Citation: 2008 TCC 407
Date: 20080731
Docket: 2001-2877(IT)G

BETWEEN:

RUSSELL WITT,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

AMENDED REASONS FOR JUDGMENT

Bowie J.

[1] These appeals arise out of a series of transactions in securities entered into by Mr. Witt and RIW Corporation Ltd. ("RIW"). These transactions were the execution of what has been described in earlier cases[1] as a convertible hedge strategy – in whole or in part the brainchild of one J.K. Maguire. The strategy has been described in some detail in the reported judgments. A description of the strategy, and of the specific facts giving rise to the remaining issue that I must decide in this case, are to be found in an Agreed Statement of Facts (Partial)[2] that was filed by the parties at the opening of the trial. A useful description of the convertible hedging strategy appears in the judgment of the Federal Court of

---

1 *Schultz v. The Queen*; [1996] 1 F.C. 423; *Rezek v. Canada*, [2005] 3 C.T.C. 241, rev. [2004] 1 C.T.C. 2605 *sub. nom. Hayes v. The Queen*.

2 The document is a statement of facts agreed on by the parties for the purpose of trial. They agreed, too, that it could be supplemented by any further evidence that either party might lead, so long as it is not inconsistent with the facts agreed upon. For convenience, I shall refer to it as the Agreed Facts.

Appeal in *Rezek v. Canada*[3] at paragraphs [3] to [20]. It is included as Appendix A to these Reasons.

the facts

[2] Initially, Mr. Witt appealed from assessments and reassessments under the *Income Tax Act*[4] for the years 1984 to 1991 inclusive, and RIW appealed from assessments for the 1987 and 1988 taxation years. At the opening of the trial, I was advised that the parties had settled the appeals of RIW, and the appeals of Mr. Witt for all years other than 1984 and 1985. The Agreed Facts are as follows:

Agreed Statement of Facts

Background Information

1. The above appeal is to be heard on common evidence and brought forward based on Canada Revenue Agency's (hereinafter "CRA") reassessment of Mr. Witt for his 1984 to 1991 taxation years, inclusively.

2. Schedule I attached contains the various Notices of (re)assessment for the above taxpayer.

3. The parties settled all other issues in dispute on May 27,2008 except for the TWC/TWA issue. Mr. Witt's corporation, RIW Corp., is no longer an Appellant due to the May 27, 2008 settlement and the Notice of Discontinuance that was filed on the same day.

4. Mr. Witt has a Bachelor of Science degree in Math from Sir George Williams University, now called Concordia University.

5. Mr. Witt is a resident of Canada for the purposes of the *Income Tax Act*.

6. RIW is a corporation incorporated in the province of Ontario and through which Mr. Witt provides consulting services and conducts convertible hedging activities. Mr. Russell Witt is the sole shareholder and director of RIW Corp.

7. The taxation year-end of RIW Corp. is September 30.

Overview

[3] *Supra*, note 1.

[4] R.S.C. 1985 (5th Supp.) c. 1, as amended.

8. Starting in the early-1980s Mr. Witt and his corporation became involved in a form of investing known as convertible hedging. They were advised by J. K. Maguire & Associates, and various stockbrokers. Mr. Witt was also advised by Richard Strand.

9. Convertible hedging involved an individual or individuals entering into offsetting long and short positions in securities.

10. For income tax purposes, Mr. Witt and his Corporation filed tax returns for the tax years before the Court, reporting income and claiming certain securities trading losses and expenses. Mr. Witt's returns were prepared by J. K. Maguire & Associates. RIW Corp.'s returns were prepared by Gary Posner, CA of Posner Finstein.

Convertible Hedging

11. Some of the convertible hedges were undertaken and managed with the assistance of J.K. Maguire & Associates.

12. Mr. Witt and RIW Corp. entered into convertible hedging transactions. This involved initiating a short position in the common stock of a company and a long position in a security convertible or exercisable into the common stocks sold short ("the convertible security"). The brokers would execute the orders at the same time or as close together as possible. The proceeds received from the short sale were applied against the cost of buying the convertible security. The difference between the funds received on the short sale and the funds required to purchase the long position represented the necessary investment to open a hedge. This spread amount was the amount at risk if the investment was unsuccessful.

13. The conversion feature provided that the brokerage firm was not at risk as it could use the convertible securities to obtain common shares to replace the borrowed shares for the short position. This allowed for the waiver of normal margin requirements.

