Docket: 2016-445(IT)G

BETWEEN:

THE BANK OF MONTREAL,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeal heard on June 4, 5, 6, 7 and 8, 2018 at Toronto, Ontario

Before: The Honourable Justice David E. Graham

Appearances:

Counsel for the Appellant:	Martha MacDonald Jerald Wortsman Patrick Reynaud
Counsel for the Respondent:	Natalie Goulard Sara Jahanbakhsh Marie-France Camiré

JUDGMENT

The appeal of the reassessment of the Appellant's taxation year ending October 31, 2010 is allowed and the matter is referred back to the Minister of National Revenue for reassessment on the basis that section 245 of the *Income Tax Act* did not apply to the transactions in question.

Costs are awarded to the Appellant. The parties shall have 30 days from the date hereof to reach an agreement on costs, failing which the Appellant shall have a further 30 days to file written submissions on costs and the Respondent shall have yet a further 30 days to file a written response. Any such submissions shall not exceed 10 pages in length. If the parties do not advise the Court that they have

reached an agreement and no submissions are received within the foregoing time limits, costs shall be awarded to the Appellant as set out in the Tariff.

Signed at Ottawa, Canada, this 12th day of September 2018.

"David E. Graham"

Graham J.

Citation: 2018 TCC 187
Date: 20180912
Docket: 2016-445(IT)G

BETWEEN:

THE BANK OF MONTREAL,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Graham J.

[1] This appeal involves the application of the general anti-avoidance rule (the "GARR") to a complex series of cross-border financing transactions entered into by the Bank of Montreal between 2005 and 2010 that avoided the application of the dividend stop-loss rules in subsection 112(3.1) of the *Income Tax Act* (the "Act"). The Bank of Montreal takes the position that it did not receive a tax benefit from the transactions and, even if it did, the receipt of that benefit was not an abuse of subsection 112(3.1).

[2] The parties filed a Partial Agreed Statement of Facts which describes the structure and the financing in detail. A copy of the Partial Agreed Statement of Facts is attached as Appendix "A". In these Reasons for Judgment, I have simplified the facts somewhat for ease of presentation.[1] Simplified transaction diagrams prepared by counsel for the Bank of Montreal are attached as Appendix "B".[2]

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1 Where there is a discrepancy between the facts that I describe in these Reasons for Judgment and those set out in the Partial Agreed Statement of Facts, those set out in the Partial Agreed Statement of Facts should be treated as the findings of fact made at trial.

2 I have included these diagrams to assist the reader in following the transactions. They were not entered as exhibits and are not evidence in the appeal.

A. Overview

[3] In 2005, the Bank of Montreal ("BMO") wanted to lend a total of $1.4 billion USD to a number of its US subsidiaries referred to as the Harris Group. BMO chose to borrow those funds from third parties.

i. Tower Structure

[4] It would not have been tax efficient for BMO to simply borrow the funds and lend them to the Harris Group. Such a structure would have resulted in BMO having to pay US withholding tax on the interest payments it received from the Harris Group. As a result, BMO implemented what is commonly referred to as a "tower structure". A tower structure is a complicated structure often used by Canadian companies to finance US subsidiaries in a tax efficient manner. It allows the deduction of interest costs by the Canadian company for Canadian tax purposes and the deduction of the corresponding interest costs by the US subsidiary for US tax purposes without having to pay withholding tax to the US on the repatriation of the funds.

[5] The tower structure implemented by BMO consisted of the following entities:

(a) a Nevada limited partnership named BMO Funding L.P. ("Funding LP") in which BMO had a 99.9% interest and a wholly owned subsidiary of BMO named BMO G.P. Inc. ("BMO GP") had a 0.1% interest;

(b) a Nova Scotia unlimited liability company named BMO (NS) Investment Company ("NSULC") that was wholly owned by Funding LP; and

(c) a Delaware limited liability company named BMO (US) Funding LLC ("LLC") that was wholly owned by NSULC.

ii. Borrowed Funds

[6] BMO borrowed $150 million USD from a third party. It invested those funds in Funding LP. Funding LP, in turn, used those funds to acquire shares of

NSULC which, in turn, used those funds to acquire shares in LLC. LLC then took the funds that it had received and lent them to the Harris Group.[3]

[7] The balance of the required $1.4 billion USD came from a $1.25 billion USD loan obtained by Funding LP from a third party. Again, Funding LP used those funds to acquire shares of NSULC which, in turn, used those funds to acquire shares in LLC. LLC then took the funds that it had received and lent them to the Harris Group.[4]

iii. Quarterly Payments

[8] Interest payments and dividends flowed through the tower structure at the end of each fiscal quarter. The Harris Group would pay interest to LLC. LLC would then use the money to pay dividends to NSULC. NSULC would pay corresponding dividends to Funding LP. Funding LP would use the funds it received to pay interest on the $1.25 billion USD that it had borrowed and would distribute the balance to BMO and BMO GP. BMO would, in turn, use the funds it received from Funding LP to pay interest on the $150 million USD that it had borrowed.

