

Docket: 2006-334(IT)G

BETWEEN:

DAVID HOWARD,
and
HER MAJESTY THE QUEEN,

Appellant,
Respondent.

Appeal heard on December 7, 2007 at Calgary, Alberta

Before: The Honourable Justice G. A. Sheridan

Appearances:

Counsel for the Appellant: Brett Anderson

Counsel for the Respondent: Margaret Irving

JUDGMENT

In accordance with the attached Reasons for Judgment, the appeal from the reassessment made under the *Income Tax Act* is allowed, with costs, and the reassessment is referred back to the Minister of National Revenue for reconsideration and reassessment on the basis that the Appellant, David Howard, was a trader or dealer in the business of selling Cell-Loc Inc. shares in the 2000 taxation year.

Signed at Ottawa, Canada, this 22nd day of February, 2008.

"G. A. Sheridan"

Sheridan, J.

Citation: 2008TCC51
Date: 20080222
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DAVID HOWARD,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Sheridan, J.

[1] The Appellant, David Howard, is appealing the assessment of the Minister of National Revenue of his 2000 taxation year. The issue is whether certain losses incurred by the Appellant from a share disposition were capital or business losses.

[2] In assessing and confirming Mr. Howard's assessment, the Minister assumed the facts set out in paragraph 24 of the Reply to the Notice of Appeal. The assumptions shown in bold type are challenged by the Appellant as inaccurate or incomplete:

- a) The Appellant is a chartered accountant.
- b) The Appellant was employed with [Cell-Loc Inc. ("Cell-Loc")] from May 1, 1999 – December 13, 2000.
- c) The Appellant was Vice-President and Chief Financial Officer of Cell-Loc.
- d) Cell-Loc had a stock option plan for directors, officers and employees.
- e) The Appellant received stock options by virtue of his employment.
- f) In 1999 and 2000, the Appellant purchased 38,100 Cell-Loc shares on the open market and by exercising stock options, as set out in Schedule "A" to this Reply.

- g) The Appellant exercised stock options, as set out in the Schedule "A" to this Reply, to realize the compensation benefit offered by Cell-Loc.**
- h) The Appellant did not acquire the Cell-Loc shares with the intention of selling them as soon as possible for a profit.**
- i) As of June 30, 2000, the total number of Cell-Loc shares outstanding was 20,892,305.
- j) Between March of 2000 and December of 2000, monthly volume of trades of Cell-Loc shares averaged 2,732,369 shares per month.
- k) The Appellant was unable to sell the shares because of a trading blackout as an insider.**
- l) Further, the Appellant was encouraged to hold his share position in order to communicate confidence to the marketplace.**
- m) At the first opportunity, which was immediately after his employment with Cell-Loc ended, the Appellant sold 38,100 Cell-Loc shares, as set out in Schedule "A" to this Reply.**
- n) The Appellant prepared and filed his 2000 tax return.
- o) The Appellant reported a capital loss of \$801,788 in 2000, as a result of the disposition of the shares, as set out in Schedule "B".
- p) The Appellant purchased and sold other security investments, and reported the gains and losses on account of capital.

Background

[3] Mr. Howard was the only witness to testify. I found him candid and convincing in the presentation of his evidence. Mr. Howard received his Bachelor of Commerce in 1992 and in 1995, his Chartered Accountant designation. In 1996 he left KPMG, where he had articulated, to take a position as Vice-President (Finance) with Position Inc., a small private technology company and one of his former clients. His primary role was to prepare an initial public offering of that company's stock.

[4] After two years, its goals achieved, Position Inc. was sold. Mr. Howard found new work as a consultant with yet another former client, Cell-Loc Inc. Like Position Inc., Cell-Loc was a burgeoning technology company. When Mr. Howard started his consultancy work in November 1998, Cell-Loc had a small staff of about 20, mainly

software developers and one or two administrative people. It had no commercially viable product, no customers and no revenues. What it did have was a newly developed initial prototype of its technology for locating wireless devices. Mr. Howard's role was to update Cell-Loc's business plan to reflect the (then) current state of its technological development.

[5] At that time, Cell-Loc's shares were trading at around \$1.60 per share on the Venture Stock Exchange¹. During his time as a consultant, Mr. Howard was sufficiently impressed with Cell-Loc's potential for growth that he purchased 2,100 Cell-Loc shares.

[6] In May 1999, Mr. Howard became a Cell-Loc employee. He was paid an annual salary of \$105,000 and granted 104,000 Cell-Loc share options. As the company's Controller and Vice-President (Finance), he was responsible for overseeing all aspects of Cell-Loc's accounting and financial reporting as well as ensuring compliance with stock exchange and securities commission requirements. Equally important to his role were his duties in promoting the sale of Cell-Loc shares in the investment community.

