchaser was found to have earned ordinary income from transactions in beef, corn and pork futures. The taxpayer's knowledge of market trends was characterized as fundamental, not technical, and the knowledge that was relevant to the ruling was the taxpayer's special knowledge of the beef futures market.\footnote{For consideration of whether commodities futures contracts are securities, see infra, text accompanying notes 120 and 131.}

The distinction between this type of ordinary business and an adventure in the nature of trade is difficult to define, and the courts have treated them as overlapping in many instances. Because of the substantial similarity between business and adventure where
special knowledge is involved, it is submitted that there is no logical basis for excluding one, but not the other, from trading. Adventure in the nature of trade can be excluded from trade on grammatical and legal grounds. Where the special knowledge is insider information, knowledge of an industry and the like, the transaction can be classed as a non-trading business transaction. Any other approach requires the courts to forge a distinction between trade and adventure in the nature of trade, an endeavour which would be highly artificial. If such a course were chosen and the distinction between adventure and trade could not be sustained, the election under section 39(4) would be rendered nugatory because it could not "guarantee" capital gains except to those who would be treated as investors by jurisprudential criteria.

The category of people included in the proposed definition of trader is diverse. Corporate insiders and their families or friends, industry observers plus acquaintances, promoters and controlling shareholders all have access to the kind of information that increases the possibility of successful transactions, yet none of them may possess technical market knowledge that would classify them as traders. Depending on the scope of "dealer", however, such taxpayers may still be denied the election.

B. "Dealer" in securities

1. Relationship to "trader"

The term "dealer", when used in conjunction with "trader", implies a distinction in meaning, so that "dealer" would include acting as agent in purchase and sale transactions, whereas "trader" would apply to the principal. However, "dealer" is likely to be interpreted as denoting more than agents trading over an exchange. Judicial decisions indicate incidentally that dealing includes trading and that it may even include adventures in the nature of trade in securities. This is not to suggest that earlier judicial discussions should control the definition of "dealer or trader in securities". The legislative purpose of the section should prevail, but Canadian courts have concerned themselves with these concepts for more

45 Although the broad proposition that adventure and business are mutually exclusive can be criticized, the suggestion that trade and adventure in the nature of trade are distinguishable is the proper reading of Lord President Clyde's judgement in C.I.R. v. Livingston (1926) 11 T.C. 538 (Ct Sess., Scot.), and it is the only proposition that counsel for the Minister should have attempted to establish before Thorson P. in M.N.R. v. Taylor [1956-60] Ex. C.R. 3.
than sixty years and the meanings thus established are at least a point of departure for the interpretation of the same terms in current legislation.

One approach is to give "dealing" and "trading" the same meaning as business in general, so that all of the terms are interchangeable. In *Admiral Investments Ltd v. M.N.R.*, the appellant corporation had been formed for the purpose of engaging in security transactions. It took the position that it was a dealer in securities, even though it carried out the transactions through the medium of investment and security dealers. The evidence relied upon by the corporation consisted of the corporate charter and the volume of transactions, taken together with testimony as to the intention of the controlling shareholder. In holding that the gains and losses in question were from business, Cattanach J. stated:

While the appellant was not a trader in securities in the sense of that term that it was an underwriter and held a seat on a stock exchange, but rather made its purchases and sales through a stock exchange in the usual manner, nevertheless, the acts of the appellant were just the ordinary transactions of a person who deals in shares. This case suggests that a corporation which devotes $90,000 to securities transactions and acts within its corporate objects will be classified as a dealer in securities for the purpose of the election. However, it should be noted that the legal authority upon which Cattanach J. relied was *I.R.C. v. Livingston*, which turned on adventure or concern in the nature of trade. In concluding that the transaction was carried on in a manner characteristic of those engaged in ordinary trading in securities, Cattanach J. reduced dealing, trading and adventuring to synonyms, which, in the context of section 39(4), reduces the election to meaninglessness.

*Gairdner Securities Ltd v. M.N.R.* illustrates a narrower concept of trading and dealing, but again the two terms are used interchangeably. The appellant corporation had resigned its membership in an investment dealers' association and had sold its equipment, records and goodwill to an associated corporation that carried on a business dealing in securities. The appellant retained its securities at the time of reorganization and then sold them over a period of time at considerable gain, using the associated company as a trading agent in each transaction. Mr Justice Rand held that,

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46 [1967] 2 Ex. C.R. 308 per Cattanach J.

47 Ibid., 319 [emphasis added].

48 Supra, note 45.

notwithstanding its formal resignation from the dealers' association, the company continued to carry on the business of dealing in securities. The definition of business had not yet been amended to include an adventure or concern in the nature of trade. The fact that the trading of the shares was performed by another legal entity, albeit an associated corporation, did not affect Rand J.'s conclusion that the corporation was a dealer or trader in securities. He stated that evidence of one hundred and twenty-four purchases and two hundred sales after the corporation changed its objects demonstrated that it was "completing the business admittedly carried on by the company as a dealer before 1938".

*McMahon and Burns Ltd v. M.N.R.* supports the proposition that the relation of dealer and trader connotes an agency role, although both terms can also refer to a principal as well. The appellant corporation was a securities dealer which purported to purchase debentures as an investment, but Dumoulin J. held that the debentures could not be distinguished from the larger class of transactions in which it acted as agent. However, even where the taxpayer's investments and inventory are clearly segregated, classification of the taxpayer's business as dealing or trading precludes use of the election for the investment gains, unless a holding company can be used to create a surrogate legal entity.

