Docket: 2011-3489(IT)G

BETWEEN:

GEORGE WESTON LIMITED,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on August 18, 19, 20 and 21, 2014, at Toronto, Ontario.

Before: The Honourable Justice Lucie Lamarre

Appearances:

Counsel for the Appellant:	Salvatore Mirandola Patrick Lindsay
Counsel for the Respondent:	Elizabeth Chasson Alexandra Humphrey

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JUDGMENT

The appeal from the reassessment made by the Minister of National Revenue (**Minister**) against the appellant for its 2003 taxation year under the *Income Tax Act* (**ITA**) is allowed and the reassessment is referred back to the Minister for reassessment on the basis that the proceeds received by the appellant in that year in respect of the termination of cross-currency basis swap contracts totaling CAD$316,932,896 are a capital gain, half of which (CAD$158,466,448) is a taxable capital gain pursuant to section 38 of the ITA. The appellant is awarded its costs.

Signed at Ottawa, Canada, this 19th day of February 2015.

"Lucie Lamarre"

Lamarre A.C.J.

Citation: 2015 TCC 42
Date: 20150219
Docket: 2011-3489(IT)G

BETWEEN:

GEORGE WESTON LIMITED,

Appellant,

and

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REASONS FOR JUDGMENT

Lamarre A.C.J.

Introduction

[1] During its taxation year ended December 31, 2003, the appellant, George Weston Limited (**GWL**), received in respect of the termination of cross-currency basis swap contracts (**swaps**) proceeds totalling CAD$316,932,896. In its income tax return for its 2003 taxation year, GWL treated that amount as being on account of capital and reported a taxable capital gain of CAD$158,466,448. The Minister of National Revenue (**Minister**) reassessed GWL on the basis that the CAD$316,932,896 was on income account and added to GWL's income the full amount, hence the present appeal.

[2] GWL is a Canadian publicly traded corporation and the parent holding company of subsidiary corporations inside and outside Canada. A significant portion of the assets owned and businesses operated by the GWL corporate group is in the United States.

[3] In its Notice of Appeal, GWL stated that it had entered into the swaps in order to preserve its consolidated balance sheet equity and protect against Canadian dollar and United States dollar (**USD**) foreign exchange fluctuations that would create volatility in GWL's consolidated balance sheet equity. In its submissions to the Court, GWL offered some specifics. GWL indicated that it

carried on various existing and newly acquired bakery-related businesses in the United States, using US currency, through indirectly held subsidiaries (referred to as self-sustaining foreign operations or USD Operations) and that this was the reason GWL was affected by the Canadian dollar and USD exchange rate fluctuations. Those fluctuations affected GWL's consolidated equity, which in turn affected the debt to equity ratio. Hence, they had an impact on the value of GWL's direct capital investments in other corporations in the GWL corporate group, and on GWL's very capital structure.

[4] In the end, GWL took the position that, because the Canadian dollar had appreciated relative to the USD between 2001 and 2003, the proceeds it received in 2003 upon terminating the swaps it entered into in 2001 were a capital gain.

[5] The respondent is of the view that the receipts from the closing out of a derivative such as the swaps will be treated as being on capital account for income tax purposes only if it can be shown that the derivative is linked to an underlying transaction that is the purchase or sale of a capital asset, the repayment of a debt denominated in a foreign currency or the investment of idle capital funds, in accordance with what is referred to in the case law as the "linkage principle". In the Crown's view, if the derivative is not linked to such a transaction, the profit or loss on the closing out of the derivative is considered either as resulting from speculation or, by default, as being part of the ordinary business of the taxpayer, and is therefore considered to have been received on income account. In the present case, the respondent submits that, as the swaps were not linked to any transaction or debt obligation of the appellant denominated in a foreign currency that it entered into on its own account, the amount received by the appellant when it closed out the swaps is considered to be part of the business of the appellant and therefore a profit from its business that is taxable as income.

Facts

[6] The parties have agreed on many of the relevant facts in a Partial Statement of Agreed Facts (Exhibit A-7), which is attached at the end of my reasons for judgment.

Appellant's interpretation of the facts

[7] The appellant gave its own assessment of the key facts in its opening statement and in its written submissions. I will summarize them below.

[8] GWL is a large publicly traded Canadian holding company that, at all relevant times, held direct and indirect subsidiaries that carried on food processing or food distribution businesses in Canada and in the United States.

[9] Prior to 2001, GWL carried on a bakery business in the United States through a company called Weston Foods Inc. (**WFI US**) and its subsidiaries. WFI US was an indirect subsidiary of the Canadian company Weston Foods Inc. (**WFI Can**), which was in turn a direct subsidiary of GWL.

[10] In 2001, the GWL corporate group acquired another mainly United States-based bakery business called Bestfoods Baking (**Bestfoods**) and its subsidiaries and related trademarks. This acquisition drastically increased the GWL corporate group's net investments in USD Operations from approximately US$800 million to well in excess of US$2 billion.

[11] The Bestfoods acquisition was financed entirely by debt, through loans from Canadian banks to GWL (CAD$2.1 billion and US$400 million). As a result, in 2001, GWL's debt to equity ratio rose well beyond its internal corporate policy of 1:1 or lower. GWL invested the borrowed funds in its subsidiaries, which then acquired Bestfoods for US$1.765 billion, as detailed in the Partial Agreed Statement of Facts.

[12] As a Canadian publicly traded company, GWL prepared consolidated financial statements in Canadian dollars, in accordance with generally accepted accounting principles (**GAAP**). In those statements, it combined the assets and liabilities of its controlled subsidiaries, including the USD Operations. When the value of its net investments in the USD Operations was translated into Canadian dollars, the fluctuations in the exchange rate affected the equity section of GWL's consolidated balance sheet (generally reflected in the "cumulative foreign currency translation adjustment" account — hereinafter "currency translation account" or "CTA") in the sense that when the Canadian dollar appreciated relative to the USD, GWL's consolidated equity decreased, and when the Canadian dollar depreciated, GWL's consolidated equity increased.

[13] Because the Canadian dollar was at historical lows in 2001, GWL was concerned that it would appreciate substantially relative to the USD, with the effect

of eroding its consolidated equity and worsening its debt to equity ratio, which in turn could affect its credit rating and cost of capital.

[14] After the acquisition of Bestfoods in 2001, the investment in USD Operations exposed to currency risk increased from US$666 million (US$816 million investment in WFI as at December 31, 2000, less US$150 million in swaps entered into in 2000) to approximately US$2 billion.

[15] To circumvent that risk, GWL decided to hedge its increased USD currency risk. Following the closing of the Bestfoods transaction, GWL entered into a number of swaps with various financial institutions (the “counterparties”) for terms of mostly 10 to 15 years to hedge, or protect against, currency fluctuations affecting the reported value of the old and the newly acquired USD Operations (Exhibit A-7, par. 27, and Transcript, vol. 1, page 211).

[16] The USD notional value of the swaps closely approximated the total net investments in the USD Operations that were exposed to currency risk. According to Ms. Lisa Swartzman, who held the positions of assistant treasurer, treasurer and vice president-treasurer of GWL at various times during the years at issue, the swaps were entered into by GWL, as opposed to subsidiaries, because the counterparties wanted to deal with the parent corporation, and GWL had a higher credit rating than the subsidiaries, which reduced the cost of swaps (Transcript, vol. 1, page 216).

[17] The appellant submitted that the swaps were entered into solely as a hedge. They mitigated GWL’s exposure to exchange rate fluctuations because changes in the value of the swaps due to those fluctuations varied inversely with, and therefore offset, changes in the Canadian dollar translated value of the net investments in USD Operations due to the same exchange rate fluctuations. Indeed, once the swaps were in place, if the Canadian dollar appreciated, the increase in the value of the swaps would offset the decrease in the Canadian dollar translated value of GWL’s net USD investments in USD Operations on GWL’s consolidated balance sheet; conversely, if the Canadian dollar depreciated, the decrease in the value of the swaps would offset the increase in the Canadian dollar translated value of GWL’s net USD investments in USD Operations on GWL’s consolidated balance sheet.

[18] The appellant stated that GWL’s balance sheet equity was protected and, because GWL was the ultimate parent company of the USD Operations, the swaps protected the value of GWL’s investments in its own subsidiaries.

[19] In the consolidated financial statements, the "swaps [were] identified as a hedge against foreign currency exchange rate fluctuations on [GWL]'s [US] dollar denominated net investment in self-sustaining foreign operations with realized and unrealized foreign currency exchange rate adjustments on . . . swaps recorded in the cumulative foreign currency translation adjustment." (Notes to the 2002 consolidated financial statements, Exhibit A-1, Tab 2, page 125). This was in conformity with an internal memorandum issued on April 10, 2001, in which GWL recognized that the Bestfoods purchase would directly expose GWL to increased risk, and in which GWL designated the swaps as a hedge, indicating that if sufficient swaps were entered into, the debt to equity ratio would be protected from exchange rate fluctuations (Exhibit A-9, Tab 1).

[20] As a matter of fact, GWL's risk exposure was commented on by credit agencies. On February 20, 2001, Standard & Poor's Global Credit Portal issued a report titled "[GWL] 'A' Ratings Placed on Credit Watch Negative; Re: Purchase of Unilever Asset", indicating that the Bestfoods acquisition would be bank-financed and that "[t]he net effect . . . [would] be detrimental to Weston's capital structure in light of . . . much higher overall leverage" (Exhibit A-8).

[21] Under GWL's internal guidelines, the debt to equity ratio was to be no worse than 1:1 (Transcript, vol. 1, page 80 and GWL Quarterly Reports, Exhibit A-3, Tab 12, page 1021, and Tab 14, page 1050). After the Bestfoods transaction, the ratio worsened to well beyond that desired ratio. This was a particular concern because any devaluation in the USD would cause further deterioration in the ratio, which could negatively affect the capital structure if the credit rating were to drop. This was so because when the USD depreciated, GWL's indirect investment in USD Operations, expressed in Canadian dollars, decreased in value, and consequently GWL's direct investment in subsidiaries, expressed in Canadian dollars, similarly decreased in value, with a loss in balance sheet equity for GWL (Transcript, vol. 1, pages 167-168).