[7] In June 1999, he began his promotional work, initially with "friendly" investors (those who had been involved in Cell-Loc's first public offering) and in particular, Kelly Reid of the firm Goepel McDermid. Things went so well that by September 1999, Cell-Loc was ready to take the next step in Mr. Howard's business plan: raising \$10 million in financing on Bay Street. At that time, Cell-Loc's stock was trading aggressively up and within days of their arrival in Toronto, the company had outstripped its original objectives, securing some \$50 million in financing at a fixed price² of \$17 per share. Over the fall, Mr. Howard busied himself fulfilling the conditions attached to the Bay Street deal, while at the same time continuing to promote Cell-Loc stock to the now quite interested investment community. By early 2000, market interest stimulated by the Bay Street deal had driven the share price up into the \$20-\$40 range. Analysts came calling from Wall Street, ultimately predicting that if listed on the New York Stock Exchange, Cell-Loc shares could be trading at \$150 per share in the next 12 months. In this environment, Mr. Howard decided the time was right for Cell-Loc to embark on the next aspect of its business plan, the

¹ The Venture Stock Exchange is the lesser of the two Canadian stock exchanges where the stock of small businesses engaged in riskier ventures tend to be listed until they have developed sufficiently to be welcomed onto the Toronto Stock Exchange.

² Known in the industry as a "bought deal".

securing of the \$2 billion needed for a network system to support Cell-Loc's wireless locator technology.

[8] Thus it was that on March 7, 2000, Mr. Howard found himself on the floor of the New York Stock Exchange and Cell-Loc, the darling of Wall Street. Shares were then trading at a heady \$50-60 per share. All signs were pointing "north", to use Mr. Howard's vocabulary. What happened next can be explained no more eloquently than by Mr. Howard himself:

Q Okay. And during that trip, what happened?

A During the trip, we were very well received. Our initial meetings were with Goldman Sachs and JP Morgan and Solomon Smith Barney Monday. Tuesday, we had Goldman Sachs was touring us around the New York Stock Exchange so we could get a feel for the -- if -- that American Stock Exchange.

On that very day that we were touring through the Exchange, that's when the stock market crash, as we've come to call it, began. Particularly in technology stock, there was tremendous selling on technology stocks with very little buying. Prices were plummeting 20, 40, 50 percent, you know, in one day, had everybody just scrambling on the -- on the trading floor. It was actually quite the scene.

So, all of a sudden, this -- the stock market itself had become incredibly volatile, and no matter how good your company is or how good your stock is, you are now riding the waves of this horrible storm in the market and now you're -- the pricing of your stock is now just subject to the ebbs and currents of the -- of the market and less so on really, the fundamental aspects of your company and the stock.

So by the time that week was over, we had met with everybody we had planned to meet. Again, the response was very positive. They threw every aspect of support that they could at us. We wanted to deal with these guys because some of their clients were the big players in the telecommunications and internet space such as Google and Verizon and players like that, which would be ultimate customers or business partners of ours, so they -- they offered everything they could but money because they -- they didn't want to do a deal when the market was so incredibly volatile. They wanted to wait until things stabilized again and there was a reliable environment in which to make their investments.³

³ Transcript page 30, line 10 to page 31, line 18.

[9] From that day until June 2000, there was great volatility in technology stocks in general; the price and volume of Cell-Loc shares fluctuated accordingly⁴. Confident, however, that the quality of its product and the soundness of its business plan would permit the company to weather the storm, Mr. Howard and Cell-Loc carried on as planned. On March 28, 2000, Cell-Loc shares were duly listed on the Toronto Stock Exchange. A launch of the company's commercial product set to coincide with Calgary's Stampede Week, went forward in July 2000. The activation of the first segment of Cell-Loc's infrastructure network in Texas proceeded on schedule in August. Meanwhile, throughout this period, Mr. Howard continued with his promotional activities in the investment community. Despite everyone's best efforts, however, by December 5, 2000, the Cell-Loc shares had declined to what Mr. Howard described as a "solid \$4.00"⁵. On December 13, 2000, Mr. Howard lost his job, a victim of the general downturn in the high tech industry and Cell-Loc's need to cut costs accordingly.

[10] By that time, Mr. Howard had acquired 43,100 Cell-Loc shares⁶. Initially, he financed his purchases using funds from his line of credit and money borrowed from his father. However, following the company's triumph on Bay Street, in December 1999 Mr. Howard had decided to enhance his purchasing power by opening a margin account through his broker, Kelly Reid. In this way, he was able to use his existing Cell-Loc shares (at that time, steadily increasing in value) as security to finance additional acquisitions. When the value of Cell-Loc shares began to plummet after the upset on the New York Stock Exchange in March 2000, Mr. Howard was forced to exercise some of his options to shore up the value of his margin account. As market conditions worsened, his broker began exercising his right to force the sale of the Cell-Loc shares in Mr. Howard's margin account. By the end of 2000, Mr. Howard had disposed of more than 30,000 Cell-Loc shares.