2. Non-trading participants in the securities industry

It should be noted that securities legislation generally divides the dealer category into sub-categories: brokers, broker-dealers, investment dealers, mutual fund dealers, securities dealers, and the like. The characteristic that unifies these participants is their engagement in the "business of trading in securities" as principal or agent. All dealers who so trade must be registered under the applicable securities legislation, and evidence of registration would establish that the registrant is a dealer or trader for purposes of the election. But what of the other participants in the securities industry? Sales people, promoters and advisers are traders in the context of securities legislation. For example, in Ontario, a trade includes "any act, advertisement, solicitation, conduct or negotiation directly or indirectly in furtherance of" an actual transfer of a

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50 *Supra*, note 49, 27.
The tax usage of "trade", on the other hand, has been limited to cases of purchase and sale of property, but "dealer" appears to be more flexible.

The tendency in judicial analysis is to treat promoters and advisers as having enough special knowledge concerning the securities in question to classify the transaction as a business transaction. Where there is not enough evidence to support a finding of "business", "adventure" has sufficed, leaving the definitions murky once again. Whether such a combination of facts will push all participants in the securities industry into the category of dealer is difficult to predict at this time, but there are some guidelines which the courts may follow.

One criterion is the definition of "dealer" in the American scheme of taxing gains on securities transactions. Those rules define a dealer as a taxpayer who holds property "for sale to customers", which implies that the dealer buys at wholesale for resale to persons other than the seller, and that the transaction will not be carried out by brokers. Using this approach, the promoter or adviser who occasionally engages in securities transactions will not be classified as a dealer because he or she would not be offering securities for sale to customers, but would be using an intermediate entity (often the taxpayer's employer) to resell the securities. Frequency and organization of the transactions would not be crucial evidence if this approach were used, for the sole issue would be whether the persons who acquired the shares were "customers".

Another approach would be to take the definition of a dealer in securities legislation as including all those who are engaged in the business of trading securities. This can be a sweeping definition, as illustrated in an obiter dictum by LeDain J. in Cooper v. M.N.R.: The question ... is when as a matter of fact an officer or employee should be considered to be carrying on the campaign to sell shares to the public for which his company is primarily responsible. It would not be reasonable to fix every employee of an incorporated securities dealer, regardless of his function, with participation in the campaign ... . One view might be that the officer or employee must have a certain control or direction over the campaign so that it can reasonably be considered to be his campaign. On the other hand, it does not seem reasonable to

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54 Ibid., s. 1(1)42(v).
exclude one, who, though not in a position to control or direct, is nevertheless actively engaged as a salesman in promoting the market for his own shares. A "campaign" to sell shares is a course of action that involves not only juridical acts but non-juridical activity of an organizational and promotional nature. The juridical act of sale is the culmination of an effort to create and develop a market for the shares and to induce persons to purchase them. It is that effort that is the campaign. Where it is not carried out by a single person it requires some organization involving more than one person. In my view, anyone actively involved in that organization and effort must be held to be carrying on the campaign. It must at least be true of a salesman who is actively promoting the shares and who actually sells a considerable number of them to several individuals.\textsuperscript{58}

There is considerable authority for the proposition that a promoter is engaged in the business of trading securities, at least when he or she has an allotment of shares being sold at a gain. For example, \textit{McAdam v. M.N.R.}\textsuperscript{59} held that gains on the disposition of mining shares by a promoter-prospector were business receipts because the promoter had always been in the business of mining "in the widest sense" and because he had actively promoted the corporation.\textsuperscript{60} Similarly, a taxpayer who is an officer and a founding shareholder with a history of dealings related to those of the corporation,\textsuperscript{61} or who combines the talents of promoter and securities specialist,\textsuperscript{62} will be denied capital gains treatment.

Can these cases also be taken as describing the promoters as traders or dealers? The only case that discusses whether promoters are traders is \textit{Davidson v. M.N.R.}\textsuperscript{63} The appellant was an individual stockbroker, a promoter and the president of an underwriting and security trading company. With an associate, he held the controlling interest in a steel company, shares of which produced a loss of half a million dollars. In holding that the loss was deductible, Gibson J. observed that the taxpayer acted as a trader throughout, as illustrated by sales of the steel company's shares to dealers at below market value in an attempt to sustain interest in the company. The reference to the taxpayer as a trader may well have been prompted by the stock-brokerage transactions and not by the

\begin{itemize}
\item \textsuperscript{60} \textit{Ibid.}, 218.
\item \textsuperscript{61} \textit{Angle v. M.N.R.} [1969] C.T.C. 624, 69 D.T.C. 5423 (Ex.) \textit{per} Sheppard D.J.
\item \textsuperscript{63} \textit{Supra}, note 62.
\end{itemize}
promotions. Except in cases where the intention to capitalize business profits is judicially discernible, it would seem better to reserve classification as a trader for these promoters whose other activities constitute trading, whether as agent or as a principal.