14. The Appellant and RIW Corp. maintained separate trading accounts through which the transactions were executed.

15. The transactions were executed by stockbrokers through stock exchanges.

16. The transactions entered into by the Appellant and RIW Corp. can be classified under three categories:

    a. two-party convertible hedges involving both Appellants;

b. one-party convertible hedges involving one of the Appellants; and

c. other security transactions that did not involve convertible hedges (requiring regular margins).

17. The transactions entered into by the Appellant and RIW Corp. in 16(c) above, were all on normal margin requirements, which meant that the financing was provided by the stockbrokers. When shares were sold short, the general margin requirement was 150 per cent of the market value of the shares sold short. When convertible securities were purchased, the general margin requirement was 50 per cent of the market value of the underlying securities. These margin requirements were determined by the stockbrokers daily and adjusted according to the closing price of the respective securities.

18. As a result of the trades entered into by the Appellants and depending on the circumstances, they:

a) may have received interest or dividend income on their long positions;

b) may have paid compensatory dividends, stock rental/borrowing fees, on their short positions; and/or

c) may have paid other expenses, including interest, hedge fees, management fees, broker fees, and accounting fees.

19. Schedule 2 attached entitled "Analysis of Security Transactions" is a list of transaction entries on which the parties are in agreement.

20. Schedule 3 attached entitled "Income & Expenses" is a list of income and expense entries categorized by broker on which the parties are in agreement.

21. Schedule 4 attached titled "Profits and Losses From Hedges" is a list of profits and losses and has been agreed to all items [*sic*] except those pertaining to Trans World Corp and Trans World Airlines.

22. Schedule 5 attached titled "Reconciliation Positions" is a summary of reconciliation of each party's taxable income position for the taxation years under appeal. This was prepared on the basis of the Appellants being in a partnership relationship for the purposes of hedging, and has been agreed to on all items except those pertaining to Trans World Corp and Trans World Airlines.

23. Schedule 6 attached titled “Tax Returns” are the tax returns for Mr. Witt for the years currently under appeal.

Two-Party Convertible Hedges

24. The Appellant and RIW Corp. entered into two-party convertible hedges. Each of the Appellant and RIW Corp. opened a separate account with the same brokerage firm and guaranteed in writing the obligations of the other to that stockbroker.

25. The stockbrokers were entitled to rely on the account of one Appellant to support the margin requirements of the other. In essence, the cross-guarantees provided margin support without additional outlays.

26. The two-party convertible hedges were typically initiated in one account with either Mr. Witt or RIW taking a short position by selling a security short and also taking a long position by purchasing a security convertible or exchangeable into the security sold short.

27. Once formed, the two-party convertible hedge was eventually either eliminated by:

    a. the sale of the long securities and the cover purchase of the short securities; or

    b. a position was reached where the securities in one Appellant account exactly matched the securities sold short in the other Appellant account (a common shares versus common shares position).

Two-Party Convertible hedge: Trans World

28. Mr. Witt and RIW, as co-hedgers in a partnership relationship, participated in convertible hedging and Mr. Witt and RIW Corp. opened broker accounts with Midland Doherty in January of 1984.

29. The business of the partnership was convertible hedging and Mr. Witt and RIW Corp. opened broker accounts with Midland Doherty in January of 1984. Mr. Witt guaranteed the account of RIW Corp. on January 20, 1984.

30. Mr. Witt borrowed Trans World Corporation (“TWC”) common shares and sold them, thereby taking a short position. At the same time, RIW Corp. relied on the proceeds of the short sale to purchase another security, being the TWC preferred shares. The difference in values between the positions was the spread. The preferred shares were convertible into common shares at a 1 to 1 ratio, thereby resulting in a hedged position.

31. On January 26, 1984 Mr. Witt sold short 5,000 common shares of Trans World Corporation and RIW Corp. purchased 5,000 convertible $2.66 Preferred C shares of Trans World Corporation.

32. On January 31, 1984, Mr. Witt sold short an additional 5,000 common shares and RIW Corp. purchased another 5,000 shares, for a total of 10,000 convertible $2.66 Preferred C shares Trans World Corporation held long and a short position of 10,000 common shares Trans World Corporation. That is, the Appellant and RIW Corp. were fully hedged at 10,000 common shares short to 10,000 convertible preferred shares held long.

33. The short sale proceeds was $539,752.96 and the cost of the shares held long was $575,479.05. The spread, or amount required to finance the hedge position, was the difference between these amounts, $35,726.09.

34. As previously announced, effective Feb 1, 1984 TWC distributed both common and preferred shares of Trans World Airlines ("TWA") as a dividend to its common shareholders.