[11] Mr. Howard described his circumstances in the first few months of the new year as follows:

Q Okay. Describe to me the circumstances surrounding the filing of your 2000 tax return.

⁴ Exhibit A-1, Tab 21.

⁵ Transcript page 34, line 10.

⁶ Exhibit A-1, Tab 24.

A Well, 2000 had been a roller-coaster year. By the time the year was out, I had no -- no longer had any employment, thus no paycheque. My wife was pregnant. The entire technology industry was in a state of -- of -- they were battering down the hatches in order to ride out the storm. There was no more capital moving in on technology companies or technology sales. Layoffs were occurring left and right.

Technology companies had very little cash resources, so they were controlling spending down to every last penny. There was really many technologies company had gone bankrupt by this time. There was no demand for somebody of my expertise in as a financial officer of technology companies. (A), they couldn't afford me or it wasn't commensurate with their down-sizing.

So trying to find a new job in early 2001 was extremely difficult, so I was living on whatever savings I had. Obviously my investments, the value of my investments had been just decimated. Obviously my -- my scheme of profiting on Cell-Loc stock had proven unsuccessful, and, well, I was actually quite a -- quite a rattled state of mind not knowing where I'm going to pay my mortgage next month.

Q Okay. Did you hire somebody else to prepare your tax return?

A No, I couldn't afford. I didn't have any extra cash to afford accountants and lawyers, et cetera. Adding to this, in late February of 2000, I received my T4 from Cell-Loc, and it showed my salary income, and it showed this -- this gigantic number of stock option, taxable stock option benefit that I must claim on my tax return.

It was, you know, mentally or I guess spiritually challenging for me to deal with the circumstances I was in, but long story short, I knew I had to file a tax return because I didn't want to get offside with failing to file tax returns and going down that whole -- that whole scene with CRA.

I've always had a good history of filing my own tax returns. I'd always prepared them using Quick Tax software, so in late October or late, sorry, April, I decided to do the same, let me just file this return the way I usually do, and, so, I did. I sat down. Plunked -- grabbed all my receipts, plunked in all the numbers into the boxes in the software, and it spit out this tax return.

I -- I knew there was something wrong with the tax return because it made no sense how I could have such a gigantic or such a large income, a taxable income, yet at the same time I had suffered such substantial loss that I actually have no profit with which to pay the taxes that came out of this tax return, so there was -- there was obviously some sort of disconnect, but by

this time, it was April 30th. Something had to get filed. I didn't want to get offside, so I signed it and filed it.⁷

[12] Not surprisingly, the Minister assessed Mr. Howard's 2000 tax according to the return as filed.

[13] After receiving the assessment, Mr. Howard, now employed and still troubled by the way he had reported his 2000 income, sought professional assistance from KPMG. His tax accountant quickly confirmed his fears that he had incorrectly reported various aspects of his income, the most significant error occurring in the Cell-Loc share disposition. KPMG prepared an amended income tax return which, among other relatively minor changes, claimed a Disposition Loss of \$739,043.06 and a Write-Down Loss⁸ of \$257,779.51.

[14] Unmoved by either the amended return or Mr. Howard's quite reasonable attempts to explain his circumstances⁹, the Minister confirmed Mr. Howard's losses as on account of capital, as originally reported.

Analysis

[15] Mr. Howard's primary position is that he was a "trader or dealer"¹⁰ in the business of selling Cell-Loc shares; alternatively, that he was at the very least, involved in an "adventure in the nature of trade". The distinction matters since, if Mr. Howard's activities amounted to an adventure in the nature of trade, he would be precluded by subsection 10(1.01) from claiming a "Write-Down Loss" deduction.

[16] The Respondent's position is that Mr. Howard was not in the business of selling Cell-Loc shares.

[17] The definition of "business" is set out in subsection 248(1) of the *Act*:

"business" includes a profession, calling, trade, manufacture or undertaking of any kind whatever and, except for the purposes of paragraph 18(2)(c), section 54.2,

⁷ Transcript page 60, line 6 to page 62, line 8.

⁸ Subsection 10(1.01).

⁹ For example, Exhibit A-1, Tab 36.

¹⁰ Subsection 39(5) of the *Income Tax Act*.

subsection 95(1) and paragraph 110.6(14)(f), an adventure or concern in the nature of trade but does not include an office or employment;

[18] Whether Mr. Howard's activities in respect of his Cell-Loc shares amounted to a "business" is a question of fact; of assistance in making this determination are the factors established by the Federal Court of Appeal in *Vancouver Art Metal Works Ltd. v. R.*:

...