3. Salespeople

Securities legislation ordinarily defines a salesman as "an individual who is employed by a dealer for the purpose of making trades in securities on behalf of such dealer". The issue arising under section 39(5) of the Income Tax Act is whether the salesperson's trading in securities on behalf of an employer requires that he or she be designated a trader for the purposes of an election. There is no authority for the proposition that trading on behalf of an employer only would be sufficient ground for ruling a salesperson a trader. On the contrary, Argue v. M.N.R. would appear to establish the converse proposition. Most Canadian litigation in this matter has considered whether securities transactions of a salesperson constitute business or adventure, and so the question is whether a salesperson whose transactions are clearly of an investment nature may take advantage of the election. Swansburg v. M.N.R. would resolve that issue in the affirmative. The taxpayer was an employee of a brokerage firm who placed orders on his own account and lost some $5,000, which he sought to deduct as a trading loss. Mr. Frost ruled that the taxpayer did not himself carry on the trading business as an employee and was not a professional trader: thus it is presumably the employer, and not the employee, that is the trader in such a case:

[1] In so far as his own accounts were concerned, [the taxpayer] was in the same position as any other client. When he placed an order for himself, he was performing the same services as he normally would for other clients of his firm.

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64 See, e.g., Fraser v. M.N.R. [1964] S.C.R. 657, a case concerning the sale of shares as a means of effecting the transfer of underlying land as a substitute for the transfer of title in the land itself, which was held in the ordinary course of the taxpayer's business as a real estate developer.


66 Except perhaps by analogy to Appleby, supra, note 58, or Cooper, supra, note 57: see supra, text accompanying notes 59 and 60.


69 Ibid., 2126.
Other decisions suggest that it is possible for a securities salesperson to be classified as a trader. For example, the taxpayer in Marcus v. The Queen\textsuperscript{70} acted as a promoter and then as a director of a goldmining company in which he had a substantial interest. The profit arising from the disposition of his shares was treated as income from a business because he was much more involved in the corporation than an ordinary securities salesman would be. Heald J. gave specific illustrations of this involvement: (1) he assisted materially in the marketing of the securities, (2) he promoted the shares as actively as possible, and (3) he used "inside information" in pursuing his objectives. The full implications of statutory insider-trading rules for the tax treatment of securities transactions cannot yet be predicted, but it would seem possible for the Department of National Revenue to argue that an employee can be treated as a trader or dealer in his or her own right where there has been a breach of the statute.

When will an employee who earns business income from share transactions be classed as a trader? If McLaw\textsuperscript{71} is followed, never, unless the employee acts as an agent on his or her own time; if Donata Investments Ltd\textsuperscript{72} is followed, the test will be the number and frequency of the transactions. Smith v. M.N.R.\textsuperscript{73} suggests that such "extracurricular" activities must reach a significant level in order to be treated as business transactions. Mr Smith was a full-time, commissioned securities salesman who engaged in an increasing number of transactions over a period of seven years, and allegedly gained expertise each year. Unfortunately he lost heavily at the end. The losses were deductible because he was carrying on a business with these transactions; he used borrowed money, the shares were speculative, and his transactions disclosed a "systematic and extensive scheme". It was not suggested that Mr Smith was a trader, but merely that the transactions constituted a business.

C. The business of lending money

One of the prime disqualifications in section 39(5) is the lending of money as a principal business. The concept of "security" includes not only corporate obligations but also secured and un-
secured loan obligations.\textsuperscript{74} "The business of lending money" serves the same function in respect of loan obligations that "trader or dealer in securities" does in respect of corporate obligations and other securities. The function of these phrases is to draw a distinction between investment and business transactions. But the money-lending exclusion affects only corporations. The Act permits individuals who would be classed as carrying on a money-lending business to avail themselves of the election, and this option remains because to some extent the rules relating to "deep discounting" have displaced jurisprudential criteria for the tax treatment of the capital element in discounted obligations.\textsuperscript{75}

When is a taxpayer in the business of lending money? The leading Canadian authority on the question is Argue v. M.N.R.\textsuperscript{76} The taxpayer in that case earned money from a number of sources: in addition to receiving commissions from a loan company which he managed, he earned insurance commissions, interest on mortgages and promissory notes, and discounts and bonuses on obligations. The Minister contended that these receipts were income from "one or more businesses", but Mr Justice Locke held that the employment income could not be considered income from business and that the loan transactions themselves did not constitute a business. The factors which motivated his characterization of the loan transactions were the amount of money invested, the number of mortgages involved, the source of the funds loaned, the quality of the mortgages, the extent to which the taxpayer personally involved himself in producing the income, and the taxpayer's entire course of conduct in relation to the mortgages over a period of years. These factors were considered because Locke J. believed that the transactions were mere investments unless the activity carried on by the taxpayer was an identifiable commercial business.\textsuperscript{77}

Locke J.'s approach has been followed in determining whether the taxpayer is carrying on the business of lending money, whether or not he is incorporated. Orban v. M.N.R.\textsuperscript{78} illustrates the approach