[22] In 2002, certain of GWL's indirect US subsidiaries sold some of the assets of the USD Operations for proceeds that were US$200 million higher than had been anticipated. As a result, GWL terminated approximately US$200 million of the swaps so that the total USD notional value of the swaps would not exceed what was needed to ensure that the USD Operations were fully hedged. Retaining swaps that exceeded what was needed to hedge the investment in USD Operations was contrary to GWL's credit facilities and corporate policy (testimony of Lisa Swartzman, Transcript, vol. 1, pages 221-222).

[23] By 2003, the Canadian dollar had appreciated to what GWL thought was a multi-year high against the USD, and GWL determined that its currency risk was waning. GWL had refinanced or repaid its initial Bestfoods acquisition financing and this, along with other measures, was expected to cause its debt to equity ratio to fall. GWL needed funds to, among other things, repurchase certain of its shares from its majority shareholder (Transcript, vol. 1, pages 228-232 and 237-238). Accordingly, GWL and its counterparties agreed to terminate the swaps. Because the Canadian dollar had appreciated between 2001 and 2003, the counterparties had to make net principal repayments to GWL, and these make up the amount at issue in this appeal.

<u>Facts added by the respondent</u>

[24] The respondent added the fact that, prior to closing the Bestfoods transaction and entering into additional swaps in 2001, the appellant held approximately US$150 million in swaps to offset part of the net assets of GWL's bakery business having a value of approximately US$816 million.

[25] The respondent recognized that the appellant entered into swaps after the acquisition of Bestfoods to offset fluctuations in the currency translation account (**CTA**) in its consolidated balance sheet. She also acknowledged that a negative adjustment to the account would result in an increase in the debt to equity ratio and that a decrease in shareholders' equity would negatively influence that ratio and put the appellant outside of its 1:1 guideline (Respondent's Argument, par. 7).

[26] The respondent pointed, however, to measures taken by the appellant in 2002 and 2003 to decrease its liabilities through refinancing its short-term debt, increasing retained earnings through profits of the operating subsidiaries, selling assets to pay down debts and raising capital on the public markets through preference share issuance. These activities positively affected the debt to equity ratio and resulted in the appellant achieving its guideline figure in that regard (Respondent's Argument, par. 8).

[27] The respondent added that, commencing in the first quarter of 2003, the Canadian dollar appreciated against the USD and the rate of exchange was significantly higher in 2003 than it had been in October 2001 when the swaps were entered into by the appellant (Respondent's Argument, par. 9).

[28] According to the respondent, in 2003, the appellant made a business decision to terminate the swaps and realized a profit of close to CAD$317 million, being the

amount at issue in this appeal. The Bestfoods assets that were exposed to fluctuations in the CTA were not sold in 2003. It was only in January 2009 that GWL's indirect subsidiary Dunedin Holdings S.a.r.l, a Luxembourg company, sold some of the Bestfoods assets (Transcript, vol. 1, page 152, and Exhibit A-3, Tab 9, page 959).

[29] The respondent pointed out that the variation in the CTA is a notional amount which is not included in the income statement of the parent company. Relying on her accounting expert, Professor Chlala, she stated that foreign exchange translation risk exists because of the requirement under GAAP to translate the value of the net assets of subsidiaries into Canadian dollars for consolidated reporting purposes. According to the respondent, foreign exchange "translation" risk has no impact on the cash flow or earnings of a company. It is not reflected in the legal entity financial statements, that is, the unconsolidated financial statements, of GWL. In contrast, foreign exchange "transaction" risk arises from a legal obligation denominated in a foreign currency and does have an impact on the cash flow or earnings of a company. That risk is reflected in both the unconsolidated and the consolidated financial statements (Professor Chlala's expert report, Exhibit R-1, pages 21-24 and 30).

[30] Thus, the unconsolidated financial statements filed for Canadian income tax purposes reflect only the income earned and the assets and liabilities held directly by the appellant. Thus, the appellant's list of investments in the unconsolidated financial statements does not include shares in the capital of Bestfoods, as the appellant did not acquire the shares of that company. The shares of Bestfoods were acquired by Weston Acquisition Inc (**WAI**). Only the investment in a direct subsidiary is reflected, at historic cost (a figure that is therefore not subject to any fluctuation) in Canadian dollars, in the legal entity financial statements.

<u>Issues</u>

[31] The appellant raised three questions to be addressed in order to determine whether the proceeds received from unwinding the swaps are to be characterized as capital or as business income.

- Were the swaps entered into as a hedge?

- If so, what was the character of the item that prompted the hedge and was that item capital in nature so that the proceeds derived from the swaps are to be treated as being on capital account?

- Regardless of whether the swaps constituted a hedge, did the swaps relate to GWL's capital structure such that the proceeds are on capital account or, instead, were the swaps part of GWL's income earning process such that the proceeds are on income account?

[32] The respondent advanced three arguments in support of the determination that the profit received in the amount of CAD$316,932,869 is on income account:

- The swaps were not linked to an underlying capital transaction denominated in a foreign currency or a debt obligation denominated in a foreign currency that exposed the appellant to foreign currency risk. Accordingly, the profit received on the termination of the swaps is considered to be part of the business income of the appellant;

- In deciding to close out the swaps when they were "in the money" in the hands of the appellant (meaning that the Canadian dollar had strengthened at the time of termination of the swaps and the appellant received money from the counterparties), the appellant was speculating in currency or meeting a business need for cash. Thus, the profit received is income from an adventure in the nature of trade; and

- Swaps are not capital property and the payment received by the appellant on their termination is not proceeds of disposition of a capital property.

<u>Appellant's arguments</u>

i) *The swaps were entered into as a hedge*

[33] The appellant stated that there is no reasonable basis for the respondent to deny that the swaps constituted a hedge. To so conclude, it referred to the following points from the evidence:

- The respondent agreed in her examination for discovery that GWL did not enter into the swaps for speculative purposes (Exhibit A-13, Tab 1, Undertaking Response 13).

- GWL had a formal derivative policy and GWL's credit facilities prohibited it from speculating in derivatives (Transcript, vol. 1, pages 51-54, and Credit Agreement with various lenders, Exhibit A-4, Tab 22, page 1230, article 6.6 Hedging Agreements).

- GWL's contemporaneous annual reports publicly confirmed that GWL used swaps as a hedge and not for speculative purposes (Exhibit A-1, Tab 1, page 51, Tab 2, page 125 and Tab 3, pages 223-4).

- The relevant corporate records clearly and consistently indicated that GWL intended to and did enter into the swaps to hedge the risk associated with the investment in USD Operations, which risk was reflected in the CTA (Exhibit A-9, Tabs 1-8).

- The decision to enter into the swaps was made in a careful and systematic manner, having regard to the anticipated volatility in, and erosion of, the CTA as a result of the currency risk associated with the investment in USD Operations and the effect of this currency risk on GWL's debt to equity ratio (Exhibit A-9, Tabs 3 and 6 and testimony of Richard Mavrinac, Senior Vice-president, Finance of GWL in 2001, and CFO of GWL in 2002-2003, and of Lisa Swartzman, Transcript, vol. 1, pages 59-61 and 167-179).

- Ms. Joyce Frost, who provided expert evidence on the commercial meaning of a hedge, explained that the swaps were inappropriate for use as a speculative trading instrument (Exhibit A-11, Riverside Report, page 24, par. 73 d.).

- Ms. Frost opined that, from a commercial perspective, the swaps "were hedges that mitigated the foreign exchange risk imbedded in GWL's USD sensitive net assets" (Exhibit A-11, Riverside Report, page 9, par. 31).

- The respondent has agreed that GWL was not in the business of entering into and terminating swaps (Exhibit A-13, Tab 1, Undertaking Response 3).

- The notional amount of the swaps was determined on the basis of the amount needed to correspond with the total value of the investment in USD Operations that was subject to currency risk. GWL took steps to ensure that it would not own swaps in excess of what was needed to hedge that value (Partial Statement of Agreed Facts, par. 20-21 and

33, and testimony of Ms. Swartzman, Transcript, vol. 1, pages 221-222).

- The reason the swaps were terminated was the conclusion that the currency risk associated with the investment in USD Operations was waning and that GWL's debt to equity ratio would return to desired levels independently of the swaps (testimony of Mr. Mavrinac and Ms. Swartzman, Transcript, vol. 1, pages 80-81 and 228-232).

- From an accounting perspective, the swaps were treated and properly recorded as a hedge in GWL's consolidated financial statements in accordance with GAAP (Expert Accounting Report prepared by Professor Daniel B. Thornton, Exhibit A-12, page 7, par. 14).

[34] The appellant then argued that it entered into the swaps to hedge the foreign exchange risk with respect to its net investment in foreign operations, which risk is primarily borne by it, the parent company. It did so because volatility in equity due to changes in foreign exchange rates is not favourably regarded by equity investors or credit-rating agencies. In addition, declines in equity caused by foreign exchange losses could result in a violation of a loan covenant or encourage investors to sell the stock (testimony of Ms. Frost and Exhibit A-11, Riverside Report, pages 10 and 13, par. 34, 35 and 40).

[35] The appellant added that, had GWL not entered into the swaps to hedge the increased risk, a devaluation of the USD would have lowered the equity figure on its consolidated balance sheet. The attendant results would have been an erosion of GWL's debt to equity ratio, a reduction in its credit rating, a deterioration of its capital structure and a negative impact on GWL's share price. The experts called by the appellant concluded that the underlying USD net investments were highly and directly sensitive to GWL's currency risk (Riverside Report (Ms. Frost), Exhibit A-11, pages 10, 13, 17-18, par. 34, 53 and 54, and Thornton Report, Exhibit A-12, par. 73-75).

[36] Absent a definition of a hedge in the *Income Tax Act* (**ITA**) (except in section 20.3 in the context of weak currency loans), the appellant analyzed the meaning of hedge in its commercial and accounting sense as well as the meaning it has been given in the case law that I will review in my analysis. It concluded that GWL genuinely had investments exposed to currency risk and that it hedged that risk by entering into the swaps and explicitly designating those swaps, in its consolidated financial statements, as hedges of GWL's investment in self-sustaining foreign operations.

ii) The item that prompted the hedge was capital in nature and therefore the proceeds from unwinding the hedge were to be treated as being on capital account

[37] The appellant, unlike the respondent, is of the view that the underlying item to which the derivative (the swaps) relates does not necessarily need to be a separate transaction when it is the derivative itself, as is the case here, that directly gives rise to the gain or loss. In this case, the appellant argued that the evidence shows a strong link between the swaps and the investment in the USD Operations. This is confirmed by the GWL 2001 and 2003 presentation materials (Exhibit A-9, Tabs 3 and 6), which show no intention to relate the swaps to the business operations or to make a profit in the financial markets.