35. At the same time, the conversion ratio of the convertible preferred shares of TWC was increased from the 1 to 1 ratio, as prior to the share dividend, to a 1 to 1.412 ratio on February 1, 1984. This changed conversion ratio, also published in advance, was to recognize a decrease in the value of the TWC shares arising from the spin-off of the TWC division.

36. By virtue of being short in TWC common shares when the share dividend spin-off occurred, Mr. Witt acquired short positions of the TWA common shares and TWA .05 preferred shares.

37. The following instructions were given to the brokers and executed in early February, 1984 thus maintaining a hedged position:

    a) Mr. Witt sold short a further 4,120 shares of TWC (2,000 shares with a settlement date of Feb 7, 1984, and 2,120 shares with a settlement date of Feb 8, 1984); by virtue of the changed conversion ratio on the TWC preferred shares he remained hedged at 14,120 common shares short (the initial 10,000 plus the further 4,120) to 10,000 convertible preferred shares held long; and

    b) the proceeds of these additional short sales were used to purchase shares of TWA; these purchases covered the short positions of the TWA common shares and the TWA $0.05 preferred shares acquired by virtue of the spin-off.

38. The additional purchases of TWA common were of 6,000 shares with a settlement dates of February 7, 1984, 7,132 and February 8, 1984. and 3 shares on March 8, 1984. The additional purchases of TWA preferred shares was on May 4, 1984.

39. On November 16, 1984, RIW Corp. converted the 10,000 preferred shares into 14,120 common shares. This resulted in the accounts of Mr. Witt and RIW Corp being in a common shares versus common shares position, which remained unchanged until January 1987 when the positions were liquidated.

the issue defined

[3] Following my pre-trial direction, the parties executed and filed at the opening of trial an agreement as to the precise issue that remains to be decided.

AGREED STATEMENT OF ISSUE

> In this appeal, the Appellant and the Respondent are in agreement that the sole remaining issue in dispute is the treatment of the covering purchases by the Appellant of the Trans World Airlines share distribution in the Trans World Corp hedge, in the Appellants 1984 taxation year.
>
> The parties wish to determine the appropriate treatment of the $200,988.97 purchase amount as identified in the analysis of the Trans World Corp. hedge on Schedule 2 Tab 21 (being the total of $15,184.21, $45,552.62, $31,021.49, $1,534.29, $60,065.49, $46,518.10, $490.98, $44.26, $2.64, and $574.89).

[4] During the trial the parties advised me that they had also agreed that one of the terms of the partnership agreement between Mr. Witt and RIW was that the profits of the partnership business were to be divided between the partners on the basis that is described by the Court of Appeal in the first two sentences of paragraph [107] of the Reasons for Judgment in *Rezek v. Canada:*[5]

> SHARING OF PROFITS OR LOSSES
>
> [107] The Tax Court judge found that the gains or losses on the spreads were to be split equally between the [partners]. … [T]he income and expenses were taxable to the [partner] in whose account they were received or incurred.

Partners are, of course, free to agree to divide the fruits of their endeavours in any way that commends itself to them. In this case there is no written partnership

[5] *Supra*, note 1.

agreement, and no evidence of an oral agreement that would conflict with this additional fact. It is on the basis of that division of the profits that the appeals of RIW and those of Mr. Witt for the other taxation years have been settled, and so I accept that this is the formula upon which Mr. Witt and RIW had agreed to share the profits of their partnership. At year end, the profit is to be computed in two pools. One consists of the profit, or loss, from the hedge which arises from the fluctuation in the spread. The other consists of the profit, or loss, resulting from the positive, or negative, cash flows during the year of the kind referred to by Rothstein J. A. in *Rezek* at paragraph [20] as

> … net income from dividends or interest during the period of the hedge.

The profit or loss from the first of these (the hedge pool) is to be divided evenly between the partners. The profit or loss from the second (the cash flow pool) is to be divided between them on the basis that payments made or received by each partner are for that partner's account alone.

