

Date: 20071026

Docket: A-474-06

Citation: 2007 FCA 337

**CORAM: LINDEN J.A.
NOËL J.A.
RYER J.A.**

BETWEEN:

HER MAJESTY THE QUEEN

Appellant

and

JES INVESTMENTS LTD.

Respondent

Heard at Regina, Saskatchewan, on October 9, 2007.

Judgment delivered at Ottawa, Ontario, on October 26, 2007.

REASONS FOR JUDGMENT BY:

RYER J.A.

CONCURRED IN BY:

**LINDEN J.A.
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REASONS FOR JUDGMENT

RYER J.A.

[1] This is an appeal from a decision of Sheridan J. (2006 TCC 508) of the Tax Court of Canada, dated September 27, 2006, allowing an appeal of JES Investments Ltd. (the “taxpayer”) against a reassessment that was issued in respect of its 1998 taxation year by the Minister of National Revenue (the “Minister”), pursuant to the *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.) (the “ITA”), and that denied a capital loss that was claimed by the taxpayer from a disposition of certain shares in that taxation year. Unless otherwise indicated, all statutory references are to the corresponding provisions of the ITA for the taxation years under consideration.

[2] The issue that was before the Tax Court of Canada and that is present in this appeal is whether the shares (the “Shares”) that the taxpayer acquired in 1997 from Deena Energy Inc. (“Deena”) pursuant to a Share Subscription and Renunciation Agreement (the “Agreement”), which bears the date of November 18, 1997, constituted flow-through shares, as that term is defined in subsection 66(15) (“flow-through shares”). The significance of the determination of this issue is apparent from a brief review of the events that occurred.

Background

[3] Pursuant to the Agreement, Deena agreed to incur certain Canadian exploration expenses and Canadian development expenses, as those terms are defined in the ITA, and to renounce in favour of the taxpayer an amount of those expenses equal to the subscription price that the taxpayer paid for the Shares. Deena failed to incur any amount of those expenses and its purported renunciation of the agreed amount of those expenses in favour of the taxpayer was invalid. To make matters worse for the taxpayer, Deena went into receivership and as a consequence the Shares became worthless.

[4] Having failed to receive a valid renunciation of the expenses that it had bargained for, the taxpayer attempted to obtain some solace in the form of a capital loss on the Shares as a result of the receivership of Deena. However, the Minister resisted that outcome, contending that because the Shares constituted flow-through shares, the taxpayer was deemed, by virtue of subsection 66.3(3), to have acquired them at a cost of nil. As a result, a capital loss from an actual or deemed disposition of the Shares was denied to the taxpayer.

[5] In allowing the appeal of the taxpayer, Sheridan J. held that the fact that Deena had breached the Agreement in a number of respects, “deprived the shares issued under that agreement from ever acquiring their intended status as flow-through shares” (paragraph 12). In so deciding, Sheridan J. concluded that it was unnecessary to consider the argument of the taxpayer that the Shares were prescribed shares (“prescribed shares”), within the meaning of section 6202.1 of the *Income Tax Regulations*, C.R.C., c. 945 (the “ITR”), and therefore were not flow-through shares.

[6] While I am in agreement with the conclusion that was reached by Sheridan J., with respect, I cannot agree with the basis upon which that conclusion was reached. The relevant time to determine whether a share is a flow-through share is the time at which it is issued and the record shows that, at the time that the Shares were issued, no breach of the Agreement had been committed by Deena. It was not open to Sheridan J. to determine that the Shares were not flow-through shares with the benefit of hindsight, that is to say with regard to breaches of the Agreement that occurred after the issuance of the Shares. However, for the reasons that follow, I am of the view that the Shares were not flow-through shares because they were prescribed shares.