I have no doubt that a taxpayer who makes it a profession or a business of buying and selling securities is a trader or a dealer in securities within the meaning of paragraph 39(5)(a) of the Act. As Cattanach, J. stated in *Palmer v. M.N.R.*, [1973] C.T.C. 323, 73 D.T.C. 5248 (F.C.T.D.) at page 325 (D.T.C. 5249), "it is a badge of trade that a person who habitually does acts capable of producing profits is engaged in a trade or business". It is, however, a question of fact to determine whether one's activities amount to carrying on a trade or business. Each case will stand on its own set of facts. Obviously, factors such as the frequency of the transactions, the duration of the holdings (whether, for instance, it is for a quick profit or a long term investment), the intention to acquire for resale at a profit, the nature and quantity of the securities held or made the subject matter of the transaction, the time spent on the activity, are all relevant and helpful factors in determining whether one has embarked upon a trading or dealing business.¹¹

[19] Whether Mr. Howard was in the "trading or dealing" business depends on whether his activities were those of a "trader or dealer" within the meaning of subsection 39(5) of the Act. This is also a factual determination. In *Kane v. R.*¹², Noël, J. held that the *Vancouver Art Metal Works Ltd.* factors apply equally to an individual carrying on business as a trader or dealer in securities, or engaged in that activity as an adventure in the nature of trade. What distinguishes the "trader or dealer", however, is a taxpayer's "... particular or special knowledge of the market in which he trades"¹³; in this way, "... he distinguishes himself from the common risk takers who 'play the market' regularly or sporadically based on commonly available investment advice and information"¹⁴.

¹¹ [1993] 1 C.T.C. 346 at page 350.

¹² [1995] 1 C.T.C 1 (F.C.T.D.).

¹³ *Kane, supra*, at page 7.

¹⁴ *Supra*.

[20] In reaching this conclusion, Noël, J. also considered the taxpayer's level of involvement in the company's management and financial operations:

In the case at hand, the plaintiff had a special knowledge of the market in which Orell shares were traded. He was one of the directors of the corporation, its president, an insider by virtue of his holdings and a promoter as that term is defined in the B.C. *Securities Act*. But more importantly, he was directly involved in the mining ventures of Orell and in organizing its public financing offerings. As such he was in a position to anticipate market reaction to Orell's ongoing activities. That is the context in which the plaintiff bought and sold Orell shares. His trading activities were not only stamped with the usual badges of trade which characterize the dealings of common risk takers, but they were conducted by reference to, and were driven by, the special knowledge which the plaintiff had of the market in which the Orell shares were traded. Those in my view are the activities of a trader or dealer in securities as that term is used in subsection 39(5) of the Act. [Emphasis added.]¹⁵

[21] In the present case, Mr. Howard was even better placed to acquire a "special knowledge" of Cell-Loc's operations and financial prospects. That special knowledge had as its source his dual role as a manager and promoter. Mr. Howard described his involvement as Controller and Vice-President (Finance) in Cell-Loc's management as follows:

A The management of Cell-Loc, it was -- was the group of vice presidents, myself included, as well as the president. Each vice president was responsible for various aspects of the company. That'd be a vice president of hardware development, of software development, of sales or marketing. Later on, there was a vice president of human resources, vice president of operations, so all these people were in charge of their various departments.

An important role in the management of the company is the coordination of all the activities of all these departments to ensure that collectively, we are working together to meet the business plans, the business objectives of the company. To do so, we would meet. The seven vice presidents and the president, we would meet weekly to discuss the individual performance of each other's department, challenges, successes, objectives, accomplishments, frustrations, et cetera, and as a group, we would (a) coordinate the responsibilities of our departments amongst each other, and (b) do what we could to assist the departments of others in accomplishing their objectives.¹⁶

¹⁵ *Supra*, at pages 7 – 8.

¹⁶ Transcript page 18, line 22 to page 19, line 16.

[22] As part of this management team, Mr. Howard was well aware of the strengths and weaknesses of each department and was able to assess how they affected its bottom line:

Q So where was your estimate of the share price coming from?

A My estimate was based on, well, two sources of information. Internally, I knew how successful we were in accomplishing the business plan. I knew about the business plan. Where we were going. What we were expecting to achieve. I knew what our successes and challenges were internally towards achieving those objectives. I knew as -- as the head of accounting and finance, I know how everybody is spending their money. I mean, anything that anybody's doing within the company ultimately has an impact or flows through the accounting department, so I have this great intimate knowledge as to where we're focusing our actions, what successes, how rapid our successes are, and how well we're doing at achieving our plan.¹⁷

[23] It was also Mr. Howard who was responsible for the preparation of Cell-Loc's long-form prospectus¹⁸:

Q Okay. Go back to the joint book of documents. Can I ask you to turn to Document 5, Tab 5. So can you describe to me what this is and who prepared it?