[5] The parties are agreed, and from the evidence it is clear, that all the transactions in this case took place on income account. It is only the profits arising in 1984 that are in issue, and the TWC hedge was closed before the end of that year. The only question remaining for decision, therefore, is whether, when dividing the partnership profit at the end of its 1984 fiscal period, in accordance with the agreement just described, the $200,988.97 amount should be considered as an expense to be deducted from the appellant's share of the cash flow pool, as the payments were made by him, or if it should be considered a cost of establishing the hedge and therefore to be taken into account in computing the hedge pool profit or loss. The appellant contends that the amount was, in effect, a compensatory dividend payment, and that it should be accounted for on that basis as a cash flow amount, with the result that his share of the partnership income for 1984 would be decreased by $200,988.97. The respondent's position is that the amount is not a compensatory dividend payment, but an amount paid to cover a short position in the appellant's account. Mr Gluch relies on the following statement of the Court of Appeal in *Rezek*:

> [105] Because the business of the partnerships was convertible hedging, the individual transactions creating losses on the disposition of convertible securities or the covering of short sold shares in one account are not, in isolation, taxable events. The maximum gains or losses sustained by the partnerships are the gains or losses on the spreads.

[6] The issue that I have to decide, therefore, is one that could have arisen between the partners at the 1984 year end as to the distribution of their profit, or loss, for the year. Its significance for present purposes is that if the amount is to be considered an expenditure from the cash flow pool then the appellant can take it into account in computing his share of the partnership income for 1984. In that event it will eliminate his other income for the year 1984, and he will have a loss to carry forward to 1985. It is only for that reason that the parties have not settled the 1985 appeal. I am told that they have agreed on all the other issues relating to 1985.

the opinion evidence

[7] The appellant sought to introduce opinion evidence from Richard Strand. He is President, Chief Compliance Officer and Portfolio Manager of two companies that he started a year ago, and of which, if I understood him correctly, he is the sole shareholder. These companies manage funds for corporations, trusts, institutions and individuals, on a discretionary basis, including bond, equity, commodity futures and financial futures accounts. He has been involved in the futures and derivatives trading business for some 22 years in several capacities and in responsible positions. I have no doubt that he knows and thoroughly understands the workings of the financial and equity markets and the principles behind convertible hedge trading. He also advised Mr. Witt, to some extent at least, in respect of some of his many convertible hedge transactions. Mr. Strand was called to give both opinion and factual evidence. I had considerable doubt, however, as to the admissibility of his opinion evidence, it being not at all obvious to me that it would meet the necessity test: see *R v. Mohan*.[6]

[8] At the suggestion of Mr. Gluch, and with the concurrence of Mr. Rotfleisch, I reserved the question of the admissibility of the opinion evidence to be dealt with after all the evidence was heard. While this is not a practice I favour, it did expedite the trial, and it may have saved some time and expense. During argument, Mr. Gluch withdrew his objection to the admissibility of the opinion evidence. Nevertheless, I have concluded that Mr. Strand's opinion ought not to be admitted as it does not meet the necessity requirement in *Mohan*. Sopinka J. said there at page 23:

> In *R. v. Abbey*, *supra*, Dickson J., as he then was, stated, at p. 42:
>
>> With respect to matters calling for special knowledge, an expert in the field may draw inferences and state his opinion. An expert's function

---

6 [1994] 2 S.C.R. 9 at pages 21 to 25.

> is precisely this: to provide the judge and jury with a ready-made inference which the judge and jury, due to the technical nature of the facts, are unable to formulate. "An expert's opinion is admissible to furnish the Court with scientific information which is likely to be outside the experience and knowledge of a judge or jury. If on the proven facts a judge or jury can form their own conclusions without help, then the opinion of the expert is unnecessary" (*Turner* (1974), 60 Crim. App. R. 80, at p. 83, *per* Lawton L.J.)

> This pre-condition is often expressed in terms as to whether the evidence would be helpful to the trier of fact. The word "helpful" is not quite appropriate and sets too low a standard. However, I would not judge necessity by too strict a standard. What is required is that the opinion be necessary in the sense that it provide information "which is likely to be outside the experience and knowledge of a judge or jury": as quoted by Dickson J. in *R. v. Abbey*, *supra*. As stated by Dickson J., the evidence must be necessary to enable the trier of fact to appreciate the matters in issue due to their technical nature.

Mr. Strand's proposed evidence does not meet this test. The subject matter is neither complex nor highly technical. It is simply a matter of applying the facts of this case to the formula by which the partners have agreed to divide their profits. This requires an understanding of the nature of common shares and securities convertible to common shares, but that is not a subject that is alien to the experience of judges. Moreover, the opinion that Mr. Rotfleisch sought to elicit from the witness was as to the precise issue that the parties have defined for the purposes of the appeal before me. As Sopinka J. pointed out in *Mohan* at page 24:

> Although the [ultimate issue] rule is no longer of general application, the concerns underlying it remain. In light of these concerns, the criteria of relevance and necessity are applied strictly, on occasion, to exclude evidence as to an ultimate issue.