[9] The dividends received by BMO from NSULC (indirectly through Funding LP) were taxable dividends. BMO benefited from a subsection 112(1) deduction in respect of those dividends.

iv. Hedging Foreign Exchange Risk

[10] From a business point of view, by borrowing US dollars to make an investment in a US asset, BMO effectively hedged its foreign exchange risk. If the Canadian dollar decreased in value against the US dollar between 2005 and 2010, then the increase in value (in Canadian dollars) of BMO's indirect US dollar

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3 The amount lent to the Harris Group was actually only $149,100,000 USD. The remaining funds were either spent or held by each entity in the tower structure as the funds passed through. As the specific amounts invested or lent by each entity are not relevant, I have described the transaction as if the entire $150 million USD flowed through. The specific amounts are set out in Appendix "A".

4 The amount lent to the Harris Group was actually only $1,247,115,000 USD. The remaining funds were either spent or held by each entity in the tower structure as the funds passed through. As the specific amounts invested or lent by each entity are not relevant, I have described the transaction as if the entire $1.25 billion USD flowed through. The specific amounts are set out in Appendix "A".

investment in the Harris Group would be matched by the increased cost (in Canadian dollars) of repaying the $1.4 billion USD in borrowed funds. Conversely, if the Canadian dollar increased in value against the US dollar between 2005 and 2010, then the decrease in value (in Canadian dollars) of BMO's indirect US dollar investment in the Harris Group would be matched by the decreased cost (in Canadian dollars) of repaying the $1.4 billion USD in borrowed funds.

[11] However, from a tax point of view, BMO faced a potential problem with hedging its foreign exchange risk. There would not be any problem if the Canadian dollar decreased in value. Any increase in the value of the NSULC shares held by Funding LP that arose from a decrease in the value of the Canadian dollar would be taxable as a capital gain. That capital gain would be offset by the corresponding capital loss that would arise on the repayment of the $1.4 billion USD in borrowed funds. On the other hand, BMO would have a problem if the Canadian dollar increased in value. The resulting decrease in the value of the NSULC shares held by Funding LP would give rise to a capital loss. However, the stop-loss rule in subsection 112(3.1) would reduce that capital loss by an amount equal to the value of any non-taxable dividends that Funding LP had received from NSULC. As a result, the reduced capital loss would not be sufficient to fully offset the capital gain that would arise on the repayment of the $1.4 billion USD in borrowed funds.

v. Modified Structure

[12] To avoid this potential mismatch of the capital gain and capital loss, BMO implemented a modification to the tower structure. Subsection 112(3.1) applies separately to each class of shares. Therefore, BMO decided to create a structure whereby NSULC had two classes of shares. When the first set of quarterly dividends was being paid, instead of paying a cash dividend, NSULC paid a stock dividend consisting of preferred shares. This resulted in Funding LP holding two classes of shares of NSULC: common shares with a high cost base and preferred shares with a low cost base. From that point forward, all quarterly dividends were paid on the preferred shares. By isolating the dividends in this manner, BMO ensured that, if the Canadian dollar increased in value resulting in a capital loss on the common shares of NSULC, the loss would not be ground by the value of the non-taxable dividends that had been paid by NSULC and thus the loss would fully offset the capital gain on the borrowed funds.

[13] BMO's planning proved fortuitous. The Canadian dollar increased in value significantly between 2005 and 2010.[5] The use of the two-class structure ensured that the capital loss on the disposition of the shares of NSULC matched the capital gain on the borrowed funds.

vi. Unwinding the Structure

[14] The tower structure was unwound in 2010. The Harris Group repaid the loans made by LLC. LLC was wound up and its assets were distributed to NSULC. NSULC, in turn, was wound up and its assets were distributed to Funding LP. Funding LP used the funds it received to repay the $1.25 billion USD that it had borrowed. It distributed the balance of the funds to BMO and BMO GP. BMO used the funds it received from Funding LP to repay the $150 million USD that it had borrowed.

vii. Reassessment

[15] The Minister of National Revenue was not pleased with the modifications that BMO had made to the tower structure to address its foreign exchange-related tax risk. The Minister concluded that, while the resulting structure technically complied with the Act, the GAAR should be used to reduce BMO's share of the capital loss on the disposition of the common shares of NSULC by the amount by which the loss would have been ground under subsection 112(3.1) had BMO not modified the structure. Accordingly, the Minister reassessed BMO to reduce its capital loss by $287,766,503.