[38] Further, the swaps were entered into contemporaneously with the period in which the Bestfoods purchase occurred, which purchase greatly increased the investment in USD Operations and, accordingly, GWL's currency risk. Most of the swaps were part of GWL's planning for the Bestfoods acquisition and were implemented in connection with, and as a result of, that important acquisition. The amount of the swaps entered into correlated directly with the investment in USD Operations through the matching, as closely as possible, of the notional amount of the swaps with the amount of GWL's net investment in self-sustaining US operations (Thornton Report, Exhibit A-12, par. 19). There was a sufficient correlation between the swaps and the investment that was subject to currency risk. Further, the fact that the swaps were terminated in 2003 does not retroactively change GWL's intention when entering into the swaps in 2001. Indeed, GWL only intended to hedge the USD Operations while the associated currency risk exceeded acceptable levels.

[39] Finally, the appellant stated that the investment in USD Operations, the item that prompted the hedge, was capital in nature and, accordingly, the proceeds from unwinding the swaps are to be treated as being on capital account. According to the appellant, this is true whether one takes the approach that it is a direct investment for GWL or whether one views it as an indirect investment.

[40] On the one hand, one may consider the value of GWL's direct investment in companies in the GWL corporate group (that directly or indirectly own the USD Operations), which necessarily fluctuates according to the value of the investment in USD Operations. From this perspective, it is the value of those USD Operations that is used to determine the amount of the hedge required to protect the value of GWL's direct capital investment.

[41] On the other hand, there is the approach under which the USD Operations constitute a capital investment made by indirect GWL subsidiaries, all of which in the end are wholly owned by GWL at the top of the corporate chain. Changes in the Canadian dollar value of those indirect subsidiaries have a direct impact on GWL's capital structure (debt to equity ratio). From this perspective, GWL is hedging an indirect capital investment that has a direct impact on GWL's capital structure.

[42] The appellant submitted that, whatever approach is taken, GWL, as a holding company, held subsidiaries as a capital investment. Mr. Mavrinac testified that GWL acquired Bestfoods with the intention of holding it long-term (with the exception of one component of the business that was intended to be sold), which was in line with GWL's corporate history of holding Loblaws and its US baking assets for the long term (Transcript, vol. 1, page 61). GWL financed its subsidiaries through loans or equity investments which were in turn used to acquire control of the USD Operations. Those outlays are of a capital nature (*Neonex International Ltd. v. The Queen*, [1978] C.T.C. 485; 78 DTC 6339; *Stewart & Morrison Ltd. v. M.N.R.*, [1974] S.C.R. 477). GWL did not speculate and it was not in the business of acquiring and terminating swaps.

[43] The appellant also questioned the Canada Revenue Agency (**CRA**) approach according to which the linkage test demands the existence of a sale or proposed sale of an underlying item owned directly by the taxpayer. This restrictive view precludes the possibility of hedging an investment that is either (i) not intended to be sold or (ii) owned indirectly through subsidiaries.

[44] The appellant submitted that this restrictive view has no legal basis and makes no commercial sense. Among the case law relied upon by the respondent, the appellant referred to *Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622. In the appellant's view, the Supreme Court of Canada (SCC) made therein no statement consistent with the CRA's position. On the contrary, that case, according to the appellant, stands for the proposition that hedge proceeds will be on capital account if the item being hedged (whether it is an asset, a liability or a transaction) is a capital item. Further, in *Neonex*, *supra*, the Federal Court of Appeal attributed the capital character of the subsidiary's capital asset to the parent company's investment in its subsidiary. In that case, it was held that a loan made solely for the purpose of replenishing the working capital of a subsidiary which had acquired control of another company was a capital transaction.

iii) Whether or not the swaps constitute a hedge, the proceeds from their termination were part of GWL's capital structure and are on capital account

[45] The appellant examined the factors considered in the case law when the courts are seeking to characterize an "unusual" amount either as being part of the capital structure or as being part of the income-earning process. It concluded that the proceeds from the swaps were received as part of GWL's capital structure and therefore were on capital account.

[46] The appellant submitted that the swap proceeds were analogous to awards of damages and to contract termination payments. It argued that such proceeds are on capital account where the underlying item is more closely connected to the capital structure than to the income-earning process (*Tsiaprailis v. Canada*, 2005 SCC 8, [2005] 1 S.C.R. 113 at par. 7 and 15 and *Imperial Tobacco Canada Ltd. v. The Queen*, 2011 FCA 308, 2012 DTC 5003 at par. 29).

[47] More generally, the appellant outlined the capital gain versus income test outside of the derivative context. The Supreme Court of Canada has framed the test as follows: "were [the] sums expended on the structure within which the profits were to be earned or were they part of the money-earning process?" (*Johns-Manville Canada v. The Queen*, [1985] 2 S.C.R. 46 at 57 (Lexum at par. 14), quoting from the Privy Council decision in *B.P. Australia Ltd v. Comr. of Taxation of the Commonwealth of Australia*, [1966] A.C. 224). Additionally, the SCC in *Ikea Ltd. v. Canada*, [1998] 1 S.C.R. 196, provided further guidance on the distinction between income and capital gains, in the context of a tenant inducement payment. The Court found that the payment was "clearly received as part of ordinary business operations and was, in fact, inextricably linked to such operations" (par. 24, 25, 30 and 33).

[48] The appellant stated that the courts often consider the following factors to distinguish income from capital: (1) intention, (2) benefit, (3) duration, (4) recurrence, and (5) financial reporting (Vern Krishna, *The Fundamentals of Canadian Income Tax* (Taxnet Pro, 2014), ch. 7.I.D, and see Interpretation Bulletin IT-479R, "Transactions in Securities" (February 1984)). A review of the case law under each heading was presented, which I will not summarize here.

[49] The appellant submitted that the common law often looks to an underlying item when seeking to characterize a receipt as income or capital for tax purposes. Under this test, the appellant argued, the same conclusion as above is reached; the

swap proceeds were received in connection with GWL's capital structure and were therefore on capital account.

The respondent's arguments

[50] The respondent submitted that the character of hedging gains or losses is determined by reference to the underlying transaction to which the hedge relates. If the hedge cannot be linked to an underlying transaction that is on capital account, it must be considered as being on income account.

[51] The respondent acknowledged that as a result of the requirement to prepare consolidated financial statements, the translation of the financial statements of GWL's subsidiaries from their domestic currency into Canadian dollars created a translation risk that was recorded in the CTA, which had a direct impact on the consolidated shareholders' equity. However, she is of the view that the decision to enter into the swaps was a management decision flowing from concerns that a negative fluctuation in the CTA could have a material impact on the debt to equity ratio that could not be absorbed by the balance sheet alone. As a consequence of the designation of the swaps as hedges under GAAP hedge accounting rules, the impact that foreign exchange fluctuations had on the swaps was the opposite of the impact foreign exchange fluctuations had on the translation of the net assets. The swaps thus stabilized the CTA balance while GWL went about implementing other methods to bring its debt to equity ratio back to its 1:1 internal guideline. During that transition period, they ensured creditworthiness, which had an impact on the cost of borrowing, and all of these decisions were part of the ordinary business of managing a public company.

[52] In the respondent's view, the fact that the appellant used swaps to hedge the translation account and applied hedge accounting in its consolidated financial statements does not assist in the determination of whether the swaps were a hedge for tax purposes. Hedge accounting is a choice that taxpayers make in their financial statements. For tax purposes, she submitted, whether the swaps were a hedge or not depends on whether there is interconnection or linkage with an underlying transaction undertaken by the appellant on its own account.

[53] In this case, while the appellant funded the acquisition with a borrowing on its own account, the swaps were not linked to this borrowing and the borrowing did not give rise to any foreign exchange exposure. The appellant made a series of loans and equity investments denominated in Canadian dollars to four of its subsidiaries.

[54] For income tax purposes, submitted the respondent, it is not sufficient to hedge the net investment in foreign subsidiaries through a hedge of the CTA without there being an intention to sell that investment, as there is no offsetting position against which any of the gains or losses arising from the contract could be matched. The respondent added that the appellant cannot, for tax purposes, link its derivative to the risk of another taxpayer. She concluded that here there is no hedge for income tax purposes.

[55] Further, she argued that the swaps were not linked to the acquisition of Bestfoods. The value of the swaps exceeded the value of the Bestfoods transaction but matched the combined value of the Bestfoods transaction and the pre-existing US bakery business. Hence, the appellant could not, for tax purposes, link the swaps with any foreign currency transaction or a debt obligation in a foreign currency.

[56] The respondent, referring to *Salada Foods Ltd. v. The Queen*, 74 DTC 6171 (FCTD) and *Saskferco Products ULC. v. The Queen*, 2008 FCA 297, 386 N.R. 276, stated that the courts have rejected the appellant's argument. The hedging of net investments from an accounting perspective, that is, the hedging of translation exposure, is simply not sufficiently linked to the shares or the assets of a subsidiary for it to be possible to obtain capital account treatment. Such translation hedging is geared toward the net investment of the parent in a subsidiary on a book basis (including undistributed earnings) and not toward transaction exposure (Shawn D. Porter and Kenneth J.A. Vallillee, "Tax and Accounting Aspects of Treasury Operations", *Report of Proceedings of the Fifty-Second Tax Conference*, 2000 Conference Report (Toronto: Canadian Tax Foundation, 2001), 20:1-51 at 20:26).

[57] The respondent's position is that, while it is possible for a taxpayer to establish a linkage between a currency-hedging contract and the net investment in a foreign subsidiary, a linkage for tax purposes would only be made out if the taxpayer had intended to sell the subsidiary, the subsidiary was directly held and it was likely that the sale would occur. Here, the swaps were not linked to any underlying capital transaction that exposed the appellant to foreign exchange risk.