A This document is what we call a long-form prospectus. This is a regulatory filing required by the Securities Commission in order to qualify any new issuances of shares from the company's Treasury, which, as I said, is -- is my responsibility, for distribution to shareholders. So this would -- this authorizes the issuance of new shares to the investment community.

Q Okay. And who at Cell-Loc was responsible for that?

A I -- I prepared this document. This is very much my responsibility.

Q Sorry, just to clarify, you were responsible for preparing it, but did you -- there was outsiders, or, you know, is there a law firm or?

A Oh, well, okay. There would be other parties. I would engage a team of people for accumulating all of this information. Some of the information would be legal-type information that would come from our securities' counsel. Some of this information would be historical information, which

¹⁷ Transcript page 85, line 16 to page 86, line 4.

¹⁸ Exhibit A-5.

would come from either my knowledge or knowledge of other parties in the company.

Q Okay. So while it was your responsibility, you didn't necessarily write the whole document?

A I did not personally write the entire document. I wrote many sections and was responsible for virtually every number in this document, and the document bears my signature on page 66.

Q Okay. Can you turn to page 28 of this document.

A Just to be clear, if there was any deficiencies in this document, it was on my head. Page 28, yes.¹⁹

[24] Such in-depth information assisted Mr. Howard in his duties promoting Cell-Loc shares to potential investors. It put him in a prime position to keep abreast of the company's standing in the investment community and to assess how that might affect the share price:

... Externally now, from the investment community, I know how well-received our stock is, the market conditions in which they're trading, what sort of buy and sell volumes are, bids and asks. I know what analysts' assessments and conclusions are about our stock, so as to where -- where do I get a sense as to where our stock is or its valuation is today and into the near future, I have -- see what sort of trajectory we're on internally towards achieving our objectives, and, externally, I have experts in the investment banking field telling me that, you know, this \$20 stock's going to \$50 or this \$50 stock's going to \$150.²⁰

[25] Armed with such information and equipped with the professional expertise to analyze and apply it to his own Cell-Loc shareholdings, Mr. Howard possessed the kind of "special knowledge" of the "trader or dealer" contemplated in the *Kane* decision.

[26] The next step is to consider the evidence pertaining to the applicable factors established in *Vancouver Art Metal Works*. Not every factor must be satisfied; it is the combined effect of those present that is important²¹.

¹⁹ Transcript page 20, line 21 to page 21, line 25.

²⁰ Transcript page 86, lines 5 to 16.

²¹ *Rajchgot v. R.*, [2005] 2 C.T.C. 2262 (T.C.C.) at paragraph 18.

Time Spent on Activity

[27] I accept Mr. Howard's evidence that he devoted virtually all of his time to monitoring and assessing the performance of Cell-Loc shares. He described his activities in the spring of 2000 as follows:

Q Okay. Between the period of time when you first increased your margin security by exercising options in March and in June when you began buying more Cell-Loc shares, what attention were you paying to the market for Cell-Loc shares?

A Oh, the market. Paying attention to the market was my daily living and breathing focus. By this time, in fact in late '99, the -- the controllership responsibilities, as I said the accounting portfolio under my -- my department was substantially all handed off to another chartered accountant who -- who reported to me, but he was responsible for all the accounting and financial reporting, et cetera, freeing me up to be 100 percent dedicated to investment banking, market, market intelligence, dealing with analysts, promoting the stock, making decisions and modifying planning regarding corporate finance deals, i.e., new issuances of shares from Treasury, raising the capital required, making preliminary discussions with investment bankers about what deals would look like because if they wanted more Cell-Loc stock, they had to deal with me.²²

[28] The Respondent submitted that because Mr. Howard was required by his employment responsibilities to devote himself to tracking the financial health of Cell-Loc and promoting its shares, little weight should be given to this evidence. I am not convinced by this argument; there was nothing to prevent him from simultaneously using the same special knowledge and exploiting it for the purposes of his own business of trading in his own Cell-Loc shareholdings.

[29] Nor am I persuaded by the Respondent's submission that because there were certain times in 2000 when Mr. Howard was unable or unwilling to sell his shares, he could not have been intending to resell them for a quick profit. Mr. Howard was unable to sell his Cell-Loc shares during "blackout" periods imposed by the Securities Commission. These were rare occurrences of two or three days' duration and applied equally to other "insiders" who, like Mr. Howard, held Cell-Loc shares. His unwillingness to sell - even at times when the share price was increasing - was rooted in his informed opinion that the Cell-Loc shares had not yet reached their

²² Transcript page 46, line 12 to page 47, line 5.

optimal value. Given his objective of driving up the share price, Mr. Howard felt it would be counter-productive to dispose of his own Cell-Loc shares while actively promoting their acquisition to prospective investors. His own Cell-Loc shareholdings inspired confidence in would-be purchasers. The greater the investment in Cell-Loc shares, the greater his profit margin when, ultimately, Mr. Howard did decide the time was right to sell. Not selling his shares at such times is indicative of his professional integrity and prudent management rather than an intention to treat the Cell-Loc shares as a capital investment.