This is one of those occasions when the criterion of necessity should be strictly applied.

[9] In any event, if I were to admit Mr. Strand's opinion into evidence I would not find it to be useful. His *Rule* 145 affidavit is 6½ pages long. The first 6 pages are no more than a recitation of facts that are found in the Agreed Facts. The last seven lines express his opinion on the very question that I have to decide, consisting simply of a bald conclusion, devoid of any significant analysis or reasoning. The opinion evidence, which was marked as Exhibit A-2 at the trial, is ruled inadmissible. For clarity, however, I shall reproduce the final paragraph of it as Appendix B to these

Reasons. His factual evidence is admissible, although it is almost entirely repetitive of the Agreed Facts.

extraneous concerns

[10] In the course of argument, both counsel addressed the question of a possible windfall that might result from my decision, in the form of income going untaxed. Mr. Rotfleisch also suggested that some double taxation of the appellant may have taken place along the way. None of this is at all relevant to what I have to decide. It should be borne in mind that I am, in effect, deciding how a dispute between the partners as to the division of the partnership profit for the 1984 fiscal period would have been decided, had it arisen 24 years ago. The case has no overtones of tax avoidance. If a windfall results from my decision, it will be the result of one or more years having become statute barred during the protracted delay since the initial assessments of the partners for 1984 — a delay to which both parties have no doubt made some contribution. As Evans J.A. said in *Sherway Centre Ltd. v. Canada*:[7]

> It is the nature of limitation periods that their application will sometimes cause taxpayers to pay either more, or less, tax than they were legally obliged to pay.

If Mr. Witt has paid more tax in other years than he thinks he should have, then his remedy was to appeal those other years' assessments. It is trite that I cannot take such matters into account in deciding the narrow point that is before me in this case.

Analysis

[11] The immediate facts giving rise to the issue are found in the Agreed Statement of Facts at paragraphs 29 to 39 above, and they are not complex. In January 1984, the partnership opened the Trans World Corp. (TWC) hedge with the broker Midland Doherty. The appellant had the short account, and at January 31 it was short 10,000 common shares. RIW had the long account, and it was long 10,000 preferred shares, each of which was convertible to one common share. The hedge was therefore established and in balance. On February 1, TWC spun off its subsidiary Transworld Airlines (TWA). It did this by declaring a dividend that entitled the holder of each common share of TWC to receive 1.3135 common shares of TWA and 0.5023 $0.05 preferred shares of TWA. At the same time the conversion ratio of the TWC preferred shares was changed from 1:1 to 1:1.412. The reason for this change in the

[7] [2003] C.T.C. 123, at para. 44.

conversion ratio was to compensate the preferred shareholders for the fact that the value of each common share of TWC was reduced by its proportional share of the corporation that had been its TWA shareholding; thus, for the preferred shares to maintain their proportional value on conversion, the number of common shares to be received had to be increased by 41.2%.

[12] The declaration of this dividend put Mr. Witt, as the short seller, in the position that he was obliged to pay the lender of the shorted stock 10,000 x 1.3135 = 13,135 common shares of TWA and 10,000 x 0.5023 = 5023 $0.05 preferred shares of TWA. This was done by Midland Doherty when it created a short position in the appellant's account to pay the lender of the TWC shares 13,135 TWA common and 5,023 TWA preferred shares. At this point the hedge had become unbalanced in two ways: there was a short position in TWA in the appellant's account that was not hedged at all, and there was a long position in TWC in the RIW account that exceeded the TWC short position in the appellant's account, as the 10,000 TWC preferred shares were now convertible to 14,120 TWC common, while the appellant's account was short only 10,000 TWC common.

[13] For the convertible hedge strategy to work properly the appellant had to rebalance the hedge. To do this, he could have had RIW sell 2,918 TWC preferred shares, bringing the TWC into balance at 10,000 common short in his account and 7,082 preferred (convertible to 10,000 common) long in the RIW account. This would have made funds available to purchase TWA common and preferred shares to eliminate the shortage in his own account. The other alternative to produce a balanced hedge was what he in fact did. By leaving the long side of the hedge as it was and increasing the short side to 14,120 TWC, he restored the hedge to a balanced position, and did so at a value equivalent to the pre-spinoff level. One pre-spinoff TWC common share was, by definition, equivalent to one post-spinoff TWC common share plus 1.3135 TWA common shares plus 0.5023 TWA preferred shares, or 1.412 post-spinoff TWC common shares. It is evident, therefore, that the increase to the appellant's TWC short account that took place on February 7 and 8 did nothing more than maintain the hedge at its pre-spinoff value. The funds produced by those short sales equate to that part of the value of the pre-spinoff shares represented by the TWA common and preferred shares that were distributed to the holder of the 10,000 TWC shares that Mr. Witt had sold short.