[58] Further, the appellant did not have a foreign exchange risk from any of its own debt obligations as the CAD$2.1 billion loan was denominated and repayable in Canadian dollars.

[59] The swaps were never intended to be in place for a long time, but were only temporary in that the appellant took other measures to bring its debt to equity ratio back to 1:1. Thus, the swaps did not provide long-term benefits.

[60] Moreover, according to the respondent, once the board of directors decided to terminate the swaps and use the cash for another purpose, there was a change of intention from hedging the CTA to speculation. Having predicted that the Canadian dollar would not strengthen and that the balance sheet could absorb any fluctuation in the CTA, the appellant determined that it was an opportune time to crystallize its position and it closed out the swaps at a time when there was a business need for cash. Accordingly, the profit received was income from an adventure in the nature of trade.

Analysis

Preliminary issue

Admissibility of the appellant's expert evidence, presented by Ms. Joyce Frost, on the use of derivatives to hedge commercial and financial risk

[61] The respondent objected to Ms. Frost's testimony on the basis that it was highly prejudicial (in that her opinion was based on her anecdotal experience from working in risk management for 25 years), was not relevant to the issue to be decided, was not necessary to assist the trier of fact in analyzing evidence that is technical in nature and was subject to exclusionary rules (*R. v. Mohan*, [1994] 2 S.C.R. 9 at page 20; *R. v. Sekhon*, [2014] 1 S.C.R. 272).

[62] I overruled that objection. I did not agree that Ms. Frost's opinion was anecdotal. Her opinion based on 25 years' work experience in risk management cannot be compared to a police officer testifying as to the *mens rea* of a particular defendant in a criminal matter as was the case in *Sekhon*, referred to by the respondent. With respect to relevance and necessity, this is a case in which I find it particularly useful to have the insight of an expert in the risk management field as it is directly linked to one of the issues between the parties: i.e., whether or not the swaps qualify as a hedge. Hedge is not defined in the ITA in the context of a situation such as that existing in this particular case; it is therefore appropriate to consider, among other things, the commercial context of hedging, keeping in mind that well-accepted principles of commercial trading are acceptable as guidance in this regard (*Symes v. Canada*, [1993] 4 S.C.R. 695, par. 42-43). I also note that expert testimony on industry practice and on accounting principles related thereto

was accepted as being relevant in *Echo Bay Mines Ltd. v. Canada*, 1992 CarswellNat 323, at par. 15-17, [1992] 3 F.C. 707 at pages 713-14, where the court had to decide, among others things, whether forward sales contracts for silver were a hedge designed to reduce the risk of wide price fluctuations.

[63] Further, I do not find that Ms. Frost's testimony sought to usurp my role as a trier of fact as I will rely on her expertise only to better understand the hedge financing world, which in itself is not necessarily an area of common knowledge. Finally, I do not find that Ms. Frost's evidence is subject to the exclusionary rules invoked by the respondent. I agree with the appellant that her report addresses the commercial context surrounding the use of derivatives and that her testimony is relevant to the issue before me. Accordingly, I do not find that her opinion violates subsection 145(7) of the *Tax Court of Canada Rules (General Procedure)* (**Rules**), since I do not agree with the respondent that her testimony is not related to an issue in this appeal. With respect to subsection 98(3), also invoked by the respondent, which relates to the continuous disclosure obligation, the appellant informed the Court that Ms. Frost's report was sent to the respondent three months before trial, and the respondent cannot now claim that the appellant failed to comply with the disclosure of information requirement under that provision.

Existence of a hedge

[64] There is no definition of a hedge in the ITA, except in the context of weak currency debts in subsection 20.3(1). Although not applicable here, that definition does provide indirect guidance. It requires that the derivative be entered into primarily to reduce the taxpayer's risk, and that the taxpayer properly designate the derivative as a hedge.

[65] In her written submissions, at paragraph 19, the respondent alludes to the definition of a hedge in GWL's Derivatives Policy, which states that a hedge is an instrument or strategy used to offset the risks of an asset, liability, income or expense by taking an opposing position (Exhibit A-6, Tab 62, page 1840).

[66] The appellant provided some commercial definitions of a hedge. It is defined as being, among other things, a strategy used to offset investment risk (*Dictionary of Finance and Investment Terms*, 5th ed., (Barron's Financial Guides), referred to in the Riverside Report, Exhibit A-11, page 8, par. 26 and footnote 1). In her report, Ms. Frost defined a hedge as an action or an intentional inaction that results in an outcome that limits or eliminates negative outcomes of risk (Exhibit A-11, page 8, par. 25). She stated that, in the parlance of hedging, there is the hedge and

there is the hedged item. The hedge is the instrument (the derivative contract) and the hedged item is the element of the organization that is negatively affected by the risk (e.g., cash flow, revenues or expenses, value of assets, liabilities or equity)(Exhibit A-11, page 8, par. 28).

[67] In *Placer Dome Canada Ltd. v. Ontario (Minister of Finance)*, [2006] 1 S.C.R. 715 at page 719, par. 1, the Supreme Court of Canada states that it was called upon to interpret the definition of “hedging” in the *Mining Tax Act* of Ontario. It was not a capital gain versus income case. Rather, the Court had to decide whether profits derived from mining operation “hedging” programs designed to manage the risk associated with fluctuations in the spot price of gold were taxable under that Act.

[68] Nonetheless, the Supreme Court made some comments that are interesting for the purposes of the present case. It characterized hedging, as it is commonly understood, as referring to transactions that offset financial risk, such as price risk or foreign exchange risk. At page 731, paragraph 29, the Court gave a brief overview of hedging as it is understood under GAAP. Generally speaking, financial derivatives are contracts whose value is based on the value of an underlying asset, reference rate, or index. There are essentially two reasons for entering into such a contract — to speculate or to hedge. A transaction is a hedge where the party to it genuinely has assets or liabilities exposed to market fluctuations, while speculation is “the degree to which a hedger engages in derivatives transactions with a notional value in excess of its actual risk exposure”: see Brent W. Kraus, “The Use and Regulation of Derivative Financial Products in Canada” (1999), 9 *W.R.L.S.I.* 31, at page 38.

[69] Further, at page 732, paragraph 31, the Supreme Court stated that, under GAAP, derivative contracts may be settled not only by physical delivery, but also by cash settlement or offsetting contracts. The Supreme Court reiterated, at page 741, paragraph 49, that although well-accepted business and accounting principles must play a subsidiary role to clear rules of law, “it would be unwise for the law to eschew the valuable guidance offered by well-established business principles” where statutory definitions are absent or incomplete: see *Canderel Ltd. v. Canada*, [1998] 1 S.C.R. 147, at paragraph 35.

[70] In my view, the appellant has demonstrated that the swaps were entered into as a hedge and not with the intent to speculate. The reasons given above by the appellant in its submissions (par. 33 and 42 of these Reasons) are sufficiently convincing. I find it clear from the evidence that it was the Bestfoods transaction

that triggered the decision to protect the reported value of all the USD Operations against currency fluctuations. Indeed, that was a major transaction. According to Ms. Frost, "[t]he Bestfoods acquisition represented a 26% increase in GWL's total assets and a doubling of its total indebtedness" (Riverside Report, page 19, par. 57). This transaction led to a significant increase in the USD investments exposed to currency risk. In fact, the value of those investments rose from US$666 million to US$2.031 billion, which translates, according to my own calculation, into an increase of over 200%. The USD notional value of the swaps closely approximated the total net investments in the USD Operations that were exposed to currency risk.

[71] The fact that the swaps were not all carried out contemporaneously with the Bestfoods acquisition is not fatal as they were entered into over a period that was fairly close to the transaction date (*Atlantic Sugar Refineries Ltd. v. Minister of National Revenue*, [1949] S.C.R. 706, at pages 711-712).

[72] Further, the fact that the swaps were entered into by the appellant in relation to the USD Operations conducted by its subsidiaries does not alter my conclusion that the swaps constituted a hedge for the appellant (*Echo Bay Mines*, *supra*, at pages 730-31 F.C., par. 61 CarswellNat). The appellant has drawn a parallel with the situation in *Neonex*, *supra*. The Federal Court of Appeal found in that case that a loan made solely for the purpose of replenishing the working capital of a subsidiary which had acquired control of another company was a capital transaction. The parent had borrowed money in USD and lent the money back to its subsidiary. When the parent repaid its USD loan, it made a foreign exchange gain which was determined to be on capital account by the Court. In reaching that conclusion, the Court attributed the character of the subsidiary's capital asset to the parent company's loan to its subsidiary.

[73] Here, I find that the evidence establishes that the appellant, in entering into the swaps, was acting in close consultation with and on behalf of its subsidiaries in order to protect the equity of the whole Weston group, as disclosed in the consolidated financial statements. As stated by Ms. Frost and Mr. Thornton, the underlying USD net investments were in a direct way highly sensitive to GWL's currency risk. Indeed, I agree with the appellant that the fluctuations in the USD investments affected GWL's own capital structure and had an impact on the value of GWL's direct investments in its subsidiaries.

[74] The respondent submitted that the foreign exchange translation risk existed only because of the GAAP requirements that the value of the net assets of the subsidiaries be translated into Canadian dollars for consolidated reporting

purposes. In her view, that translation risk had no impact on the cash flow or earnings of the appellant. This view does not seem to be shared by Ms. Frost, whose opinion was that, although there was no periodic cash effect, GWL still faced the risk that changes in foreign exchange rates could have a negative impact on the book value of its equity, and this risk could be particularly harmful to GWL's stakeholders. In her opinion, volatility in equity due to changes in foreign exchange rates is not favourably regarded by equity investors or credit-rating agencies (par. 34 of her report, Exhibit A-11). I infer from this that the translation risk referred to by the respondent did have an impact on the cash flow earnings of the appellant, which might have lost its borrowing capacity had it not put in place a hedge to mitigate that risk. As a matter of fact, Standard and Poor's raised a red flag with regard to GWL's credit rating after GWL's decision to use bank financing for the acquisition of Bestfoods.