\textsuperscript{74} See infra, text accompanying notes 102-109.
\textsuperscript{75} Income Tax Act, s. 16(2), (3).
\textsuperscript{76} Supra, note 67, per Locke J. This case arose under the Excess Profits Tax Act, S.C. 1940, c. 32, s. 2(g) of which used "carrying on business" in a context similar to that found in current income tax legislation.
\textsuperscript{77} Ibid., 473.
\textsuperscript{78} (1954) 10 Tax A.B.C. 178, 54 D.T.C. 148 per Fordham [hereinafter cited to Tax A.B.C.]. Although this is only an administrative ruling, it has been relied upon extensively in personal corporation cases and cases under s. 125 of the Income Tax Act. Whether it will play a central role in the application of s. 35(5)(d) remains open to question.
well and Mr Fordham’s analysis of the evidence is now classic. Mr Orban had brought some $120,000 with him from Hungary and eventually he extended three unsecured loans: $20,000 to his employer, $8,000 to a friend and $20,000 to a company of which he was a shareholder. The debtors of the latter two defaulted and the taxpayer treated the amounts as business losses. Mr Fordham ruled that the taxpayer could not be considered a money lender unless there was a system or continuity to his transactions, or he held himself out to “all and sundry” as a money lender, or he engaged in a multiplicity of transactions. Applying this test to Mr Orban’s case, he found that the taxpayer did not hold himself out as a money lender, only a few acquaintances knew that he would lend money, and that he neither advertised nor listed himself as a money lender. Hence the losses were not deductible.

Subsequent taxpayers have found it difficult to achieve the status of professional money lender without incorporation. In Mullaney v. M.N.R. the appellant had devoted $250,000 in personal savings to mortgages, but was precluded from deducting travel expenses incurred in the administration of his affairs because he did not carry on a business of lending money, notwithstanding the clear fact that he did lend it. This conclusion was based upon evidence that the taxpayer was retired, and that he did not have a business office, telephone or advertising program.

Litigation involving incorporated taxpayers has yielded similar results. Sixteen loan transactions over seven years were held to fall outside the ordinary course of an exporting company’s business in Anderson and Miskin Ltd v. M.N.R. Even twelve loans, with an aggregate value of $1,200,000, by a company that had wound up its manufacturing business and had amended its charter, were classified as investments in W.H. Enterprises Ltd v. M.N.R., where the real basis for decision seems to be that loans to non-arms-length parties are not in the ordinary course of business.

Valutrend Management Services Ltd v. M.N.R. raises some compelling questions in light of Anderson and Miskin Ltd and W.H.

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70 Ibid., 180. These factors were deduced from English cases which determined whether an individual was a money-lender within the meaning of The Money-lenders Act, 63 & 64 Vict., c. 51.

80 Ibid., 181.


Enterprises Ltd. The corporation described its business as "the business of rendering management and administrative services, lending money and trading in securities". It had outstanding loans of approximately $1.2 million and had taken reserves for doubtful debts. Mr Fordham ruled that the reserve was properly taken because "the making of judicious loans of substantial sums was a part of the appellant’s income-earning process". He did not consider that the corporation was "a money-lender within the restricted meaning of Orban", though he did describe it as "a lender of money ... to a much larger degree".

The question raised by this reasoning is whether "the ordinary business [of] lending money", which was the issue of statutory interpretation in Valutrend Management, is similar to "the principal business of lending of money" in section 39(5) of the Income Tax Act. The similarity in expression is striking, and it would appear that Valutrend Management should displace Orban as the authority for defining "lending of money" in section 39(5). Thus, Mr Fordham’s twofold test for money-lending corporations rests upon a consideration of (a) the volume of transactions and (b) a determination whether the loans are of a commercial nature.

The differences of approach in Mullaney and Valutrend Management may be attributable to a shift in the policy which underlies the statutory provisions at issue. In Mullaney, the travel expenses which the taxpayer claimed were perhaps more jealously guarded than corporate reserves which would eventually be brought into income if the doubt turned out to be ill-founded. The same sort of shift in administrative attitude is seen in the application of the old personal corporation rules and the small business credit under the 1972 Act. Under section 68 it was virtually impossible for a corporation to establish that interest income was earned from the "active" business of lending money. However, since 1972 a number of small money-lending operations have qualified as active

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85 Ibid., 2171.
86 Ibid., 2172.
87 Ibid.
businesses for the purposes of section 125. Further, the effect of incorporation has a remarkable impact on these decisions, as illustrated by a comparison of the results with LeDain J.’s decision in Chaffey v. M.N.R. In that case the taxpayer (an individual) had made large advances to corporations in which he held an interest and then sought to deduct losses on the obligations as losses suffered in the ordinary course of carrying on a business of lending money. In denying the claim, LeDain J. reiterated the definition of “the business of lending money”: 

In my opinion shareholder’s advances do not constitute the business of lending money; they are simply a particular form by which capital is put into a company. The loans made by the partnership did not have as their principal object the accommodation of persons in return for income in the form of interest; they were merely a device for the financing of projects through which profit was to be made by other means.

Although this statement of the principle depends upon an assessment of the taxpayer’s intention, it allows that, if the taxpayer’s financing is not motivated by a gain on other property, the prime object is not only to profit from the investment interest.

D. Factoring commercial obligations

Section 39(5)(f)(ii) precludes a corporation whose principal business is “the purchasing of conditional sales contracts ... or other obligations representing part or all of the sale price of merchandise or services” from taking advantage of the election. The distinctions and rationale elaborated above apply with equal force to this exclusion.