[30] In these circumstances, Mr. Howard used his knowledge and expertise to devote 100 per cent of his time to exactly the sort of activities that were held in *Kane* to be those of a "trader or dealer". Everything he did as part of his employment duties was directly transferable to and useful in his business activities selling his Cell-Loc shares.

Nature and Quantity of the Shares Held

[31] First, there is no presumption that corporate shares are held on account of capital²³. In 2000, Mr. Howard held Cell-Loc shares and a small number of non-Cell-Loc shares (referred to herein as "Other Shares"). He treated the Other Shares as a capital investment because unlike the Cell-Loc shares, he had "no great insight into or ability to influence"²⁴ the Other Shares. He felt their value was more likely to be realized over the long-term rather than in a quick turn-around. He reported them on account of capital in his original filing and in his amended return.

[32] The Cell-Loc shares were quite a different matter. As Controller and Vice-President (Finance), Mr. Howard knew that the Cell-Loc shares were not currently paying, or expected to pay dividends any time soon²⁵. While not enough in itself to be determinative of an intention to trade²⁶, when taken as part of his overall special knowledge of the promising short-term performance potential of the Cell-Loc shares, this fact is consistent with his direct evidence that his intention was to acquire

²³ *Pollock v. R.*, [1994] 1 C.T.C. 3 at pages 10 - 11. (F.C.A.).

²⁴ Transcript page 80, lines 24-25.

²⁵ Exhibit A-1, Tab 5 at pages 28 and 45.

²⁶ *Irrigation Industries Ltd. v. Minister of National Revenue*, [1962] C.T.C. 215 (S.C.C.) at page 223.

as many Cell-Loc shares as he could reasonably afford with the idea of turning them for a quick and substantial profit at the opportune moment.

[33] As for the quantity of shares held, the Respondent relied on *Irrigation Industries Ltd.* to argue that the test is not whether the number of shares held is significant to the taxpayer but rather, whether the number of securities held is such that they could only have been bought on account of a business or trading intention. I do not take that to mean, however, that in considering the *Vancouver Art Metal Works* factors, the Court is precluded from considering all the circumstances of the taxpayer's shareholdings. In *Robertson v. R.*²⁷, the Federal Court of Appeal restated the *Irrigation Industries Ltd.* test as follows:

...

The Tax Court judge applied the proper test, namely whether the appellant, at the time of purchase, intended to resell the shares as soon as possible for a profit.

[34] Mr. Howard held far more Cell-Loc shares than Other Shares which, as already noted, he treated as a capital investment. Mr. Howard impressed me as a prudent fiscal manager, not one to be overly comfortable carrying huge debt in risky ventures. The money that he owed to his father and his other creditors weighed on his mind:

Q So how did you decide in June when you were buying Cell-Loc shares, how did you decide how many Cell-Loc shares to buy, how many transactions?

A Myself personally? I -- in which period, I'm sorry?

Q In June of 2000.

A The \$130,000 worth of stock that I acquired, that was as much as I could comfortably incur the debt for. i.e., I had the better part of \$200,000 worth of debt accumulated by this time. That was about as much as I could personally stomach.²⁸

[35] The 43,100 Cell-Loc shares ultimately purchased by Mr. Howard represented, for a man of his means and risk tolerance, a significant acquisition. When in 1998 he first began to acquire shares as a consultant at Cell-Loc, he was a young man starting

²⁷ [1998] 3 C.T.C. 147 at paragraph 20.

²⁸ Transcript page 47, lines 6 - 15.

his career. Later, as an employee with Cell-Loc, he enhanced his shareholdings, using his savings, line of credit and money borrowed from his father. In December 1999, when Cell-Loc's prospects began to exceed dramatically all reasonable expectations, he increased his share acquisition capacity by opening a margin account. At their apex in March 2000, the Cell-Loc shares held by Mr. Howard were valued at some \$1.2 million, by most people's standards, nothing to sneeze at. His debt load was made bearable because of his confidence that he would be able to realize a profit in the short-term and repay his creditors.

Frequency of Transactions

[36] The Respondent submitted that there were too few transactions in 2000 for Mr. Howard to claim that he had been in the business of selling Cell-Loc shares: 16 share purchases and 20 sales, 17 of which were initiated by his broker under the margin account agreement.