[16] It is important to note that the GAAR reassessment did not challenge the use of the tower structure itself, only the modification to the structure that BMO made by introducing the second class of shares.

viii. Issues, Positions and Conclusion

[17] There are three conditions that must be present for the GAAR to apply. First, there must have been a tax benefit arising from a transaction. Second, that

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5 The CAD/USD exchange rate was 1.2550 on June 9, 2005 and 1.0236 on June 16, 2010 (Partial Agreed Statement of Facts, para. 31).

transaction must have been an avoidance transaction. Finally, the avoidance transaction must have been abusive.[6]

[18] The Respondent submits BMO received a tax benefit when its share of Funding LP's capital loss on the NSULC common shares was not reduced by the $287,766,503 in non-taxable dividends received by Funding LP on the NSULC preferred shares. BMO submits that there was no tax benefit. It asserts that, even if a second class of shares had not been introduced into the tower structure, subsection 112(3.1) would still not have applied to grind the capital loss. BMO argues that, as the Act read in 2010, subsection 112(3.1) did not apply to capital losses that arose from foreign exchange fluctuations.

[19] BMO accepts that, if I find there was a tax benefit, the benefit resulted from a series of transactions that were primarily undertaken to obtain the benefit. In particular, if I find there was a tax benefit, BMO accepts that the stock dividend by which the preferred shares of NSULC were created and the subsequent payment of all dividends on those preferred shares to the exclusion of the common shares was an avoidance transaction.

[20] However, BMO argues that the Respondent has failed to prove that the avoidance transaction was an abuse of subsection 112(3.1). The Respondent submits that the object, spirit and purpose of subsection 112(3.1) is to prevent the overstatement of capital losses incurred on the disposition of shares by reducing the losses by any tax-free dividends received on those shares. The Respondent says that BMO abused that object, spirit and purpose.

[21] For the reasons that follow, I find that there was no tax benefit. Having reached that conclusion, there is no need for me to consider whether subsection 112(3.1) was abused.

B. Tax Benefit

[22] Subsection 245(1) defines a "tax benefit" as a reduction, avoidance or deferral of tax. The Respondent says that the tax benefit BMO received was the reduction in its tax payable as a result of subsection 112(3.1) not applying to reduce its share of the capital loss on the disposition of the common shares of NSULC.

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6 *Copthorne Holdings Ltd. v. The Queen*, 2011 SCC 63, at para. 33; *Canada Trustco Mortgage Co. v. The Queen*, 2005 SCC 54, at para. 17.

[23] The relevant portions of subsection 112(3.1) read as follows:

> . . . [W]here a taxpayer . . . is a member of a partnership, the taxpayer's share of any loss of the partnership from the disposition of a share that is held by a particular partnership as capital property is deemed to be that share of the loss determined without reference to this subsection minus,
>
> . . .
>
> (*b*) where the taxpayer is a corporation, the total of all amounts received by the taxpayer on the share each of which is
>
> (i) a taxable dividend, to the extent of the amount of the dividend that was deductible under this section . . . in computing the taxpayer's taxable income or taxable income earned in Canada for any taxation year,
>
> . . .
>
> [Emphasis added.]

[24] Subsection 112(3.1) reduces a taxpayer's share of any loss from the "disposition of a share". BMO says that its loss from the disposition of the NSULC common shares was not a loss from the "disposition of a share" because subsection 39(2) deemed it to be a loss from the "disposition of currency".