Relevant Statutory Provisions

[7] The relevant provisions of the ITA and the ITR are as follows:

<p>66(15) "flow-through share" means a share (<u>other than a prescribed share</u>) of the capital stock of a principal-business corporation that is issued to a person under an agreement in writing entered into</p>	<p>66(15) « <i>action accréditive</i> » --- « action accréditive » Action du capital-actions d'une société exploitant une entreprise principale, <u>à l'exclusion d'une action visée par règlement</u>, émise en faveur d'une</p>
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between the person and the corporation after February 1986, under which the corporation agrees for consideration that does not include property to be exchanged or transferred by the person under the agreement in circumstances in which section 51, 85, 85.1, 86 or 87 applies

(a) to incur, in the period that begins on the day the agreement was made and ends 24 months after the end of the month that includes that day, Canadian exploration expenses or Canadian development expenses in an amount not less than the consideration for which the share is to be issued, and

(b) to renounce, before March of the first calendar year that begins after that period, in prescribed form to the person in respect of the share, an amount in respect of the Canadian exploration expenses or Canadian development expenses so incurred by it not exceeding the consideration received by the corporation for the share,

and includes a right of a person to have such a share issued to that person and any interest acquired in such a share by a person pursuant to such an agreement.

66.3(3) Any flow-through share (within the meaning assigned by

personne conformément à une convention écrite conclue après février 1986 entre cette personne et la société et par laquelle la société s'oblige, pour une contrepartie qui ne comprend pas un bien que la personne doit échanger ou transférer aux termes de la convention dans des circonstances où les articles 51, 85, 85.1, 86 ou 87 s'appliquent :

a) d'une part, à engager, au cours de la période commençant à la date de conclusion de la convention et se terminant 24 mois après la fin du mois qui comprend cette date, des frais d'exploration au Canada ou des frais d'aménagement au Canada pour un montant total au moins égal au paiement prévu pour l'action;

b) d'autre part, à renoncer en ce qui concerne l'action en faveur de cette personne, avant mars de la première année civile commençant après cette période, sur le formulaire prescrit, à un montant au titre des frais ainsi engagés qui ne dépasse pas le paiement reçu par la société pour l'action;

le droit d'une personne à l'émission d'une telle action et tout droit sur une telle action acquis par une personne conformément à une telle convention sont assimilés à une action accréditive.

66.3(3) La personne qui acquiert une action accréditive – au sens du

subsection 66(15)) of a corporation acquired by a person who was a party to the agreement pursuant to which it was issued shall be deemed to have been acquired by the person at a cost to the person of nil.

6202.1(1)(c)(i) For the purposes of the definition "flow-through share" in subsection 66(15) of the Act, a new share of the capital stock of a corporation is a prescribed share if, at the time it is issued,

(c) any person or partnership has, either absolutely or contingently, an obligation (other than an excluded obligation in relation to the share) to effect any undertaking, either immediately or in the future, with respect to the share or the agreement under which the share is issued (including any guarantee, security, indemnity, covenant or agreement and including the lending of funds to or the placing of amounts on deposit with, or on behalf of, the holder of the share or, where the holder is a partnership, the members thereof or specified persons in relation to the holder or the members of the partnership, as the case may be) that may reasonably be considered to have been given to ensure, directly or indirectly, that

(i) any loss that the holder of the share and, where the holder is a partnership, the members thereof or specified persons in relation to the holder or the members of the partnership, as the case may be, may sustain by reason of

paragraphe 66(15) – auprès d'une société et qui est partie à la convention relative à l'émission de l'action est réputée acquérir celle-ci à un coût nul.

6202.1(1)(c)(i) Pour l'application de l'alinéa 66(15)d.1) de la Loi, est une action exclue l'action nouvelle du capital-actions d'une société si au moment de son émission, selon le cas:

c) une personne ou une société de personnes a l'obligation, conditionnelle ou non (à l'exception d'une obligation exclue relative à l'action), de fournir un engagement, immédiat ou futur, relatif à l'action ou à la convention en vertu de laquelle l'action est émise – notamment une garantie, une sûreté, une promesse ou un accord et y compris le dépôt d'un montant ou le prêt de fonds au détenteur de l'action ou, si celui-ci est une société de personnes, aux associés de celle-ci ou aux personnes apparentées au détenteur de l'action ou aux associés, ou pour le compte des uns ou des autres – qu'il est raisonnable de considérer comme donné pour faire en sorte, directement ou indirectement:

(i) qui soit limitée d'une façon quelconque toute perte que le détenteur de l'action et, si celui-ci est une société de personnes, les associés de celle-ci ou les personnes apparentées au détenteur de l'action ou aux associés peuvent subir parce qu'ils détiennent l'action ou un

the holding, ownership or disposition of the share or any other property is limited in any respect, or

[Emphasis added.]

autre bien, en sont propriétaires ou en disposent, ou

[Je me souligne.]