[14] In reality, the common and preferred TWA shares received for each pre-spinoff common share of TWC held on February 1, 1984 simply represented and replaced part of the value of that pre-spinoff TWC share. It is a misnomer to describe them as a dividend as they, together with the post spin-off TWC shares are simply the same asset that the shareholder had on January 31 (a proportional share of the TWC corporation, including its interest in TWA) in a different form. The TWA shares spun off to TWC shareholders are simply part of the same asset (the pre-spinoff share) in a different form (post-spin TWC share plus TWA shares).

[15] When Mr. Witt acquired TWA shares on the market for the lender of his short-sold TWC shares he was, in reality, repaying part of the borrowed shares, specifically that part by which the borrowed shares of TWC had decreased in theoretical value as a result of the spinoff. The expenditure of $200,988.97 incurred to purchase TWA shares for the lender was made in order to return to the lender a part, 29.18% to be exact, being (1 – (1 ÷ 1.4120)) of the shares loaned (the 10,000 pre-spinoff shares). That this is so can be seen from the fact that when the hedge is closed out and the loan of shares repaid, it is repaid by the transfer of 10,000 shares of a corporation that no longer lists TWA among its assets. The lender, however, has been compensated for this reduced value of the TWC shares when it received the TWA shares purchased by the appellant for $200,988.97.

[16] This characterization of a spin-off dividend of this type was recognized by Parliament in the enactment of section 86.1 of the *Act* in 2001.[8] Before that, a spin-off dividend of shares of a subsidiary received from a US resident corporation was treated under the *Act* in the same way as any other dividend-in-kind. Section 86.1 now enables the recipient to elect to have the spinoff shares treated as a distribution of capital, with the pre-spinoff cost of the parent shares being distributed between the parent and the subsidiary shares, and any gain being deferred. That section was enacted since the TWA spinoff, and so did not apply to it. However it is legislative recognition that a spinoff of this kind from a widely held public company is really a capital distribution, and it is a misnomer to attach the word dividend to it at all.

---

[8] S.C. 2001, c. 17, s. 64(1).

[17] This was recognized as well by Miller J. in *Morasse v. The Queen.*[9] The facts of that case were different from, but not distinguishable from, the TWA spinoff. A Mexican corporation, A, caused a new corporation, B, to be created, and then transferred a portion of its business to it. It then caused B to distribute its shares to the common shareholders of A. The spinoff did not qualify for the benefit of section 86.1 because A was not a US corporation. Nevertheless, Miller J. held that receipt of the shares of B by a Canadian shareholder of A was not a taxable event, because the nature of the payment was more akin to a split of the shares of A than to the payment of a dividend. The character of the shares of B was that of a portion of the pre-spinoff shares of A rather than an income amount.

[18] From the foregoing, it can be seen that the outlay of $200,988.97 was made to maintain the hedge in balance rather than to pass an element of income through to the lender of the TWC shares. The spinoff of TWA by TWC did not come as a surprise to Mr. Witt, who was, of course, the decision-maker for both members of the partnership. The spinoff had been approved by the shareholders of TWC on December 28, 1983, and so was common knowledge.[10] I infer that when he established the hedge on January 25, 1984 Mr. Witt had already formed the intention of making the additional short sales of TWC common shares, and the purchases of TWA common and preferred shares that he made, for the most part, on February 7 and 8. These transactions cannot be looked at in isolation. By spending $200,988.97 to cover his obligation to the lender of the TWC common shares sold on January 26 and 31, and receiving $199,770.76 on the additional short sales of TWC common shares, also on February 7 and 8, he brought the hedge into balance at 14,120 common shares short on his personal account and 10,000 preferred shares, convertible to 14,120 common shares, on the RIW account. This only increased the spread (his at-risk investment) by $1,218.21. From this, it is clear that both the expenditure of the $200,988.97 and the receipt of the $199,770.76 were transactions to be taken into account as part of the hedge pool and not the cash flow pool in computing the partnership profit.

[19] Counsel for the respondent, as the successful party, may prepare a judgment to be approved as to form by counsel for the appellant. In the unusual circumstances of this case I am not inclined to make any order as to costs.

---

[9] [2004] 2 C.T.C. 3085.

[10] See Exhibit A-1, Schedule 2, Tab 21, p. 2, note [3].