[25] Subsection 39(2) has since been amended but, in 2010, the relevant portions of subsection 39(2) read as follows:

> Notwithstanding subsection (1), where, by virtue of any fluctuation after 1971 in the value of the currency or currencies of one or more countries other than Canada relative to Canadian currency, a taxpayer has made a gain or sustained a loss in a taxation year, the following rules apply:
>
> (*a*) the amount, if any, by which
>
> (i) the total of all such gains made by the taxpayer in the year . . .
>
> exceeds
>
> (ii) the total of all such losses sustained by the taxpayer in the year. . . . , and
>
> (iii) if the taxpayer is an individual, $200,

> shall be deemed to be a capital gain of the taxpayer for the year from the disposition of currency of a country other than Canada, the amount of which capital gain is the amount determined under this paragraph; and
>
> (*b*) the amount, if any, by which
>
> (i) the total determined under subparagraph (*a*)(ii),
>
> exceeds
>
> (ii) the total determined under subparagraph (*a*)(i), and
>
> (iii) if the taxpayer is an individual, $200,
>
> shall be deemed to be a capital loss of the taxpayer for the year from the disposition of currency of a country other than Canada, the amount of which capital loss is the amount determined under this paragraph.
>
> [Emphasis added.]

[26] The Respondent accepts that subsection 112(3.1) applies after subsection 39(2) applies and thus that a loss deemed by subsection 39(2) to be a loss from the disposition of currency would not be a loss from the disposition of shares for the purpose of subsection 112(3.1). Capital gains and losses determined under section 39 are used to determine a taxpayer's income under section 3. A taxpayer's income under section 3 is then used to calculate the taxpayer's taxable income under section 2. Under subsection 2(2), the additions to and deductions from income found in Division C are made when calculating a taxpayer's taxable income. Subsection 112(3.1) is found in Division C. Therefore, subsection 112(3.1) applies after subsection 39(2).

[27] BMO submits that, because subsection 39(2) applies before subsection 112(3.1), if subsection 39(2) applied to deem the foreign exchange loss on the NSULC common shares to be a capital loss from the disposition of currency, there would be no loss from the disposition of a share to which subsection 112(3.1) could apply. BMO argues that it cannot have received a tax benefit by avoiding the application of an otherwise inapplicable subsection.

[28] The Respondent accepts that BMO's capital loss ensued from the fluctuation of the US dollar relative to the Canadian dollar.[7] The Respondent also accepts that,

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[7] Respondent's Written Representations, paras. 23 and 24.

if subsection 39(2) applied to deem the foreign exchange loss on the NSULC shares to be a capital loss from the disposition of currency, then BMO did not receive a tax benefit. However, the Respondent says that subsection 39(2) did not apply in that manner. The question is therefore whether subsection 39(2) applied to the capital loss or not. BMO says it did and the Respondent says it did not.

[29] For the reasons that follow, I find that subsection 39(2) applied to deem the foreign exchange loss on the disposition of the NSULC common shares to be a capital loss from the disposition of currency and thus that BMO did not receive a tax benefit. I reach this conclusion based on a textual, contextual and purposive analysis of subsection 39(2).

i. Textual Analysis

[30] At first glance, subsection 39(2) appears to be straightforward. The text indicates that any gains or losses that arise from the fluctuation of the Canadian dollar will be deemed to be capital gains or losses from the disposition of currency. However, a closer examination reveals significant ambiguity.

[31] To understand the ambiguity in subsection 39(2), one must first recognize that a taxpayer can make a gain or sustain a loss on capital account by virtue of a fluctuation in the value of the Canadian dollar in two different ways: disposing of property or satisfying an obligation.[8]

(a) Disposing of property: A taxpayer can make a gain or sustain a loss by virtue of a fluctuation in the value of the Canadian dollar by disposing of capital property that is a foreign currency or is denominated in a foreign currency. For example, a taxpayer who held US dollars in a bank account on capital account could convert those US dollars into Canadian dollars. The conversion would be a disposition of property and the resulting gain or loss would have occurred by virtue of a fluctuation in the value of the Canadian dollar between the time the taxpayer acquired the US dollars and the time he or she disposed of them. In this example, the taxpayer's gain or loss would be entirely related to the fluctuation in the Canadian dollar. A second example would be a taxpayer who owned shares in a US public company and

[8] Subsection 39(2) only applies to gains and losses on capital account (*Saskferco Products ULC v. The Queen*, 2008 FCA 297, at para. 26, citing the Federal Court of Appeal decision in *Imperial Oil Ltd. v. The Queen*, 2004 FCA 361).

sold those shares on the market. In this example, part of the taxpayer's gain or loss would consist of a gain or loss on the underlying shares and the balance would consist of a foreign exchange gain or loss.