[75] Further, the respondent's argument fails to recognize that a real risk existed in GWL's business after the Bestfoods acquisition, regardless of any GAAP requirements or "notional" reporting prior to the termination of the swaps. That risk was reflected in the CTA, in accordance with GAAP, but that does not change the fact that GWL was exposed to currency risk associated with an increasing debt to equity ratio as a result of its expanded indirect holdings in US assets. That risk led to tangible consequences as detailed by Ms. Frost and as evidenced by Standard & Poor's credit watch discussed above. This caused management to hedge the risk using swaps which were directly tied to the value of GWL's US assets.

Characterization of the hedging gain

[76] The respondent submitted that in the absence of any linkage to a capital transaction or a debt obligation denominated in a foreign currency that exposed the appellant to foreign currency risk, the foreign exchange gain is considered to be part of business income. She added that, for income tax purposes, it is not sufficient to hedge the net investment in foreign subsidiaries through a hedge of the CTA without having an intention to sell that investment, as there is no offsetting position against which any of the gains or losses arising from the contract could be matched.

[77] The respondent relied first on *Atlantic Sugar Refineries Ltd.*, *supra*, and on *Tip Top Tailors Ltd. v. Minister of National Revenue*, [1957] S.C.R. 703. In both cases, the Supreme Court of Canada held that profits received from derivatives linked to the purchase or sale of commodities or supplies (raw sugar in the first

case and cloth in the second) were connected with the business and had to be treated as business income. Here, GWL does not dispute that earnings from derivatives linked to commodities are to be treated as business income. In the present case, the swaps were not linked to the purchase or sale of commodities. They were entered into to stabilize the value of the USD assets exposed to currency risk on the balance sheet.

[78] The respondent then referred to *Salada Foods*, *supra*. In that case, Salada Foods derived a profit from the purchase and sale of foreign exchange through a forward sale contract with a bank. Salada Foods argued that the forward sale contract was entered into for the sole purpose of protecting its investment in its United Kingdom (**UK**) subsidiaries and that the gain was offset by the loss in that investment as a result of the devaluation of the pound. The gain therefore, according to Salada Foods, was on capital account and did not result from either a transaction entered into in the course of its trading operations or an adventure in the nature of trade. The Crown pointed out that there was no realized loss shown on the company's books and that it was a notional loss only. The Federal Court came to the conclusion that there was little or no relationship between the gain received by Salada Foods on its forward sale contract and its actual investment loss as a result of the devaluation of the pound. In reaching that conclusion, the Court observed that Salada Foods did not provide evidence linking the proceeds to the capital investment in the subsidiaries. The Court also concluded that Salada Foods was simply buying and reselling currency at a profit, and it was admitted by the company that the transaction was wholly speculative (page 6175).

[79] As pointed out by GWL, the Court in *Salada Foods*, *supra*, was influenced by the fact that Salada Foods was regularly speculating in currency. Further, the Court observed that there was no evidence as to the value of the assets and therefore there was no sufficient link between the derivatives and the capital investment. The Court did not really say that it was impossible to hedge a capital asset.

[80] In *Shell*, *supra*, also relied upon by the respondent, Shell entered into a foreign currency debt obligation in a weak currency. The borrowed funds were used for capital purposes. At the same time, Shell entered into a forward exchange contract in the same amount as the principal amount of the debt to hedge its exposure to foreign exchange fluctuations upon the repayment of the debt. Shell realized a foreign exchange gain on the repayment of the debt. It also realized a foreign exchange gain on the settlement of the forward exchange contract when it repaid the debt. Although the gain on the closing out of the forward exchange

contract occurred when Shell repaid the capital debt, the Supreme Court of Canada accepted the fact that there were two separate foreign exchange gains arising from two distinct transactions with two separate arm's length parties (page 652, par. 65). The Court characterized the gain on the repayment of the debt as being on capital account because the purpose of the underlying transaction, the debenture agreements, was to provide Shell with working capital for a five-year term. It was a capital debt obligation (page 654, par. 69). With respect to the characterization of the foreign exchange gain arising from the hedging contract as being on income or on capital account, the Court stated that it depended on the characterization of the debt obligation to which the hedge related (page 654, par. 70). The Court noted that Shell would not have entered into the debenture agreements in the absence of the forward exchange contract. Because the gain on the debenture agreements was on capital account, so also was the gain on the forward exchange contract.

[81] The appellant pointed out that the Supreme Court of Canada did not say that the derivative must necessarily be linked to a separate transaction, as submitted by the respondent in the present case. Rather, argued the appellant, the Supreme Court said that, in order to characterize the proceeds from a derivative transaction, one needs to identify the underlying item that created the risk (in the *Shell* case, the debt obligation) to which the derivative relates (which item does not necessarily need to be a transaction). I agree. The Supreme Court recognized the existence of two transactions but did not say that the gain or loss on a derivative transaction must necessarily be linked to a gain or loss on another transaction as argued by the respondent. What is important is to identify the risk to which the derivative transaction is related and to determine whether the related item at risk (be it a debt obligation or foreign investments) is capital or income in nature. I am therefore prepared to accept the appellant's proposition that, if it is found that the derivative was used to hedge a capital investment, any gain derived from the derivative will be on capital account.

[82] The respondent also referred to the recent decision of the Federal Court of Appeal in *Saskferco Products ULC v. The Queen*, *supra*, in which the Court rejected the application of hedge accounting principles so as to cancel out, for tax purposes, Saskferco's foreign currency losses and gains on its loan repayments and revenue from US sales respectively (par. 6). In that case, Saskferco claimed that a USD loan used to finance the construction of a plant was obtained as a natural hedge of USD sales revenues. Saskferco anticipated that the USD revenues would be used to repay the USD loan. The decline in the Canadian dollar against the USD resulted in foreign currency losses on Saskferco's principal repayments on the USD loan. At the same time, Saskferco had foreign currency gains on its USD

sales revenues. The Court held that the underlying transaction was the foreign currency denominated loan (and not the hedging of USD sales revenues) and determined that the foreign exchange losses were on capital account. The Court noted in that case that Saskferco's loan had an independent commercial purpose (financing the construction of the plant, a capital asset) that was unrelated to the contracts of sale (par. 24 and 29).

[83] The appellant pointed out that in the *Saskferco* case, there was no correlation between the hedge transaction (the USD loan) and the item said to be hedged, the USD sales revenue. In contrast, in the present case, submitted the appellant, the swaps were not an independent commercial transaction and there was no lack of correlation.

[84] The respondent also relied on *Ethicon Sutures Ltd. v. The Queen*, 85 DTC 5290, [1985] 2 C.T.C. 6 (FCTD), as a further application of the linkage principle. In that case, the taxpayer realized a foreign currency gain on funds placed in USD term deposits. Some of the funds went to capital expenditures and some were used for inventory purchases. The Court said that it is necessary to look at the nature of the underlying transaction which gives rise to the gain in order to determine whether it is on capital or on income account (page 5293 DTC, 10 C.T.C.). The Court found that the primary intention of the taxpayer was to use the disputed funds for a capital purpose but that a secondary intention existed to have funds available to make inventory payments (pages 5292-93 and 5294 DTC, 8-9 and 11 C.T.C.). To be treated as capital, the funds must be surplus and must be exclusively for capital expenditures: "it must be a firm final dedication, and not enough if 'earmarked primarily'" (page 5294 DTC, 11 C.T.C.).

[85] The appellant pointed out that *Ethicon* did not deal with a hedge and does not support the Minister's restrictive approach to the linkage principle. I agree that *Ethicon* does not suggest that the linkage principle is limited in the manner suggested by the respondent.

[86] The appellant argued that nothing in the present case suggests that the swaps were related to an underlying item that was on income account (such as production or inventory costs, or sales revenues). Nor is there any evidence showing that the intention was to make a profit in the financial markets when entering into the swaps. As a matter of fact, GWL was not permitted under either its credit facilities or its corporate policy to speculate (GWL was only allowed to enter into hedging agreements for the purpose of managing its risks in a manner consistent with the derivatives risk management policy approved by the board of directors; see, for

example: Exhibit A-4, Tab 22, page 1230, par. 6.6 of a credit agreement with the Canadian Imperial Bank of Commerce signed on July 25, 2001; GWL's annual reports for 2001, 2002 and 2003, Exhibit A-1, Tab 1, page 51, Tab 2, page 125 and Tab 3, pages 223-224; and Minutes of the Board of Directors, Exhibit A-9, Tab 2, pages 14-19).

[87] The appellant added that GWL's exclusive hedging intention was reaffirmed in 2002 when Bestfoods West was sold for more than anticipated, subsequent to which a corresponding number of swaps were terminated to ensure that the amounts of the swaps did not exceed the net USD investments.

[88] Further, added the appellant, GWL's termination of the swaps in 2003 was consistent with this intention because GWL only intended to hedge the USD Operations while the associated currency risk exceeded acceptable levels. After GWL concluded that the risk had declined in 2003 in that its debt to equity ratio had returned to the desired level, the remaining swaps were no longer needed to protect the capital structure and were terminated. The settlement of derivative contracts in advance of their maturity date does not preclude those transactions from constituting a hedge (*Echo Bay, supra*, at pages 730-31 F.C., par. 61 CarswellNat, and appellant's written submissions, par. 79, 84 and 98).

[89] I agree with the appellant. My perception on the whole is that, from a commercial perspective, GWL would not have entered into the swaps in issue in the absence of the Bestfoods transaction. Before that acquisition, GWL had entered into a few cross-currency swaps to hedge part of its assets in the United States. Apart from that, it was not GWL's policy to get involved in derivatives or to speculate on currency fluctuations. I accept that the intention in entering into the swaps was to hedge the investment in the USD Operations, which exposed GWL to currency risk in that it had an impact on its investments and its capital structure. GWL's indirect investment in USD Operations, just like its direct investment in its subsidiaries, was capital in nature. I therefore find that the swaps were entered into to hedge a capital investment.

[90] Further, I also accept that in 2003, when the appellant decided to terminate the swaps, there was no change of intention. The appellant determined that its exposure risk associated with the investment in USD Operations had decreased, in part because GWL had repaid some of its debt. Both Mr. Mavrinac and Ms. Swartzman said that the debt to equity ratio was expected to be back in line with GWL's internal guideline of 1:1 by the end of that year and that the balance sheet in the consolidated financial statements was now strong enough for GWL to

be able to absorb the risk exposure due to currency fluctuations associated with an unhedged CTA. That being so, the swaps were no longer required for the purposes that originally motivated GWL to initiate them (Transcript, vol. 1, testimony of Mr. Mavrinac, pages 80-81, and Ms. Swartzman, pages 228-232). The decision to terminate the swaps early was related to a re-evaluation of the very risks which had caused GWL to enter into the swaps in the first place. There is no evidence to suggest that the termination was related to speculation or to a change in intention such that the intent was now to profit from the derivatives market.