Signed at Ottawa, Canada, this **31st day of July, 2008.**

"E.A. Bowie"

Bowie J.

APPENDIX A

Extract from *Rezak v. Canada*, [2005] 3 C.T.C. 241

CONVERTIBLE HEDGE STRATEGY

Introduction

[3] Under the convertible hedge strategy, common shares of publicly traded companies are "sold short" and at approximately the same time, another security carrying the right to acquire approximately the same number of common shares is purchased. The purchased securities may be preferred shares or debentures, both convertible to common shares, or a warrant to acquire common shares.

Selling Short

[4] A short sale of shares is a sale of shares that the seller does not own. The shares are said to be "borrowed." That means that the sale is facilitated by entering into an agreement with a broker who will permit the sale of shares belonging to another person (who may be the broker or a customer of the broker). The proceeds of the sale, net of broker's fees, are credited to the account of the short seller. On the record here, when shares were sold short by the appellants, they paid a fee called a "rental fee" to the brokers. In addition, they paid an amount equal to the dividends paid on the shares between the time they were borrowed and the time they were returned. Such payments are referred to as "compensatory dividends."

[5] The profit or loss on a short sale is determined when the short sale is "closed out". That occurs when the short seller replaces the borrowed shares. That is done by having the broker purchase an equivalent number of identical shares for the person who lent them to the short seller. The cost of the purchase, including broker's fees, is debited to the account of the short seller.

[6] If the cost of acquiring the replacement shares is less than the proceeds of the short sale (because the value of the shares has declined), the short seller realizes a profit on the short sale. If the cost of acquiring the replacement shares is more than the proceeds of the short sale (because the value of the shares has increased), the customer will realize a loss on the short sale. Any broker's fees, rental fees and compensatory dividends paid by the short seller between the short sale and the close out will reduce the profit or increase the loss.

[7] A short sale of shares is different from a normal sale of shares in two ways. First, the seller receives the proceeds of sale before incurring the cost of acquiring the shares. Second, a short sale results in a profit only if the value of the shares declines, while a normal sale results in a profit if the value of the shares increases.

Hedging

[8] A "hedge" is a technique for mitigating the risk of loss. The main risk of loss on a short sale is the risk that the value of the shares may increase. To mitigate that risk, a short seller of common shares may acquire a security carrying the right to acquire the same number and kind of common shares. That right may be found in a right of conversion attached to a convertible share or a convertible debenture, or in a warrant to acquire common shares.

[9] The value of a convertible share or a convertible debenture includes the value of the common shares into which the security may be converted, plus the value of the security without the conversion feature (the stated capital if it is a preferred share or the principal amount if it is a debenture) plus, in certain circumstances, a premium representing the value of the right to make the conversion. The cost of acquiring a convertible security necessarily includes the cost of all of those components.

[10] A warrant confers the right to acquire common shares for a limited period of time at a specified price. If the market price of the common shares is below the specified price that entitles the warrant holder to acquire the common shares (sometimes referred to as the "strike" or "exercise" price), the warrant would have no value. If the market price of the common shares exceeds the specified price at which the warrant holder is entitled to acquire the common shares, the market price of the warrant should be the difference between the specified price and the market price of the common shares plus a premium for the right to acquire the common shares. For example, if the warrant entitles the holder to acquire common shares at ten dollars per share and the market price of the common shares is twelve dollars, the market price of the warrant should be about two dollars plus a small premium.

[11] To the extent that the value of a convertible security includes the value of the common shares into which it may be converted, its value necessarily increases as the value of the common shares increases. Similarly, the value of a warrant will increase as the value of the common shares increases. Therefore, a short seller of common shares who is at risk of loss on the short sale (because of an increase in the value of the common shares) may mitigate that risk by holding convertible securities or warrants carrying the right to acquire the same number and kind of common shares.

[12] Holding a convertible security or warrant entails a risk of loss resulting from

a decline in the value of the common shares. Such a decline will automatically reduce the value of the convertible security or warrant. However, if the holder of a convertible security or warrant has also made a short sale of the common shares, a decline in the value of those common shares will result in a profit on the short sale. Thus, a short sale will mitigate the risk of loss on the convertible security or warrant.

[13] Holding a convertible security or warrant to hedge a loss on a short sale of common shares was referred to in the record as a "convertible hedge" or a "convertible hedge strategy". A person who has made a short sale of common shares and who also holds a convertible security or warrant representing the same number of identical common shares is hedging two potential losses. The potential loss on the short sale resulting from an increase in the value of the common shares is hedged by holding the convertible security or warrant. The potential loss on the convertible security or warrant resulting from a decline in the value of the common shares is hedged by the short sale.