Relevant Provisions of the Agreement

[8] The application of subparagraph 6202.1(1)(c)(i) of the ITR to several provisions of the Agreement, which are reproduced below, must be considered:

9. The Corporation covenants and agrees with the Subscriber:
...
 - (b) to incur, during the Expenditure Period, Qualifying Expenditures in such amount as enables the Corporation to renounce the Subscriber in accordance with the Act and this Subscription Agreement, Qualifying Expenditures equal to the Subscription Amount with effect on or before December 31, 1997;
 - (c) to renounce (in accordance with the Act and this Subscription Agreement) to the Subscriber, effective on or before December 31, 1997, Qualifying Expenditures incurred during the Expenditure Period equal to the Subscription Amount;
...
10. The Corporation hereby agrees to indemnify and save harmless the Subscriber from and against any liability, loss, damage, cost or expense which the Subscriber may sustain or incur arising out of or in any way connected with the expenditure of the Subscription Amount.

Analysis

[9] A share cannot be a flow-through share if it is determined to be a prescribed share. That determination is also required to be made at the time of issuance of the share in question.

[10] The narrow issue in this appeal is whether the Shares are prescribed shares, within the meaning of subparagraph 6202.1(1)(c)(i) of the ITR, which will be the case if it may reasonably be considered, at the time the Shares were issued, that the indemnity that is contained in clause 10 of the Agreement (the “Indemnity”) was given by Deena to the taxpayer to ensure, directly or indirectly, that any loss that the taxpayer may sustain by reason of the holding, ownership or disposition of the Shares was limited in any respect.

[11] In interpreting subparagraph 6202.1(1)(c)(i) of the ITR and considering its potential application to the circumstances under consideration in this appeal, in my view, the phrase “may reasonably be considered to have been given” mandates an objective determination of the proper construction of clause 10 of the Agreement and the reason that the Indemnity was given by Deena to the taxpayer. Two different interpretations of clause 10 of the Agreement were put forward by the parties.

[12] The Minister stated that clause 10 of the Agreement was a typical indemnity that was necessary in the flow-through share regime that existed prior to 1986, under which an investor was required to incur resource expenditures (directly or, more often, through an agency agreement with the issuing corporation) solely as consideration for flow-through shares. According to the Minister, the typical indemnity protected investors against unanticipated third party liabilities (see paragraph 50 of the Minister’s factum).

[13] The Minister further stated that the administrative practice of the Canada Revenue Agency, as stated at the 1984 Canadian Tax Foundation Annual Conference, was that the prescribed share regulations would not apply to an indemnity given by a resource company to a subscriber against liability that might be incurred as a result of the resource company incurring the requisite expenses as agent for the subscriber (see paragraph 51 of the Minister's factum).

[14] The Minister further argued that the Indemnity protected the taxpayer against third party liability arising from Deena's exploration programs and concluded that the Indemnity did not operate to limit any loss that the taxpayer may sustain by reason of its holding, ownership or disposition of the Shares (see paragraph 52 of the Minister's factum).

[15] The Minister's argument that the purpose of the Indemnity was to protect the taxpayer from third party liabilities that might arise out of the expenditure by Deena of the subscription price of the Shares is, in my respectful view, untenable. By the Minister's own admission, clauses like the Indemnity were typically used in the pre 1986 era in relation to resource expenditures that were incurred by the resource company as agent for the subscriber. In those circumstances, the subscriber was exposed to third party liabilities. However, under the current flow-through share regime, a subscriber for flow-through shares does not have an obligation to incur resource expenses (directly or through an agent) and therefore does not face risks of third party liability as a result of the subscription for flow-through shares and the expenditure of the subscription price of those shares. I therefore do not accept the Minister's characterization of the purpose of the Indemnity, nor do I

accept that the Indemnity can be read out of the Agreement altogether. Some meaning must be given to that provision.