[91] I conclude from the evidence given by the appellant's representatives, from the experts' testimony and reports, and from the case law, that financial derivatives, generally, are "contracts whose value is based on the value of an underlying asset, reference rate, or index" (*Placer Dome*, *supra*, par. 29). Such derivatives are used for the purpose of mitigating a financial risk (hedging), as was the case, for example, in *Placer Dome* and in *Shell, supra*, or for speculation, as was the case in *Salada Foods*, *supra*.

[92] It is true that accounting practices, by themselves, do not establish rules of income tax law (*Shell*, par. 73) It has also been determined that an accounting hedge may not be appropriate for tax purposes in the absence of correlation between the hedge transaction and the element of risk to be hedged (*Saskferco*, *supra*). However, I find, as was suggested in *Placer Dome*, that the definition of hedging as understood under well-established business principles, including GAAP, is relevant, particularly in a situation, as in the present case, where the ITA is silent and does not define what a hedge is for tax purposes (except, as mentioned earlier, in section 20(3.1) of the ITA in the context of weak currency loans; but that definition is not applicable here).

[93] Professor Thornton in his expert report, Exhibit A-12, at paragraphs 77-88, concluded that the appellant satisfied the GAAP requirements for hedge treatment: 1) it credibly designated the swaps in advance, as a hedge in the consolidated financial statements, and 2) the swaps' gains and losses were highly correlated with the CTA gains and losses and the correlation remained effective throughout the entire time the hedge was in place.

[94] Professor Chlala, the respondent's expert, agreed that the appellant correctly recorded the swaps as hedges in its consolidated financial statements (Professor Chlala's expert report, Exhibit R-1, page 4). However, Professor Chlala was of the opinion that it was the appellant's choice to designate the swaps as an accounting hedge instrument. In his words, it could have reported the "gains or

losses on such derivatives in income in a similar manner as if the entity had been speculating" (pages 30-31 of his report). In fact, the gain on unwinding the swaps (at issue here) was reported in operating costs on the income statement of GWL's legal entity financial statements (the non-consolidated financial statements) for the year 2003 (Exhibit R-1, Tab 1, and Transcript, vol. 3, pages 115-117). At the same time, Professor Chlala stated that one set of financial statements (consolidated or non-consolidated) was not more reliable than the other in reporting the profits from closing out the swaps. He also noted that the legal entity statements were inappropriate for investors (Transcript, vol. 3, pages 120-121). In his view, the "gains or losses on [the swaps should not] be interpreted exclusively in light of their presentation in consolidated financial statements in which hedge accounting rules were applied as permitted under [GAAP]" (page 4 of his report). He had to admit in cross-examination, however, that he was not an expert in interpreting the tax treatment under the ITA of gains or losses from unwinding swaps (Transcript, vol. 3, pages 140-143).

[95] I also note that though there was a choice to implement hedge accounting, once the choice was made, the stringent GAAP rules for hedge accounting had to be complied with. GWL made the decision before entering into the swaps to implement hedge accounting and was therefore required to adhere to the strict rules relating thereto[1] (Thornton Report, par. 24-26 and 78-80). The respondent's expert recognized this as well, stating that "[t]he qualifying criteria for hedge accounting are rigorous and require a commitment of time and resources" (Professor Chlala's expert report, Exhibit R-1, par. 56 and page 4).

[96] I come to the conclusion that the appellant entered into the swaps and rightly reported them as a hedge in its consolidated financial statements for accounting and tax purposes. As noted by Professor Thornton in his report, the consolidated financial statements are GWL's financial statements (Exhibit A-12, par. 49 and footnote 15). I am satisfied that the appellant was not speculating, and that it was not its policy to speculate through derivative instruments. It has been demonstrated that the amount of the swaps matched as closely as possible the amount of the net investment in self-sustaining US operations (Thornton Report, Exhibit A-12, par. 19).

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1 Professor Thornton said that "[t]he requirement to declare the intention to use hedge accounting in advance precludes . . . cherry picking [of losses], which is sometimes called "earnings management" (Thornton Report, par. 79).

[97] I also do not accept the respondent's approach which denies capital treatment to proceeds earned from a hedging contract if there is no sale or proposed sale of the underlying item being hedged (see the CRA's published view on the matter reproduced in par. 110 of the appellant's submissions). I agree with the appellant that this view has no legal basis and is a wrong interpretation of the case law. In *Salada Foods*, there was no evidence linking the proceeds from the derivative to the capital investment in the subsidiaries, and the derivative was clearly speculative. In *Shell*, it was determined that hedge proceeds will be on capital account if the item being hedged is a capital item. The Court did not lay down a rule that would support the respondent's restrictive approach. In *Atlantic Sugar* and *Tip Top Tailors*, the derivatives were used to hedge what were clearly income transactions. With regard to *Placer Dome* and *Echo Bay*, neither of these cases involved a capital versus income characterization. In *Ethicon*, a secondary intention was established and a portion of the funds was clearly used for income transactions.

[98] In sum, the present case involves a situation that has not previously been brought before the courts, at least that I am aware of. The appellant made a commercial and business decision, after careful consideration, to enter into the swaps in order to protect its consolidated group equity. It knew better than anyone else the consequences of having its net investment assets exposed to the risk of currency fluctuations. The swaps are commercial derivatives designed expressly to circumvent that kind of risk. As stated by Ms. Frost, the swaps were not speculative transactions. They were designed for hedging in the financial market. Now when the risk vanished, there was no need to keep the swaps. Here, GWL was satisfied that the swaps were no longer necessary when the risk exposure of the net investment assets was reduced significantly. They therefore decided to unwind the swaps. I have concluded that the swaps were entered into to protect a capital investment, and therefore they were linked to a capital asset. Absent unacceptable risk with regard to those capital assets, the swaps had to be terminated since the reason for their existence no longer applied, and the gain or loss from unwinding the swaps should, in my view, be treated as being on capital account. The swaps were not linked in any manner to any business income per se.

Adventure in the nature of trade

[99] This alternative argument raised by the respondent does not stand up.

[100] I have concluded that the appellant did not enter into the swaps for speculative purposes. I have also concluded that the appellant's initial intention was not displaced by a subsequent speculative intention when the decision was taken to unwind the swaps. The risk that existed when the swaps were put in place had declined and there was no need to keep them anymore. To make an analogy, an investor who buys shares for his portfolio may decide to sell them if he is able to get a good price. This does not mean that he is speculating. The same applies here. The fact that the appellant took the opportunity to terminate the swaps when they were "in the money" does not automatically transform the hedge transaction into speculation giving rise to an adventure in the nature of trade, as long as there is a valid explanation for ending the hedge.

[101] The appellant cited my decision in *Belcourt Properties Inc. v. The Queen*, 2014 TCC 208, 2014 DTC 1182, which contains, at paragraph 30, the following list of factors, set out in *Happy Valley Farms Ltd. v. The Queen*, [1986] 2 C.T.C. 259, to be applied in determining whether a transaction constitutes an adventure in the nature of trade,

> Several tests, many of them similar to those pronounced by the Court in the *Taylor* case, have been used by the courts in determining whether a gain is of an income or capital nature. These include:
>
> 1. *The nature of the property sold*. Although virtually any form of property may be acquired to be dealt in, those forms of property, such as manufactured articles, which are generally the subject of trading only are rarely the subject of investment. Property which does not yield to its owner an income or personal enjoyment simply by virtue of its ownership is more likely to have been acquired for the purpose of sale than property that does.
>
> 2. *The length of period of ownership*. Generally, property meant to be dealt in is realized within a short time after acquisition. Nevertheless, there are many exceptions to this general rule.
>
> 3. *The frequency or number of other similar transactions by the taxpayer*. If the same sort of property has been sold in succession over a period of years or there are several sales at about the same date, a presumption arises that there has been dealing in respect of the property.
>
> 4. *Work expended on or in connection with the property realized*. If effort is put into bringing the property into a more marketable condition during the ownership of the taxpayer or if special efforts are made to find or attract purchasers (such as the opening of an office or advertising) there is some evidence of dealing in the property.

> 5. *The circumstances that were responsible for the sale of the property*. There may exist some explanation, such as a sudden emergency or an opportunity calling for ready money, that will preclude a finding that the plan of dealing in the property was what caused the original purchase.
>
> 6. *Motive*. The motive of the taxpayer is never irrelevant in any of these cases. The intention at the time of acquiring an asset as inferred from surrounding circumstances and direct evidence is one of the most important elements in determining whether a gain is of a capital or income nature.

[102] My decision in *Belcourt*, *supra*, cited *Canada Safeway Ltd. v. The Queen*, 2008 FCA 24, 2008 DTC 6074, a case in which the Federal Court of Appeal noted (at par. 43) that the most determinative factor is the intention of the taxpayer at the time of acquiring the property. If that intention reveals a profit-making scheme, the transaction is an adventure in the nature of trade.

[103] The Federal Court in *Salada*, *supra*, also provided guidance on the issue. Referring to the Exchequer Court decision in *M.N.R. v James A. Taylor*, 1956 CarswellNat 222, [1956] C.T.C. 189, a number of negative and positive factors were outlined. The most relevant to this appeal is one of the positive factors: "if a person deals with the commodity purchased by him in the same way as a dealer in it would ordinarily do such a dealing is a trading adventure" (*Salada*, *supra*, at 6174).

[104] In *Ethicon Sutures*, *supra*, the Federal Court said that "where the transaction is a speculation made in the hope of profit, it will be treated as an adventure in the nature of trade . . ." (page 5293 DTC, 10 C.T.C.).