One problem is suggested by earlier cases. Where two associated corporations have been established in order to separate the merchandising and financing aspects of a business, will the fact that they may be subject to common control affect the determination whether the financing corporation falls under section 39(5)(f)(ii)? This possibility is suggested by cases such as Finning v. M.N.R., in which Dumoulin J. held that where the operating corporation

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92 Income Tax Act, s. 11(1)(e), (f).
93 Supra, note 91, 6179.
94 Supra, note 89.
in such an arrangement made all the day-to-day business decisions, reducing the financing company to a passive holding company, the financing company did not strictly have a financial business, and thus did not carry on an active business for purposes of the personal corporation rules.\textsuperscript{95}

Although this view of a holding company is consistent with the legal criteria for determining that a taxpayer is carrying on a business,\textsuperscript{96} the policy of the provision makes such a result absurd. A taxpayer could separate its commercial obligations from other operations simply by transferring them to a controlled corporation; accordingly, it could retain eligibility for the election in respect of other securities transactions.

E. Other exclusions

The remaining exclusions are not complicated. Chartered banks, incorporated trustees, credit unions and life insurance corporations\textsuperscript{97} are major holders of securities, and to permit them the election would allow them to treat all securities transactions as capital transactions. But that does not mean that the only alternative is to force large institutional owners of securities to defend each individual claim to capital treatment. It should be possible to require identification and segregation of securities to facilitate a limited "guaranteed capital gain” for institutional holders.\textsuperscript{98} Otherwise, institutions may keep what they consider adequate records, yet discover in litigation that more was required.\textsuperscript{99}

F. Summary

The broad policy of the election is clear: it is intended to give investors "guaranteed” capital gains in order to make the tax treatment of securities transactions more certain, to broaden the class of investors who are eligible for capital gains and to limit the

\textsuperscript{95} Ibid., 407-9.

\textsuperscript{96} See, e.g., Hannan & Farnsworth, Principles of Income Taxation (1952), 152 et seq.

\textsuperscript{97} Income Tax Act, s. 39(5)(b)-(e).

\textsuperscript{98} Again, the American experience offers a useful model: I.R.C. §1236 provides that "dealers”, who are denied capital gain treatment on securities, may still qualify for such treatment on securities that are identified for long-term investment and held in separate accounts. Gains on such securities are automatically on capital account, but when a position is challenged by the I.R.S. the taxpayer bears the burden of proof.

class of investor-speculators who are eligible for ordinary losses. However, to achieve these objectives, the nature of the election depends on the scope of exclusionary clauses in the Act, which leave the taxpayer in no better position than did earlier jurisprudence. The precise relationship between ordinary business, trading, dealing and adventuring has never been the focus of Canadian tax litigation, yet the authors of section 39(5) apparently expect that the scope of "dealer or trader in securities" can be settled in light of previous decisions. The courts will find no easy way out of the maze created by the section. If they rule that "trader or dealer" includes adventurers, in order to rest eligibility on a pre-existing distinction between investment and business, the tax treatment of share gains is no more certain than before the statutory provision for the election, and in the result there will have been no modification in eligibility for the capital gains preference. If the definition of "trader or dealer" is based on a formalistic distinction between trading and adventuring, then fewer losses will receive ordinary loss treatment and uncertainty will be further compounded. It will be interesting to see whether the increase in revenue that should flow from a restricted application of losses, coupled with the effect of the new "incentive" to seek securities gains, will justify the continued expenses of administration, compliance and litigation promised by these vague rules.

III. What is a "security"?

The uncertainty spawned by the election does not end with the problems posed by a "dealer or trader". "Security" is also an elastic term and the courts can control the scope of the election by its definition. Two problems arise in defining a Canadian security as a "share, bond, debenture, bill, note, mortgage, hypothec or similar obligation". The first question is whether "similar obligation" will be read ejusdem generis with the enumerated items or whether it will receive an expanded definition as it has in securities legislation. The second question is whether the qualification "issued by a person resident in Canada" will be construed as limiting the class of issuers to "persons" as defined in section 248(1) of the Act, as well as to residents of Canada, or whether the phrase will merely be viewed as stipulating a residence requirement for unincorporated issuers. "Person" is defined as "any body corporate and politic, and the heirs, executors, administrators or other legal representatives

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100 Income Tax Act, s. 39(6).
of such person”. It has been suggested that “securities” will not include those issued by unincorporated associations,\textsuperscript{101} even though the policy behind the qualification seems to be “buy Canadian securities”, and not “buy corporate securities”.

A. Scope of “security”

The factors which connect the types of securities named in the Act are not articulated, and thus the salient criteria in defining the term are not expressed. There are two approaches that can be used. In the first, the meaning of “securities” in tax jurisprudence may be used to show that the definition has been widened where the context of the statute so requires. The second is patterned after that employed in securities legislation, and it assumes that the policies underlying securities legislation and the election provision are sufficiently similar to warrant analogy.