(b) Satisfying an obligation: A taxpayer can also make a gain or sustain a loss by virtue of a fluctuation in the value of the Canadian dollar by satisfying an obligation entered into on capital account that is denominated in a foreign currency. For example, a taxpayer who had borrowed money in US dollars to acquire a manufacturing plant could repay the loan at a point in time when the exchange rate had changed. The resulting gain or loss would be a gain or loss arising by virtue of a fluctuation in the value of the Canadian dollar. However, the gain or loss would not be a gain or loss from the disposition of property. This is because a loan payable is an obligation, not an asset.

[32] With this background in mind, the question is whether subsection 39(2) applies to foreign currency gains and losses arising from dispositions of capital property, the satisfaction of obligations or both.

Possible Interpretations

[33] I will refer to the interpretation of subsection 39(2) whereby the subsection catches only dispositions of capital property as the "Property Interpretation", the interpretation whereby the subsection catches only foreign exchange gains or losses from the satisfaction of obligations on capital account as the "Obligation Interpretation" and the interpretation whereby the subsection catches foreign exchange gains or losses arising both from the satisfaction of obligations on capital account and the disposition of capital property as the "Broad Interpretation". The Respondent supports the Obligation Interpretation. BMO supports the Broad Interpretation or a more restricted version of the Broad Interpretation (described below) which I will refer to as the "Restricted Broad Interpretation". Neither party supports the Property Interpretation.

Property Interpretation

[34] I can quickly reject the Property Interpretation. As noted above, neither party supports this interpretation. Furthermore, the case law on subsection 39(2) indicates that the Property Interpretation is wrong. There are a number of reported cases in which subsection 39(2) has been applied to foreign exchange gains or

losses that arose on the satisfaction of obligations.[9] Since the Property Interpretation would not allow subsection 39(2) to be applied in that manner, it is clearly incorrect.

Restricted Broad Interpretation

[35] In addition to the Broad Interpretation, BMO also argues in favour of the Restricted Broad Interpretation. I can quickly reject the Restricted Broad Interpretation as well.

[36] Under the Restricted Broad Interpretation, subsection 39(2) would apply to all foreign exchange gains and losses arising from the satisfaction of obligations on capital account but would only apply to foreign exchange gains and losses on the disposition of capital property if those gains or losses arose exclusively from fluctuations in the Canadian dollar. All other foreign exchange gains and losses from the disposition of capital property would be taxed under subsection 39(1).

[37] There is nothing whatsoever in the text of subsections 39(1) or (2) that supports the Restricted Broad Interpretation. Such an interpretation would require very specific language indicating that the gains made or losses sustained must not have been attributable to anything other than the fluctuation in the Canadian dollar. At a minimum, I would expect the word "only" or another word to that effect to have been inserted into the phrase "by virtue of" in subsection 39(2) such that it read "by virtue only of".

[38] BMO's sole support for the Restricted Broad Interpretation comes from a position that the Canada Revenue Agency took at a conference of the Association de planification fiscale et financière in 2005. The CRA stated the following:[10]

> The CRA's position, in respect of a gain or loss resulting from the disposition of a property that is a capital property, is that subsection 39(2) of the ITA will apply if, and only if, the gain or loss, as calculated in accordance with section 40 . . . , is solely attributable to the fluctuation in the value of a foreign currency relative to

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9 Subsection 39(2) was applied to money borrowed by the taxpayer in *Tahsis Company Ltd. v. The Queen* (1979 CarswellNat 267 (FCTD)), to shares denominated in US dollars that were redeemed by the taxpayer in *The Queen v. MacMillan Bloedel Ltd.* (1999 CarswellNat 1183 (FCA)), to convertible debentures issued by the taxpayer in *The Queen v. Agnico-Eagle Mines Ltd.* (2016 FCA 130) and to the repayment of funds borrowed by the taxpayer in *Bernier v. The Queen* (2004 TCC 376, upheld on different grounds in 2005 FCA 337).

10 Document No. 2007-0242441C6, October 5, 2007.

> the Canadian currency. If the aforesaid gain or loss is not solely attributable to the fluctuation in the value of a foreign currency relative to the Canadian currency, subsection 39(1) . . . and not subsection 39(2) . . . , must be used to calculate the capital gain or loss resulting from the disposition of the property.
>
> [Emphasis added.]

[39] The CRA provided no textual, contextual or purposive explanation of why it believed subsection 39(2) operated in this manner. I find this published position to be of no value in interpreting subsection 39(2).

[40] Based on all of the foregoing, I reject the Restricted Broad Interpretation. Having done so, I can now focus the textual analysis on the two remaining interpretations: the Obligation Interpretation and the Broad Interpretation.