Profit or Loss on the Spread

[14] On the record here, there was generally a small premium between the amount paid for the convertible securities, or the amount paid for the warrants and income earning investments on the one hand, and the proceeds from the short sale of common shares on the other. If the market value of the common shares were to increase, the value of the convertible security or warrant would also go up generally in tandem with the common shares. Upon the conversion to common shares or the exercise of the warrant, the investor would simply not recover the premium.

[15] However, if the value of the common shares were to decline, at some point the investor may make a profit. That is because at some lower value of the common shares, the market will place little or no value on the conversion feature of the convertible security or warrant and the value of the convertible security or warrant will not fall further. For example, if a warrant entitles an investor to acquire common shares for ten dollars per share and if the market value of the shares is below ten dollars, the warrants should have no value. However, the investor's profit on the short sale will continue to increase as the value of the common shares continues to decline below ten dollars. The spread between the value of the common shares sold short and the value of the warrants will increase in favour of the investor.

[16] Using the same example, assume that the investor sold common shares short at twelve dollars and at the same time purchased warrants to acquire common shares for the exercise price of ten dollars. The market price of the warrants should be two dollars plus a small premium reflecting the right to acquire the common shares in the future, say ten cents. If the price of the common shares falls to five dollars per share, the warrant will have no value because no one would pay for the right to acquire the common shares at ten dollars when the market value was five dollars. The investor

will lose two dollars and ten cents in respect of the warrant. However, the investor will be able to make a cover purchase for the short sale of the common shares for five dollars. In that case, the investor will gain seven dollars on the short sale and lose two dollars and ten cents on the warrant for a net gain of four dollars and ninety cents.

[17] Thus, in the example, while the investor will lose the ten cent premium if the value of the common shares does not decline below the exercise price, the investor will earn a profit of four dollars and ninety cents if the value of the common shares declines below the ten dollar exercise price to five dollars.

[18] For convenience, hereafter I will refer to convertible preferred shares, convertible debentures and warrants as "convertible securities" or as a "convertible security".

Income Opportunity

[19] In addition to the potential for profit on the spread under the convertible hedge, there is also an opportunity to earn income during the period of the hedge. Generally, convertible preferred shares or debentures will yield greater dividends or interest than the common shares. While convertible hedge investors will have to pay compensatory dividends to the broker, these investors expect to receive greater dividends or interest on the convertible preferred shares or debentures they hold. Even when the convertible security is a warrant that pays no dividend or interest, investors will be able to acquire treasury bills or other low risk, interest-bearing securities with that portion of the proceeds from the short sale of the common shares that exceeds the amount required to pay for the warrants. That interest is expected to exceed the compensatory dividends payable on the common shares sold short.

[20] In summary, there are two sources of income from a convertible hedge strategy - profit on the spread and net income from dividends or interest during the period of the hedge.

APPENDIX B

Extract from the *Rule* 145 Affidavit of Richard Strand

Conclusions

I find that the amounts paid by the appellant, Witt in respect of a compensatory dividend, where a dividend was declared and paid in the form of Trans World Airlines shares is an expense arising from the Witt short position in Trans World Corporation, and should be treated the same as any cash dividend. I do not see a compensatory dividend paid in the form of shares as a security transaction that should be treated as one of the security transactions comprising the hedge. Further, the method of payment in respect of the cost is irrelevant to my findings, since both a debit to a brokerage account or a payment by cheque have the same effect.

Yours truly,
[signed]
Richard G. Strand

CITATION:	2008 TCC 407
COURT FILE NO.:	2001-2877(IT)G
STYLE OF CAUSE:	RUSSELL WITT and HER MAJESTY THE QUEEN
PLACE OF HEARING:	Toronto, Ontario
DATE OF HEARING:	June 2 and 3, 2008
REASONS FOR JUDGMENT BY:	The Honourable Justice E.A. Bowie
DATE OF REASONS FOR JUDGMENT:	July 31, 2008

APPEARANCES:

Counsel for the Appellant:	David J. Rotfleisch and Daniel Lyons
Counsel for the Respondent:	Henry A. Gluch and John Grant

COUNSEL OF RECORD:

For the Appellant:

Name:	David J. Rotfleisch
Firm:	Rotfleisch & Samulovitch
For the Respondent:	John H. Sims, Q.C. Deputy Attorney General of Canada Ottawa, Canada