1. Tax concept

There are two opposing notions of what constitutes a security in tax law. First, it may be argued that as a term of art there must be an element of security inhering in property for it to be classified as such. Thus, at trial in \textit{Manitou-Barvue Mines Ltd v. M.N.R.},\textsuperscript{102} common shares which were issued in lieu of interest on debentures were held not to be securities for purposes of section 24(1) of the 1952 Act, “simply because there was no element of security attached to them”. In appeal however, Gibson J. ruled that vernacular usage would support the characterization of common shares as securities.\textsuperscript{103} This more liberal concept of security is consistent with the expanding definition of security in securities legislation and connotes an investment of any kind, and it implies that evidence of “secured” interests is not required for the classification. For example, Heald J. held in \textit{Canadian and Foreign Securities Co. Ltd v. M.N.R.}\textsuperscript{104} that a temporary demand loan note on an unsecured promissory note is a security in the context of legislation governing tax treatment of investment companies. He rejected the contention that a security must be “secured”\textsuperscript{105} and looked favorably on

\textsuperscript{101} Hogg, \textit{supra}, note 3, 384.
\textsuperscript{102} (1964) 37 Tax A.B.C. 199, 211-2; 65 D.T.C. 45, 53 \textit{per} Weldon.
\textsuperscript{103} [1966] Ex. C.R. 329, 332.
\textsuperscript{105} To be more precise, he distinguished all of the cases which supported the proposition that a “security” must be “secured”, although it is clear from the way in which he distinguishes the cases that he is rejecting the proposition and not just calling for a stronger analogy.
the proposition that the word should be given the common-sense connotation of an investment. A broad analysis like this invites expansive definitions where the policy of the provision requires it. An appropriate model for this expansion may be found in the judicial notion of "security" in Canadian securities legislation.\(^{106}\)

2. Securities legislation concept

*Re Pacific Coast Coin Exchange of Canada and Ontario Securities Commission*\(^{107}\) points the way to the expansion of the meaning of securities in provincial legislation. The appellant sold bags of silver coins to customers on margin with the understanding that the buyers would not take delivery of the coins but would sell them to the appellant when and if the price went up. The appellant engaged in a great deal of market activity in order to promote the price of the coins for its own benefit and that of its customers. If the commodity account agreement between the customer and the appellant were to constitute a security, it had to fit into one of the following descriptions of a security given in *The Securities Act*:\(^{108}\)

"Security" includes,

i. any document, instrument or writing commonly known as a security,

ii. any document constituting evidence of title to or interest of any capital, assets, property, profits, earnings or royalties of any person or company, ...

xiii. any investment contract, other than an investment contract within the meaning of *The Investment Contracts Act* ...

It was held to fall into the last category.

Judicial reasoning has given narrow ambit to paragraphs (i) and (ii),\(^{109}\) but "investment contract" has been treated as a term of

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\(^{106}\) By comparison, I.R.C. § 1236(c) defines "securities" for purposes of § 1221(i) as including shares, bonds, debentures, notes or "evidence of indebtedness", and this is in principle similar to the definition of "security" in s. 39(6) of the *Income Tax Act*. There has been considerable litigation over the meaning of "evidence of indebtedness", but that phrase is narrower than the Canadian equivalent ("similar obligations") and thus the American case law is not very helpful on this point.


\(^{108}\) R.S.O. 1970, c. 426, s. 1(1)(i), (ii), (xiii); now *The Securities Act, 1978*, S.O. 1978, c. 47, s. 1(1)(i), (ii), (xiii).

unspecified and broad meaning. "Investment contract" and "similar obligations" in the capital gains election serve the same function, that is, to expand the meaning of a security beyond the rigid notion of documents giving evidence of secured transactions, and to make it possible for the courts to find a security wherever there is a significant investment interest.

In Pacific Coast Coin Exchange Houlden J. quoted with approval the American view of "investment contract":

The phrase "investment contract", as used in the securities acts is a "nebulous term, difficult of definition and even more difficult of application". It is designed, of course, "to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits".  

In section 39(6), "similar obligation" serves the same function, and thus it is submitted that "similar obligation" should receive the same expansive reading as "investment contract". In reaching the conclusion that the commodity account agreements did constitute securities because they were investment contracts, Houlden J. posed no less than three different methods of determining whether the transaction gave rise to an investment contract: the Howey test, the risk capital test and the investment approach.

(a) The Howey test

The Howey test originated in the United States Supreme Court. Each of these four elements received broad application by the Ontario Court of Appeal in Pacific Coast Coin Exchange. A common enterprise exists when the ordinary activities of the issuer affect the value of the property acquired by the customer:

[T]he ultimate profit to the customer is not dependent merely on the price established in the bullion market for silver, but on the efforts of the appellants to make a market for silver, their ability to hedge against future obligations, and the price set is the appellant's own price dependent in part at least on the supply and demand within the appellants' own operation. In my opinion, the effect of the transaction that the appellants entered into with their customers is one which involved the investment of money in a common enterprise with the expectation of

111 Securities Exchange Commission v. W.J. Howey Co. 328 U.S. 293, 298-9 (1946) per Murphy J.
112 As put by Houlden J., supra, note 107, 408.
profit, the amount of which is for all practical purposes, if not solely, dependent on the efforts of the appellants.\textsuperscript{113}

The fourth element has also received broad application in Ontario. It is apparent from the above passage that the value of the commodity account agreements depended partly on general market forces and partly on the activities of the issuer, thus ruling out any possibility that the expected profits were derived solely from the efforts of the issuer. “Soledy” has been defined narrowly in similar legislation in the United States,\textsuperscript{114} but evidence of a contributing factor will apparently suffice before the Ontario Court of Appeal. In Pacific Coast Coin Exchange both the trial court and the Court of Appeal accepted the expanded Howey test as a valid basis for classifying the commodity account agreement as a security.