"made a gain or sustained a loss"

[41] Subsection 39(2) uses the phrase "made a gain or sustained a loss". This phrase supports both the Obligation Interpretation and the Broad Interpretation.

[42] Subsection 39(1) deals with capital gains and losses. It describes a capital gain as a "gain . . . from the disposition of any property" and a capital loss as a "loss . . . from the disposition of any property". These phrases do not appear in subsection 39(2). Instead, subsection 39(2) refers to a taxpayer who has "made a gain or sustained a loss" without specifying how those gains were made or those losses were sustained. This different language in subsection 39(2) clearly indicates that Parliament did not intend that subsection 39(2) would only apply to dispositions of property. Had Parliament intended that result, it would have used the same language that it used in subsection 39(1).

[43] While the phrase "made a gain or sustained a loss" is certainly textual support for the rejection of the Property Interpretation, it does not assist me in choosing between the Obligation Interpretation and the Broad Interpretation. Parliament may have used different language because it wanted to cover gains or losses that did not arise from dispositions of property (i.e. obligations). Alternatively, Parliament may have used different language because it wanted to cover both obligations and dispositions of property.

Calculations of Foreign Exchange Gains and Losses

[44] Under the Broad Interpretation, taxpayers would have to separate their gains or losses on the property itself from their gains or losses arising from fluctuations in the Canadian dollar. The former would be taxed under subsection 39(1) and the latter under subsection 39(2). The Respondent submits that such treatment would be redundant. The Respondent further submits that the lack of instructions from Parliament as to how subsections 39(1) and (2) should interact argues against this interpretation. For the reasons that follow, I disagree with both of these arguments.

[45] The Respondent submits that the application of subsection 39(2) to foreign exchange gains and losses arising from the disposition of property would be redundant. The amount of those gains and losses is calculated under section 40. Pursuant to subsection 261(2), that calculation is required to be done in Canadian dollars and thus already takes into account foreign currency gains and losses.[11] As a result, the Respondent submits that the portion of any gain or loss arising from the fluctuation of the Canadian dollar is already factored into the overall gain or loss in subsection 39(1). I agree that, absent subsection 39(2), foreign exchange gains and losses from the disposition of capital property would be taxed under subsection 39(1). However, that does not mean that Parliament could not have decided to separate those gains and losses and instead tax them under subsection 39(2). As discussed in more detail below, subsection 39(2) applies notwithstanding subsection 39(1).

[46] The Respondent also points out that there are no instructions in subsections 39(1) and (2) indicating how taxpayers should separate their gains and losses on underlying property from their gains and losses arising from fluctuations in the Canadian dollar. The Respondent submits that the absence of such instructions indicates that Parliament did not intend subsection 39(2) to cover dispositions of property and thus argues in favour of the Obligation Interpretation. I disagree.

[47] It could be, as the Respondent argues, that there are no instructions in subsection 39(1) and (2) because Parliament did not intend subsection 39(2) to apply to dispositions of property. However, it could also be that there are no instructions because Parliament did not think it was necessary to include them. It does not strike me that it would be particularly difficult to separate one's gain or

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[11] This need for foreign exchange gains and losses to be reflected in section 40 calculations was also recognized in *Gaynor v. The Queen*, 1991 CarswellNat 406 (FCA).

loss on an underlying asset from one's foreign exchange gain or loss in most situations.[12]

[48] Additionally, section 261 was only introduced in 2007. With some minor exceptions, it sets out how foreign currency transactions are to be handled for all purposes of the Act. Prior to the introduction of section 261, the Act contained no rules describing how foreign currency transactions were to be handled. Therefore, from a historical perspective, the absence of guidance from subsections 39(1) or (2) is neither troubling nor revealing.

[49] Based on all of the foregoing, I find that there is no redundancy under the Broad Interpretation and that the lack of instructions in subsections 39(1) and (2) does not weaken the Broad Interpretation nor is it inconsistent with it.

"Notwithstanding subsection (1)"

[50] Subsection 39(2) opens with the phrase "[n]otwithstanding subsection (1)". This phrase could be interpreted in three different ways. Two of those interpretations support the Property Interpretation and, consequently, should be rejected. The third interpretation of the phrase supports either the Obligation Interpretation or the Broad Interpretation.

(a) The phrase "[n]otwithstanding subsection (1)" could mean "despite the fact that this gain or loss is already taxed under subsection (1)". Since obligations are not taxed under subsection 39(1), this interpretation of the phrase would only work under the Property Interpretation and must therefore be rejected.