[37] I see no magic in any particular number of transactions. It seems to me that, depending on the circumstances, even one transaction could be a sufficient "frequency" of transactions. A trader's decision to buy or sell does not hinge on satisfying a notionally sufficient number of transactions. Mr. Howard watched the market, constantly assessing and reassessing Cell-Loc's performance in order to gauge when he could best realize the greatest profit. The Minister's position seems to be based in part at least, on the notion that to be in business of selling shares, a taxpayer must sell on the first occasion his shares are worth a penny more than the purchase price – that holding on to the shares beyond that point is a clear indicator of the taxpayer's intention to treat them as a capital investment. A more accurate portrayal of the activities of a trader (and one consistent with the approach taken in *Kane*) is that of Miller, J. in *Sandnes v. R.*²⁹:

... The trader attempts to maximize profit at the earliest opportunity. Presumably, this would entail a close scrutiny of the market to ensure purchases and sales at optimal moments.

[38] This was precisely what Mr. Howard was doing. These were the considerations that dictated the frequency of his transactions in the extraordinary market conditions that prevailed in 2000, described during cross-examination as follows:

²⁹ [2004] 2 C.T.C. 3139 (T.C.C.) at paragraph 13.

Q In 1999 before your employment at Cell-Loc, you acquired some small numbers of shares that totalled 2100.

A While I was a consultant, that's correct.

Q That's right. And I think --

A They were at about \$1.60. I expected, you know, if we -- I expected on the Venture Exchange, we might see upwards of \$10.

Q I think at the discovery you said somewhere in the 7 to \$10 range, so that --

A That's right.

Q -- sounds like the same thing?

A Yes.

Q But you, in fact, didn't sell those shares when it reached that price?

A That's correct. We -- the stock rocketed past \$10 and was already at \$20 and climbing from there.

Q And I think at discovery, you told me you thought at that point, maybe you'd hold out until they were \$40?

A Yes, so I -- yes, revisit my plan. Things are proceeding better than planned, so reassess. Something maybe the 40 to \$50 range would be appropriate.

Q And then they actually attained that value, and I think you told me that then at that point, you thought perhaps \$100 was an appropriate sell point?

A Well, again, as we rocketed up to the 40 to \$50 range, and that was commensurate, again, with the same time these Wall Street analysts were telling me they should be \$150 stock.

Q Yes.

A So I'm thinking I'm not selling at 50. We're going to 150, so just to comment, so along the way, I'm assessing whether it's a good time to crystallize my profits on the stock.³⁰

³⁰ Transcript page 70, line 15 to page 71, line 20.

[39] By the same token, during the market's period of high volatility, Mr. Howard postponed selling in anticipation of the Cell-Loc shares regaining their former strength.

Intention to Acquire Shares for Resale at a Profit

[40] Finally, there is the taxpayer's intention. As mentioned above, I found Mr. Howard to be a particularly compelling witness. He testified as to his intentions regarding the Cell-Loc shares:

A I expected to buy them at this price, which I felt was a low price, and I expected to sell them in the not-too-distant future at a much higher price.³¹

[41] However, the taxpayer's direct evidence of his intentions is not determinative of the matter; counsel for the Respondent cited *McGroarty v. Minister of National Revenue* for the proposition that "[g]enerally speaking, the person's intention is to be ascertained from his whole course of conduct"³². In that case, the Court underscored that "[t]he characterization of earnings as income or capital gains is a question of fact and must be assessed with regard to all the circumstances of the particular case"³³.

[42] The Respondent's position is that Mr. Howard's course of conduct is not consistent with his stated intention to acquire the Cell-Loc shares for resale at a quick profit. This argument is based, at least in part, on the fact that Mr. Howard acquired many of his Cell-Loc shares by exercising options granted to him as part of his remuneration from employment³⁴.

[43] Mr. Howard does not dispute that his "decision to accept stock options was an employment decision, not a business decision"³⁵ or that the only way he could realize this aspect of his employment compensation was to exercise the options. What he takes issue with is the relevance of these facts to the determination of the nature of the proceeds realized upon the disposition of the shares ultimately acquired by the

³¹ Transcript page 38, lines 23-25.

³² *McGroarty v. Minister of National Revenue* [1994] 2 C.T.C 52 (F.C.T.D.) at page 56.

³³ *Supra*, at page 55.

³⁴ Reply to the Notice of Appeal, paragraph 24(g).

³⁵ Transcript page 137, lines 8-9.

exercise of those options. I accept the argument of counsel for the Appellant that these are two separate transactions, each with its own source of income.

[44] Drawing a clear line between where one transaction ends and another begins is vital to the analysis of the attendant tax consequences. As Hugessen, J. explained in *Pollock v. R.*³⁶:

... While it is perfectly true that one transaction cannot constitute for a taxpayer two separate sources of income, this is clearly not what the Minister is seeking to do. The tax under paragraph 7(1)(a), upon income from employment, is triggered by the *exercise* of employee stock options, and both the timing and extent of the remuneration deemed to have been received are fixed by that event. That, however, does nothing to prevent the exercise of the options constituting the starting point for another transaction which concludes with the *disposition* of the shares and which may, in its turn, constitute another source of income. ... The point, of course, is that the exercise of the options, while it is the closing reference mark for the calculation of a deemed remuneration from employment, may easily be the opening reference mark for some other source of income.