(b) The risk capital test

Disagreeing with some of the restrictions of the Howey test, especially its emphasis on the expectation of profit, Professor Coffey developed what is known as the risk capital analysis of “security”.\textsuperscript{115} This test is based on the Howey approach but is modified heavily by a consideration of the economic realities of security transactions:

1. An offeree furnishes initial value to an offeror, and
2. a portion of this initial value is subjected to the risks of the enterprise, and
3. the furnishing of the initial value is induced by the offeror’s promises or representations which give rise to a reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the offeree as a result of the operation of the enterprise, and
4. the offeree does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.\textsuperscript{116}

This test of a security was referred to with approval by the British Columbia Court of Appeal in Re Bestline Products of Canada Ltd

\textsuperscript{11} Supra, note 107, 262 (C.A.).
\textsuperscript{114} The rigid American definition of a security in this regard was one of the factors that impelled Coffey to suggest the “risk capital analysis” in The Economic Realities of a “Security”: Is There a More Meaningful Formula? (1967) 18 Case W. Res. L. Rev. 367, 374-5, adopted by the Supreme Court of Hawaii in Commission of Securities v. Hawaii Market Center Inc. 52 Hawaii 642, 485 P. 2d 105 (1971).
\textsuperscript{115} Ibid., 375.
\textsuperscript{116} Re Pacific Coast Coin Exchange of Canada and Ontario Securities Commission, supra, note 107, 410. See Coffey, supra, note 114, 377 for the original presentation of these characteristics and a discussion of what constitutes a security in the context of American litigation.
and the Securities Commission,\textsuperscript{117} and formed the second basis for the result in \textit{Pacific Coast Coin Exchange},\textsuperscript{118} although in the latter case neither the trial court nor the appellate court analysed the components of this test in detail.

On a risk capital analysis, there are still several transactions which do not give rise to securities. Houlden J. explained that ordinary commodities futures contracts did not constitute securities merely because delivery after sale is deferred.\textsuperscript{119} The purchaser's control over most unincorporated ventures would tend to nullify the attractiveness of this test.

(c) The investment test

In Canada, the broadest approach to defining a security is set out in Houlden J.'s decision in \textit{Pacific Coast Coin Exchange}. Although he reached his conclusion on the basis of the \textit{Howey} and risk capital tests, and was affirmed on those two grounds, he stated that "the tests propounded in the American cases are too rigid and restrictive and if literally applied, could defeat the purposes of securities legislation, that is, 'the protection of the investing public' \ldots".\textsuperscript{120} He proposed that "investment contract" should refer to all contracts which provide for investment, and he adopts from tax law the concept that an investment is the transfer of value in exchange for "income or profit from its employment".\textsuperscript{121} To off-set the possibility that such a sweeping concept would lead to unwarranted expansion of "security", he suggests that the courts "can narrow its sweep by applying the test of economic reality".\textsuperscript{122} The appellate court did not comment on this aspect of Houlden J.'s reasoning.

The practical effect of this investment concept would be to remove the requirement that the purchaser's expectation of gain or profit be causally related to any representations by the issuer or seller. The gain or profit can be wholly dependent on unrelated forces, such as market forces or fortuitous events, yet the guiding objective of the purchaser would be disposition of the investment.


\textsuperscript{118} Supra, note 107, 411 (Div. Ct); aff'd 262 (C.A.).

\textsuperscript{119} Ibid., 412.

\textsuperscript{120} Ibid., 411.


\textsuperscript{122} Ibid., 412.
In defining an investment, the emphasis is on the investor’s lack of control over circumstances that determine gain or profit.

Of the three current approaches to defining securities in securities legislation, the investment test given by Houlden J. is most appropriate to the capital gains election, especially since its origin reflects the nature of an investment for speculative purposes. Essentially, this test is a modification of the risk capital test, the modification being that inducement by the seller and reliance on the efforts of the issuer for gain or profit are eliminated from consideration. A schema for the test may be set out as follows:

1. A transferee furnishes initial value to a transferor, and
2. a portion of this initial value is subjected to the risks of an enterprise, and
3. the furnishing of the initial value is induced by the transferee's ... reasonable understanding that a valuable benefit of some kind, over and above the initial value, will accrue to the transferee as a result of the operation of an enterprise, and
4. the transferee does not receive the right to exercise practical and actual control over the managerial decisions of the enterprise.123

Such a sweeping concept of a security or similar obligation would apply to almost any obligation in which there is some sort of continuing commitment, either expressed or implied, running from the other party to the taxpayer. However, the types of securities listed in section 39(6) of the Income Tax Act should not be disqualified if they fall within the enumeration in form but fail to meet the substantive test set out by Houlden J. The policy which motivates the enactment of the election is to confer as much certainty as possible on the investing taxpayer, and that policy cannot be served by the use of an expansive concept of “similar obligation” which cuts down the plain meaning of the Act’s words.124 The third element in the above scheme would not by itself prevent even a promoter from treating an investment in shares of a wholly owned corporation as securities, but when the promoter gains “the right to exercise practical and actual control over the managerial decisions of the enterprise”, the fourth element would disqualify the corporate shares from the class of securities. However, corporate shares are

123 This entire formulation is merely a variation of an otherwise verbatim reproduction of Professor Coffey's risk capital analysis, but the modifications change the scope of the definition.
124 Cf. Coffey, supra, note 114, 403-7 where he argues that the substantive result of the risk capital analysis should override the express terms of the statute if the results of the statutory rules are to be consistent with the underlying policy.
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specifically listed as securities in section 39(6), evidencing clear parliamentary intention that, notwithstanding the definition of "similar obligations" by administrators and judges, corporate shares shall be treated as securities.