(b) The phrase "[n]otwithstanding subsection (1)" could also be interpreted to mean "instead of taxing these foreign exchange gains or losses under subsection (1)". Again, since obligations are not taxed under subsection 39(1), this interpretation of the phrase would only work under the Property Interpretation and must therefore be rejected.

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12 Logically, the gain or loss on the underlying asset is the amount of the change in the value of that asset in the foreign currency multiplied by the exchange rate at the date of acquisition and the foreign exchange gain or loss is the proceeds of disposition of the asset in the foreign currency multiplied by the difference between the exchange rate on acquisition and the exchange rate on disposition. The aggregate result of these two amounts will equal the total gain or loss incurred by the taxpayer in Canadian dollars.

(c) Finally, the phrase "[n]otwithstanding subsection (1)" could be interpreted to mean "despite the definitions in subsection (1)". This interpretation is consistent with both the Obligation Interpretation and the Broad Interpretation.[13] Under the Broad Interpretation, the phrase would indicate that, despite the fact that foreign exchange gains and losses from the disposition of property already meet the definition of capital gains and losses in subsection 39(1), Parliament is going to deem them to be a different type of capital gain or loss: a capital gain or loss from the disposition of currency. Under the Obligation Interpretation, the phrase would indicate that, despite the fact that foreign exchange gains and losses from the satisfaction of obligations would not otherwise fit the definition of capital gains and losses in subsection 39(1), Parliament is going to deem them to be capital gains or losses.

[51] Based on all of the foregoing, I find that, from a textual perspective, the phrase "[n]otwithstanding subsection (1)" provides support for either the Obligation Interpretation or the Broad Interpretation.

Case Law

[52] As noted above, there are a number of decisions in which subsection 39(2) has been applied to obligations. Unfortunately, these decisions do not assist me in determining the correct approach since both the Obligation Interpretation and the Broad Interpretation cover obligations. I am not aware of any case where a court has applied subsection 39(2) to a disposition of property.[14] However, that does not mean that the subsection could not be applied in that manner.

CRA Positions

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13 It would also work under the Property Interpretation but, as set out above, I have already rejected that interpretation.

14 I do not consider subsection 39(2) to have been applied in *Rezvankhah v. The Queen* (2002 CarswellNat 3103). In that informal procedure decision, Associate Chief Judge Bowman (as he then was) allowed the $200 exemption in subsection 39(2) to be applied to reduce the taxpayer's foreign exchange gain on the sale of shares. However, he did so because the Crown had conceded that the taxpayer was entitled to that exemption. ACJ Bowman expressed doubt as to whether subsection 39(2) applied and refused to make any determination on the point.

[53] The CRA has changed its mind about subsection 39(2) so many times that its views are hardly helpful. At best CRA's conflicting administrative positions underline the textual ambiguity of the provision. The first interpretation bulletin that the CRA issued on the topic indicated that subsection 39(2) only applied to dispositions of foreign currency.[15] I cannot see any textual interpretation of the subsection that would support that view. An updated version of that interpretation bulletin indicated that subsection 39(2) applied to both the satisfaction of "capital debt obligations" and the disposition of foreign currency by any taxpayer.[16] Later, in the position noted in the discussion of the Restricted Broad Interpretation above, the CRA interpreted subsection 39(2) to apply to the satisfaction of obligations, the disposition of foreign currency and the disposition of any other property so long as the gain or loss arose solely from a fluctuation in the Canadian dollar. As described above, there is nothing in the text of the subsection that would support this view.

Commentary

[54] The ambiguity of subsection 39(2) has not gone unnoticed in the tax community. In describing the subsection, the authors of *Timing and Income Taxation* stated that "it was unclear whether subsection 39(2) was the operative provision for including in income all of a taxpayer's foreign-currency gains and losses, or whether it was intended only to capture those foreign-currency gains and losses that were not otherwise included under subsection 39(1)".[17] Other commentators have similarly noted the ambiguity of subsection 39(2).[18]

Summary

[55] In summary, the text of subsection 39(2) is ambiguous. It could support either the Obligation Interpretation or the Broad Interpretation. As the text does not

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15 IT-95, March 15, 1973, para. 5.

16 IT-95R, December 16, 1980, para. 12 and 13. Given the timing, I presume that the CRA's decision to add obligations to the bulletin was as a result of the decision in *Tahsis Company Ltd.* rather than a change of heart.