[16] In that regard, the taxpayer contends that clause 10 of the Agreement must be interpreted as providing a right to recover any loss that the taxpayer may incur as a result of the expenditure of the subscription price of the Shares by Deena. By way of example, if, in the expenditure of the subscription funds provided by the taxpayer, Deena could be shown to have acted negligently and if that negligence could be shown to have led to a drop in the trading value of the Shares, the taxpayer contends that it could claim indemnification, pursuant to clause 10 of the Agreement, from Deena for that loss in the value of the Shares.

[17] In my view, the taxpayer's interpretation of clause 10 of the Agreement is reasonable and must be preferred. Under the Agreement and the current flow-through share rules contained in the ITA, the taxpayer had no right or obligation to participate, in any way, in the expenditure of the subscription price of the Shares. Indeed, under clause 9(b) of the Agreement, Deena covenanted to incur expenses of the amount and type that would have enabled it to meet its renunciation obligation to the taxpayer under clause 9(c) of the Agreement. Moreover, after the payment of the subscription price of the Shares, the only meaningful connection of the taxpayer to Deena was by virtue of the taxpayer's holding and ownership of the Shares. It is readily apparent that the broad language contained in subparagraph 6202.1(1)(c)(i) of the ITR embraces rights that are "contingent", rights that are effective "either immediately or in the future", rights that "directly or indirectly" provide

assurances and rights to loss limitation protection “in any respect” and, in my view, the rights that accrued to the taxpayer under the Indemnity are within the broad language of that provision.

[18] I realize that the taxpayer would not have supported this interpretation of clause 10 of the Agreement if Deena had fulfilled all of its obligations under the Agreement since the taxpayer’s intention, at the time that the Agreement was entered into, was to acquire shares that qualified as flow-through shares. However, the intention that a share should qualify as a flow-through share cannot prevent that share from constituting a prescribed share if the requirements of section 6202.1 of the ITR are met and as I have concluded, the rights of the taxpayer under clause 10 of the Agreement are of the type specified by subparagraph 6202.1(1)(c)(i) of the ITR.

Conclusion

[19] In my view, it may reasonably be considered that, at the time that the Shares were issued, clause 10 of the Agreement constituted an undertaking or obligation that was given by Deena to the taxpayer to ensure, directly or indirectly, that any loss that the taxpayer may sustain from the holding or ownership of the Shares, to the extent that such a loss was related to the expenditure by Deena of the subscription price of the Shares, was limited. It follows that the Shares were prescribed shares, by virtue of subparagraph 6202.1(1)(c)(i) of the ITR, and as such were not flow-through shares.

[20] Accordingly, I would dismiss the appeal with costs.

“C. Michael Ryer”

J.A.

“I agree.
A.M. Linden J.A.”

“I agree
Marc Noël J.A.”

FEDERAL COURT OF APPEAL

NAMES OF COUNSEL AND SOLICITORS OF RECORD

DOCKET: A-474-06

(APPEAL FROM A JUDGMENT OF SHERIDAN J. (2006 TCC 508) OF THE TAX COURT OF CANADA, DATED SEPTEMBER 27, 2006)

STYLE OF CAUSE: HER MAJESTY THE QUEEN
v.
JES INVESTMENTS LTD.

PLACE OF HEARING: Regina, Saskatchewan

DATE OF HEARING: October 9, 2007

REASONS FOR JUDGMENT BY: Ryer J.A.

CONCURRED IN BY: Linden J.A.
Noël J.A.

DATED: October 26, 2007

APPEARANCES:

Ms. Bonnie Moon FOR THE APPELLANT

Mr. Hal Welsh FOR THE RESPONDENT

SOLICITORS OF RECORD:

John H. Sims, Q.C.
Deputy Attorney General of Canada
Ottawa, Ontario FOR THE APPELLANT

McCrank, Stewart, Johnson
Regina, Saskatchewan FOR THE RESPONDENT