The use of any of these three approaches to the definition of a security is subject to one theoretical difficulty. In so far as all three approaches exclude those documents revealing title in an enterprise actually managed by the taxpayer, the distinction between securities and all other participating interests is the same as that between investment and non-investment transactions. While actual control over management of the enterprise will probably be an easier standard to apply than the multiplicity of factors usually relied upon, the focus of the issue has merely been shifted from the nature of the purchase and sale to the subject-matter thereof. Yet the same concept arises in determining the nature of the taxpayer in section 39(5), and the overlap is further complicated because section 39(5)(a) and section 39(6) require an election but for different reasons. "Dealer or trader" must be defined narrowly so that the ordinary promoter is not included, and by defining "similar obligations" as investment contracts, "investment" must receive its broad vernacular meaning.

In summary, it should be clear that if the election is going to bring certainty to transactions which have always had uncertain tax consequences, "securities ... or similar obligations" will have to be construed broadly. If only corporate shares and the other enumerated securities are affected by the election, the old ambiguity will be compounded by uncertainty as to whether the property in question constitutes an enumerated security.

B. "Issued by a person resident in Canada"

An expansive reading of "security" may be of little use if "issued by a person resident in Canada" is given the restricted meaning advocated by Mr Hogg. Noting that "person" is defined in section 248(1) as "any body corporate and politic", he concludes that a number of specific types of securities will be excluded from the application of the election because they are not issued by a "person". The disqualified issuers fall into two groups, certain governmental issuers and unincorporated issuers, yet it may be possible to get around some of the obstacles he discusses.

125 Supra, note 3, 384.
1. Governmental issuers

Hogg states that "federal and provincial governments do not appear to be included within the legal definition of 'person' (i.e., government is not an incorporated body and cannot be sued)". This conclusion presupposes that "and" in the phrase "any body corporate and politic" is to be read so that a "body" is a person only if it is not merely incorporated but a body politic was well. However, legal usage has established that the "and" is to be read disjunctively. A private corporation which is in no way a body politic is of course a "person" under the Income Tax Act. To be consistent, an unincorporated body politic would also be a person. Provincial and federal governmental issues would constitute securities within the meaning of section 39(6), as would securities issued by incorporated municipalities and governmental agencies.

2. Unincorporated issuers

Hogg also takes the position that "options, commodity futures, currency contracts and interests in real estate ventures, such as the recent public issues of MURB's, will likely be excluded" because they are not issued by any body corporate. There are, at least, two ways to get around this narrow view of "securities issued by a person resident in Canada", and possibly three if one disregards the statutory definition of "person" because of context.

The first weakness in the narrow view of "person" is that the word denotes not only bodies corporate and politic but individuals. Although a partnership is not a person under the Income Tax Act, an obligation which purports to be issued by a partnership in law would be issued by its partners because they bear responsibility for all obligations undertaken. The same rationale would apply to other obligations which purport to be issued by unincorporated associations but which are in law the obligations of individuals or corporations which are members of the association. Commodity futures, currency contracts and interests in real estate ventures would thus be issued by persons, and whether they constitute securities will depend entirely on the substantive terms of the obligation.

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126 Ibid.
129 Hogg, supra, note 3.
130 See Income Tax Act, ss. 248(1), "individual”.
The second weakness of the narrow view of "securities issued by a person ..." is that "person" need not be construed as referring only to incorporated bodies. Section 248(1) states that "person" includes bodies corporate, so that an expansive reading of the statute may be employed. Further, "person" includes any legal representative of a person, and that is indeed a wide concept. While the issue has never arisen under the Income Tax Act, the Exchequer Court stated that a slightly different definition of "person" in the Income War Tax Act included a trust or an association. But as with every other difficult definitional aspect of the lifetime election, the meaning of "person" that is adopted by the courts will reflect the courts' understanding of the policy by which the election was enacted. By refusing to be distracted by an arcane and technical reading of "person", the courts would affirm that the meaning of "person" in section 2(1) is quite different from that in section 39(6).

It is submitted that a reasonable construction of "person" would operate to qualify the words "resident in Canada" and not to cut down the substantive meaning of securities. While it is true that there may be some difficulty in fixing the residence of unincorporated associations where more than one person stands behind the obligation, the problem is not insurmountable.

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132 R.S.C. 1927, c. 97, s. 2(h): "Person includes any body corporate and politic and any association or other body, and the heirs, executors, administrators and curators or other legal representatives of such person, according to the law of that part of Canada to which the context extends".

133 McLeod v. Minister of Customs and Excise [1925] Ex. C.R. 105 per MacLean J.

134 Port Credit Realty Ltd v. M.N.R. [1937] Ex. C.R. 88 per Angers J.