[105] As described earlier in these reasons, GWL's intention at the time of entering into the swaps was to hedge the currency risk associated with an increasing debt to equity ratio as a result of translating its US assets. Once the debt to equity ratio returned to acceptable levels, management determined that the swaps were no longer necessary. Although there was a need for cash in the business at the time the swaps were closed out, the evidence demonstrates that the unhedged currency risk was acceptable to management given the improved debt to equity ratio in 2003. In other words, in 2003 management felt that volatility in an unhedged CTA would not put GWL offside of its internal debt to equity guideline. GWL did not transform into a speculator in the derivatives market, thereby violating its internal policies and credit agreements, simply because the swaps were "in the money" when terminated.

[106] Further, GWL did not act as a dealer or trader in derivatives. Ms. Frost concluded that GWL's derivative transactions were inconsistent with speculating in the currency market. She stated that if GWL had truly wanted to speculate on the foreign exchange markets, "it would have likely used the more liquid spot foreign exchange or options markets, which would be a much more efficient speculative tool." This is because swaps, especially long-term ones, are very expensive and have high transaction costs (Riverside Report, par. 73(d) and Transcript, vol. 2, pages 185-187). Further, management did not express a view as to the future direction of the USD/CAD exchange rate. The analysis focused on the risk of change and its impact on the balance sheet (Riverside Report, par. 73(e) and Exhibit A-9, Tabs 3 and 6). Therefore the swaps by their very nature were an inefficient means of profiting in the foreign currency derivatives market, and GWL was not acting as a swap trader.

[107] As to length of ownership, GWL entered into the swaps for terms of mostly 10 to 15 years, thereby incurring the transaction costs associated with entering into long-term swaps. Although the swaps were terminated early, the circumstances leading to the termination were linked to an evaluation of business risk and not speculation on the exchange rate.

[108] To paraphrase *Shell*, *supra*, at paragraph 75, GWL was not acting like a trader or dealer when entering into or terminating the swaps. The swaps were used to hedge a risk in its business. In no sense was GWL speculating in derivatives or engaged in an adventure in the nature of trade.

Alternative issue: if the swaps do not constitute a hedge

[109] Because of my conclusion that the swaps were entered into as a hedge in order to protect a capital investment and that therefore the gain derived from terminating the swaps was on capital account, there is no need to address the third issue raised by the parties, that is, whether the proceeds are to be treated as being on capital or on income account regardless of whether the swaps constitute a hedge.

<u>Decision</u>

[110] For the reasons set out above, the appeal is allowed with costs to the appellant.

Signed at Ottawa, Canada, this 19th day of February 2015.

"Lucie Lamarre"

Lamarre A.C.J.

CITATION:	2015 TCC 42
COURT FILE NO.:	2011-3489(IT)G
STYLE OF CAUSE:	GEORGE WESTON LIMITED v. HER MAJESTY THE QUEEN
PLACE OF HEARING:	Toronto, Ontario
DATE OF HEARING:	August 18, 19, 20 and 21, 2014
REASONS FOR JUDGMENT BY:	The Honourable Associate Chief Justice Lucie Lamarre
DATE OF JUDGMENT:	February 19, 2015

APPEARANCES:

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Counsel for the Respondent:	Elizabeth Chasson Alexandra Humphrey

COUNSEL OF RECORD:

For the Appellant:

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Firm:	Borden Ladner Gervais LLP
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2011-3489(IT)G

TAX COURT OF CANADA

BETWEEN:

GEORGE WESTON LIMITED

Appellant

and

HER MAJESTY THE QUEEN

Respondent

PARTIAL STATEMENT OF AGREED FACTS

For the purposes of these proceedings only, the parties hereby agree as follows:

Identification of Appellant and Certain Subsidiaries

1. The Appellant ("**GWL**") is a corporation incorporated under the laws of Canada. GWL's head office is located in Toronto.

2. At all relevant times, GWL's common shares and preferred shares were listed and traded on the Toronto Stock Exchange.

3. At all relevant times, GWL was the parent holding company of subsidiary corporations in Canada, the United States ("**U.S.**"), Gibraltar, Hungary, Luxembourg, and the Netherlands.

4. At all relevant times, the Appellant's subsidiary corporations included two direct wholly-owned Canadian subsidiaries: Weston Foods Inc. ("**WFI Canada**") and Megargy Holdings Inc. ("**Megargy Holdings**").

5. As of July 30, 2001:

(a) Weston Foods, Inc. (“**WFI US**”), a United States corporation, had direct wholly-owned subsidiaries that operated bakery, dairy, and seafood businesses in the United States;

(b) the shares of WFI US were owned by a Luxembourg corporation, Dunedin Holdings Sàrl (“**Dunedin Holdings**”);

(c) the shares of Dunedin Holdings were owned by a Gibraltar corporation, Dicoa Holdings Limited (“**Dicoa**”); and

(d) the shares of Dicoa were owned by a Dutch company, Dicoa BV, WFI Canada, and GWL.

6. As of December 31, 2000, the value of the net assets of the U.S. businesses in the GWL corporate group, comprised in the great majority by the net assets of WFI US and its subsidiaries, was approximately USD816 million.

7. As a publicly traded company, GWL raised funds in the public markets. GWL also borrowed funds from financial institutions and issued debt in the public markets.

The Bestfoods Acquisition

The Bestfoods Agreement

8. On February 18, 2001 GWL entered into a Stock and Asset Purchase Agreement (the “**Bestfoods Agreement**”) with Bestfoods (a U.S. corporation) (“**Bestfoods**”), Bestfoods Baking Co., Inc. (a U.S. corporation) (“**Bestfoods Baking**”) and Thomas Trademark Holding BV (a corporation governed by the laws of The Netherlands) (“**Thomas Trademark**”).

9. Prior to February 18, 2001, Bestfoods Baking wholly owned a number of subsidiaries that carried on a bakery business in the United States.

10. Pursuant to the Bestfoods Agreement, GWL agreed to purchase, or to direct one or more of its subsidiaries to purchase:

(a) from Bestfoods, all the shares of Bestfoods Baking; and

(b) from Thomas Trademark, certain trademarks, licenses and know-how used in the bakery business carried on by Bestfoods Baking's subsidiaries (the “**Thomas Trademarks**”).

11. On June 1, 2001, GWL transferred its right to acquire the shares of Bestfoods Baking to a U.S. corporation, Weston Acquisition Inc. ("**WAI**"), whose shares were owned by Dicoa on that date.

12. On June 1, 2001, GWL transferred its right to acquire the Thomas Trademarks to a Hungarian corporation, Megargy Licensing Company Kft ("**Megargy Licensing**"), whose shares were owned by Megargy Holdings on that date.

13. On July 30, 2001, the transaction set out in the Bestfoods Agreement (the "**Bestfoods Acquisition**") was completed as follows:

   (a) WAI purchased all of the shares of Bestfoods Baking for a purchase price of approximately USD1.42 billion; and

   (b) Megargy Licensing purchased the Thomas Trademarks for a purchase price of approximately USD345 million.

14. Immediately following the Bestfoods Acquisition, Bestfoods Baking was renamed to George Weston Bakeries Inc.

Financing of the Bestfoods Acquisition

15. In order to finance the Bestfoods Acquisition, GWL borrowed approximately CAD2.1 billion and USD400 million from a syndicate of banks pursuant to a credit agreement dated as of July 25, 2001 (the "**Credit Facility**").

16. GWL used the approximately CAD2.1 billion to purchase USD.

17. Between the time the Bestfoods Agreement was signed and the time the Bestfoods Acquisition closed, GWL entered into various derivatives, such as forward contracts and options, to fix the price it would have to pay to convert its CAD2.1 billion borrowing to USD in July 2001.

The Purchase of the Thomas Trademarks

18. On July 30, 2001:

   (a) GWL subscribed for 500,000 common shares of Megargy Holdings for a subscription price denominated as the CAD equivalent of USD345,151,000, being CAD539,609,073;

   (b) GWL transferred to Megargy Holdings the USD equivalent of CDN539,609,073, being USD345,151,000, in satisfaction of the CAD subscription price;

   (c) Megargy Holdings used the USD345,151,000 it received from Megargy Holdings to make equity investments in Megargy Licensing; and

(d) Megargy Licensing transferred USD345,000,000 to Unilever Capital Corporation to purchase the Thomas Trademarks.

The Acquisition of the Shares of Bestfoods Baking

19. On July 30, 2001:

GWL Investment in Weston LLC

(a) GWL used the USD400,000,000 that it borrowed pursuant to the Credit Facility to contribute to the capital of Weston LLC in exchange for 8,001 units of Weston LLC;

Weston LLC Loan to WAI

(b) Weston LLC purchased from WAI Senior Discount Notes, Series A, having an aggregate principal amount of CAD640,226,000;

(c) Weston LLC agreed to purchase the WAI Senior Discount Notes, Series A at an original issue discount price of 95.591%, being approximately CAD612,000,000;

(d) Weston LLC purchased the WAI Senior Discount Notes, Series A by transferring to WAI the USD equivalent of CAD612,000,000, being USD400,000,000;

(e) the loan was repayable to Weston LLC in CAD;

(f) GWL and WAI entered into a cross-currency basis swap whereby GWL agreed to pay CAD612,000,000 and WAI agreed to pay USD400,000,000 on termination;

(g) in November 2001, WAI repaid to Weston LLC a portion of the loan;

(h) Weston LLC repatriated the funds it received from WAI in November 2001 to GWL by way of a return of capital;

(i) the remainder of the loan was repaid to Weston LLC in January 2002;

(j) Weston LLC then repatriated those funds to GWL; and

(k) GWL used the funds it received from Weston LLC to repay the USD400,000,000 Credit Facility;

GWL Loan to WAI

(l) GWL loaned USD305,000,000 to WAI and, accordingly, transferred USD305,000,000 to WAI;

(m) WAI issued a promissory note to GWL for USD305,000,000 as consideration for the loan;

(n) the loan from GWL to WAI was exposed to foreign exchange fluctuations;

(o) the loan was repayable to GWL in USD; and

(p) the loan was repaid to GWL prior to January 1, 2003;

GWL Loan to WFI Canada

(q) GWL loaned to WFI Canada an amount denominated as the CAD equivalent of USD692,351,000, being CAD1,082,421,552;

(r) in satisfaction of this loan arrangement, GWL transferred USD692,351,000 to WFI Canada;

(s) WFI Canada issued a promissory note to GWL denominated as the Canadian equivalent of USD692,351,000; and

(t) the loan was repayable to GWL in CAD;

WFI Canada Investment in Dicoa

(u) WFI Canada subscribed for common shares of Dicoa for a subscription price of USD692,351,000; and

(v) WFI Canada paid the subscription price for the Dicoa shares by transferring to Dicoa the USD692,351,000 it had received from GWL pursuant to the loan from GWL;

Dicoa Investment in WAI

(w) Dicoa used USD200,000,000 of the subscription proceeds it had received from WFI Canada to subscribe for shares of WAI;

Dicoa Investment in Dunedin Servicing Company Rt

(x) Dicoa used the remaining subscription proceeds it received from WFI Canada, along with cash it had on hand, to subscribe for additional shares in Dunedin Servicing Company Rt ("**Dunedin Servicing**"), one of its wholly-owned subsidiaries based in Hungary, for a total subscription amount of USD565,000,000;

Dunedin Servicing Loan to WAI

(y) Dunedin Servicing loaned the USD565,000,000 in subscription proceeds it received from Dicoa to WAI;

WAI Purchases the Shares of Bestfoods Baking

(z) WAI used USD1.42 billion of the funds it received from GWL, Dicoa and Dunedin Servicing to purchase the shares of Bestfoods Baking and, accordingly, transferred USD1.42 billion to Unilever Capital Corporation.