[45] The Respondent also took the position that the fact that Mr. Howard had amended his income tax return placed on him a more onerous burden of proof. In support of its position, the Crown cited the following passage in *Rajchgot v. R.*³⁷ in which the Federal Court of Appeal stated that:

...

[5] A taxpayer who wants to change his reporting status in circumstances where it becomes more tax efficient to do so bears a heavy onus. In this case, the Tax Court Judge held that this onus has not been met. This is a decision that was open to him on the evidence before him.

[46] There is nothing inherently wrong with amending a return; indeed, the *Act* contemplates and provides for that very contingency. In tax appeals, it is always the taxpayer who bears the onus of proving wrong the assumptions upon which the Minister's assessment was based. Whether as amended or originally filed, what a taxpayer reports in his return must be capable of substantiation. In the present case, Mr. Howard's evidentiary burden is to show that the claims in his amended return are justified. As the Federal Court of Appeal noted above, it is up to this Court to determine if that onus has been satisfied. In the present case, I am satisfied that Mr. Howard has met his evidentiary burden.

³⁶ [1994] 1 C.T.C. 3 (F.C.A.) at page 9.

³⁷ [2005] 5 C.T.C. 1.

[47] The effect of changing the way in which a transaction has been reported was one of the factors considered by Rip, J. (as he then was) in *Rajchgot*. Acknowledging that a prior filing was "indicative" rather than "determinative"³⁸ of a taxpayer's intention, he went on to say that:

[37] ... There should be some consistency in reporting share transactions. When a taxpayer all of a sudden changes from reporting transactions from capital to income account or from income to capital account there should be some evidence of the shares' changes in status. In some circumstances it may help if shares owned as capital and shares held on income account were held in separate brokerage accounts. The taxpayer should be prepared to show something that distinguishes his capital from income transactions, that his transactions are not similar. This act should be done when he first makes a transaction that is not consistent with previous transactions³⁹.

[48] In *Rajchgot*, after reviewing all of the evidence in light of the *Vancouver Art Metal Works Ltd.* factors, Rip, J. found that there had been no change in the taxpayer's original intention (as shown in prior filings), ultimately holding that the taxpayer had not altered the "overall purpose in purchasing the shares as capital assets"⁴⁰.

[49] Mr. Howard's situation is quite a different story. He did not "all of a sudden" reverse an established history of filing practices. Rather, his was a case of correcting reporting errors in one taxation year at his earliest opportunity after filing. I accept Mr. Howard's evidence that in the stressful weeks following his termination at Cell-Loc, he was troubled by how to report the share transactions properly but lacked the financial resources, technical tax expertise and overall, the clear-headedness needed to deal adequately with the complexity of his 2000 return. He was also worried about compounding his difficulties by becoming a "late filer", something he had never been prior to the Cell-Loc crisis.

[50] In all the circumstances, I am satisfied that the return, as originally filed, did not accurately reflect the Cell-Loc transactions in 2000 and is far from indicative of an intention on Mr. Howard's part to treat the Cell-Loc shares as a capital investment.

³⁸ See also *Hawa v. R.*, [2007] 1 C.T.C. 2511 (T.C.C.).

³⁹ *Rajchgot v. R.*, [2005] 2 C.T.C. 2262 (T.C.C.) at paragraph 37.

⁴⁰ *Rajchgot*, *supra*, at paragraph 38.

[51] Considered in light of the factors in *Vancouver Art Metal Works*, the evidence persuades me that Mr. Howard's course of conduct in dealing with his Cell-Loc shares was consistent with his stated intention of acquiring the shares to resell for profit at the earliest best opportunity. Applying the words of Noël, J. in *Kane* to the present case, Mr. Howard's "trading activities were not only stamped with the usual badges of trade which characterize the dealings of common risk takers, but they were conducted by reference to, and were driven by, the special knowledge which [he] had of the market in which the [Cell-Loc] shares were traded"⁴¹. But for his special knowledge, I would have found that Mr. Howard was engaged in an adventure in the nature of trade in respect of his dealings with the Cell-Loc shares; however, his special knowledge and expertise with regard to Cell-Loc's operations, of the status of its shares and of the market in which they were traded elevated his activities in the 2000 taxation year to those of a "trader or dealer" in the business of selling his Cell-Loc shares. It is on that basis that the appeal is allowed, with costs, and the reassessment is referred back to the Minister for reconsideration and reassessment.

Signed at Ottawa, Canada, this 22nd day of February, 2008.

"G. A. Sheridan"

Sheridan, J.

⁴¹ *Kane, supra*, at pages 7 – 8.

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