Bestfoods West

20. At the time GWL entered into the Bestfoods Agreement, GWL intended that after the acquisition it would cause Bestfoods Baking (renamed George Weston Bakeries Inc.) to sell its business operating in the western U.S. ("**Bestfoods West**") and anticipated that the sale proceeds would be approximately USD400 million.

21. On March 4, 2002, Bestfoods Baking (which had been renamed George Weston Bakeries Inc.) and certain of its subsidiaries sold Bestfoods West for a sale price of approximately USD610 million.

The Cross-Currency Basis Swaps ("CCBS")

22. On or about June 19, 2000, GWL entered into three CCBS whereby it agreed with its counterparties to exchange on maturity or early termination a total of USD150,000,000 for CAD220,875,000.

23. Prior to June 19, 2000, GWL had not entered into CCBS with the intention of using them to manage any foreign exchange risk associated with the translation of the value of the USD denominated net assets of its self-sustaining foreign operations into CAD for consolidated financial statement purposes.

24. On or about July 30, 2001, GWL entered into two additional CCBS whereby it agreed with its counterparties to exchange on maturity or early termination a total of USD164,816,000 for CAD253,816,640.

25. On or about October 10, 2001, GWL entered into six additional CCBS whereby it agreed with its counterparties to exchange on maturity or early termination a total of USD860,000,000 for CAD1,348,136,000.

26. On or about October 24, 2001, GWL entered into nine additional CCBS whereby it agreed with its counterparties to exchange on maturity or early termination a total of USD900,000,000 for CAD1,393,607,871.

27. Between 2000 and 2001, GWL entered into the following CCBS:

	Start Date	GWL to exchange at maturity / termination (USD)	Counterparty to exchange at maturity / termination (CAD)
1	19-Jun-00	50,000,000	73,625,000
2	19-Jun-00	50,000,000	73,625,000
3	19-Jun-00	50,000,000	73,625,000
4	30-Jul-01	102,000,000	157,080,000
5	30-Jul-01	62,816,000	96,736,640
6	10-Oct-01	225,000,000	352,710,000
7	10-Oct-01	225,000,000	352,710,000
8	10-Oct-01	180,000,000	282,168,000
9	10-Oct-01	100,000,000	156,760,000
10	10-Oct-01	99,000,000	155,192,400
11	10-Oct-01	31,000,000	48,595,600
12	24-Oct-01	180,000,000	282,168,000
13	24-Oct-01	175,000,000	269,473,925
14	24-Oct-01	146,000,000	224,818,246
15	24-Oct-01	125,000,000	192,481,375
16	24-Oct-01	100,000,000	153,985,100
17	24-Oct-01	75,000,000	115,488,825
18	24-Oct-01	35,200,000	55,179,520
19	24-Oct-01	34,800,000	54,552,480
20	24-Oct-01	29,000,000	45,460,400
		2,074,816,000	**3,216,435,511**

28. Each CCBS contained the following features:

(a) on the start date of the CCBS, GWL was treated as having exchanged with the counterparty a stipulated CAD amount for a stipulated USD amount;

(b) the stipulated amounts were calculated using the CAD/US exchange rate on the start date;

(c) in most cases, the stipulated amounts were not actually exchanged on the start date;

(d) from the start date until the maturity or termination date of the CCBS, GWL was to periodically exchange with the counterparty an amount calculated by applying a USD floating interest rate to the stipulated USD amount for an amount calculated by applying a CAD floating interest rate to the stipulated CAD amount (the "periodic amounts");

(e) these periodic amounts were not exchanged by way of two simultaneous payments;

(f) rather, one net payment was made by the party whose periodic amount was of greater value on the payment date (the "periodic payment");

(g) the periodic payment was equal to the amount by which the value of larger periodic amount exceeded the value of the smaller periodic amount;

(h) on the maturity or early termination date of the CCBS ("termination"), GWL was to exchange the USD stipulated amount for the CAD stipulated amount;

(i) the stipulated amounts to be exchanged on termination were not exchanged by way of two simultaneous payments;

(j) rather, one net settlement payment was made by the party whose stipulated amount was of greater value given the CAD/USD exchange rate on the termination date relative to the CAD/USD exchange rate on the start date;

(k) the net settlement payment was equal to the amount by which the value of the stipulated amount with the higher value on the termination date exceeded the value of the stipulated amount with the lower value on the termination date;

(l) if the value of the CAD relative to the USD was higher on the maturity or early termination date than it had been on the start date of the CCBS, the CAD amount that GWL's counterparty would have to provide on maturity or early termination would exceed the CAD equivalent of the USD amount GWL would have to provide and, accordingly, GWL's counterparty would make the net payment to GWL;

(m) if the value of the CAD relative to the USD was lower on the maturity or early termination date than it had been on the start date of the CCBS, the USD amount GWL would have to provide on maturity or early termination would exceed the USD equivalent of the CAD amount GWL's counterparty would have to provide and, accordingly, GWL would have to make the net settlement payment to its counterparty;

(n) the CCBS could only be terminated on their respective maturity dates or on early termination by mutual agreement of GWL and the relevant counterparty; and

(o) the CCBS could not be traded on any derivatives exchange.

The Interest-Rate Swaps

29. Because the periodic amounts that GWL had to exchange with its counterparty under the CCBS were calculated with reference to U.S. and Canadian floating interest rates, GWL became exposed to fluctuations in the spread between U.S. and Canadian floating interest rates.

30. In late 2002, GWL entered into interest rate swaps to manage the interest rate exposure created by those CCBS that were still in place at that time.

31. GWL did not enter into the above-noted interest rate swaps to manage interest costs associated with the funds it had borrowed to finance the Bestfoods Acquisition.

32. The interest rate swaps did not provide for GWL and its counterparties to exchange any principal amounts at the start dates or maturity dates of these swaps. Rather, the interest rate swaps provided for GWL and its counterparties to exchange amounts calculated with reference to fixed and floating interest rates on notional CAD and USD amounts.

The Termination of the Cross-Currency Swaps and Interest Rate Swaps

33. In 2002, GWL terminated three CCBS in respect of an aggregate notional amount of USD200,016,000 / CAD308,996,160.

34. Specifically, GWL terminated the following CCBS in 2002:

    (a) two of the CCBS entered into on July 30, 2001: one in respect of a principal amount of USD102,000,000 / CAD 157,080,000, and one CCBS in respect of a notional amount of USD62,816,000 / CAD 96,736,640 (numbers 4 and 5 in the above chart, respectively); and

    (b) one of the CCBS entered into on October 24, 2001 in respect of a principal amount of USD35,200,000 and CAD55,179,520 (number 18 in the above chart).

35. Following the termination of the three CCBS in 2002, GWL's remaining outstanding CCBS were in respect of an aggregate notional amount of USD1,874,800,000 / CAD2,907,439,351.

36. In September and October 2003, GWL terminated the remaining CCBS that it had entered into in 2000 and 2001.

37. On termination of the CCBS, the total of the CAD amounts that GWL's counterparties had to provide exceeded the CAD equivalent of the USD amounts that GWL had to provide by CAD316,932,896 and, accordingly, GWL received this total amount from the counterparties.

38. GWL terminated the interest rate swaps it had entered into in late 2002 at approximately the same time that it terminated the remaining CCBS in 2003.

39. At no time prior to December 31, 2003 did WAI sell the shares of Bestfoods Baking (which had been renamed George Weston Bakeries Inc.).

40. At no time prior to December 31, 2003 did Bestfoods Baking (renamed George Weston Bakeries Inc.) sell the shares it owned in any of the subsidiary corporations that carried out the baking business in the United States, though, as noted above, the Bestfoods West business was sold in March 2002.

41. At no time prior to December 31, 2003 did Megargy Licensing sell the Thomas Trademarks.

Financial Reporting

42. At all relevant times, GWL's financial reporting currency was the CAD.

43. At all relevant times, GWL prepared quarterly and audited annual consolidated financial statements, which included the accounts of GWL and its subsidiaries (the "**Consolidated Financial Statements**"). The Consolidated Financial Statements were expressed in CAD.

44. At all material times, GWL and its accountants determined that WFI US and WFI US's subsidiaries and WAI and WAI's subsidiaries were "self-sustaining foreign operations" for accounting purposes.

Tax Reporting and Assessment

45. In its income tax return in respect of its 2003 taxation year, GWL treated the CAD316,932,896 as on account of capital. Accordingly GWL reported a taxable capital gain of CAD158,466,448.

46. By Corporation Notice of Reassessment dated November 30, 2010, the Respondent reassessed GWL on the basis that the CAD316,932,896 was on income account. Accordingly, the Respondent reversed GWL's reported taxable capital gain and added to GWL's income the full CAD316,932,896.

47. By Objection dated February 24, 2011, GWL duly objected to the reassessment.

48. By Notification of Confirmation by the Minister dated August 12, 2011, the Respondent confirmed the reassessment.