17 Brian Arnold, et al., "Foreign-currency Gains and Losses", *Timing and Income Taxation: The Principles of Income Measurement for Tax Purposes*, 2nd ed. (Toronto: Canadian Tax Foundation, 2015), pg. 571.

18 Eric Bretsen and Heather Kerr, "Tax Planning for Foreign Currency", *Report of Proceedings of the Sixty-First Tax Conference*, 2009 Conference Report (Toronto: Canadian Tax Foundation, 2010), 35:1-44. James W. Murdoch and Mark A. Barbour, "Foreign Exchange", 2010 Ontario Tax Conference (Toronto: Canadian Tax Foundation, 2010), 12:1-19.

support the Property Interpretation or the Restricted Broad Interpretation, I will not consider those interpretations in the contextual or purposive analyses.

ii. Contextual Analysis

[56] A contextual analysis of subsection 39(2) reveals weaknesses in the Obligation Interpretation and supports the Broad Interpretation.

Subsection 39(3)

[57] Subsection 39(3) deals with gains or losses that may arise when a taxpayer who has issued bonds, debentures or similar instruments repurchases those obligations. It deems such gains or losses to be capital gains or capital losses. This deeming provision is necessary because the taxpayer is not disposing of property and thus is not caught by the normal capital gain and loss provisions in subsection 39(1).

[58] The relevant portions of subsection 39(3) read:

> Where a taxpayer has issued any bond, debenture or similar obligation and has at any subsequent time in a taxation year and after 1971 purchased the obligation in the open market, . . .
>
> (*a*) the amount, if any, by which the amount for which the obligation was issued by the taxpayer exceeds the purchase price paid or agreed to be paid by the taxpayer for the obligation shall be deemed to be a capital gain of the taxpayer for the taxation year from the disposition of a capital property, and
>
> (*b*) the amount, if any, by which the purchase price paid or agreed to be paid by the taxpayer for the obligation exceeds the greater of the principal amount of the obligation and the amount for which it was issued by the taxpayer shall be deemed to be a capital loss of the taxpayer for the taxation year from the disposition of a capital property,
>
> . . .
>
> [Emphasis added.]

[59] An analysis of subsection 39(3) reveals two key points. First, when dealing with gains and losses, if Parliament wants to describe something that is an obligation, it uses the word "obligation". The word appears multiple times in

subsection 39(3).[19] In light of this, the absence of the word "obligation" in subsection 39(2) significantly undermines the Obligation Interpretation. It suggests that Parliament did not use that word because it wanted subsection 39(2) to catch more than just obligations. It wanted the subsection to also catch foreign exchange gains and losses from dispositions of capital property.

[60] The second point that the contextual analysis of subsection 39(3) reveals involves the phrase "notwithstanding subsection (1)". That phrase does not appear in subsection 39(3). Subsections 39(1), (2) and (3) were all introduced at the same time. The presence of the phrase "[n]otwithstanding subsection (1)" in subsection 39(2) and the corresponding absence of the same phrase in subsection 39(3) must therefore be presumed to have been intentional. So why does the phrase not appear in subsection 39(3)? Subsection 39(3) deals with obligations. It deems the gains or losses from those obligations to be capital gains or losses. Under the Obligation Interpretation, this is exactly what subsection 39(2) would do to foreign exchange gains and losses on obligations. So if both provisions deem gains and losses on obligations to be capital gains and losses, why would Parliament think it needed to clarify that subsection 39(2) applied notwithstanding subsection 39(1) but not make the same clarification in subsection 39(3)? The absence of a logical explanation suggests that the Obligation Interpretation is not the correct interpretation.

[61] In the textual analysis, I concluded that the phrase "[n]otwithstanding subsection (1)" could support either the Obligation Interpretation or the Broad Interpretation if one interpreted the phrase as meaning "despite the definitions in subsection (1)". However, the contextual analysis of subsection 39(3) now reveals that Parliament did not consider this phrase necessary when deeming a gain or loss from an obligation to be a capital gain or loss. If subsection 39(2) only applied to obligations there would be no need for the phrase. This undermines the Obligation Interpretation and supports the Broad Interpretation. It indicates that Parliament inserted the phrase "[n]otwithstanding subsection (1)" into subsection 39(2) because Parliament intended subsection 39(2) to cover things that would otherwise be caught by subsection 39(1) – dispositions of property.[20]

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19 Parliament also uses the word "obligation" in numerous other places in the Act to refer to bonds, debentures, notes or similar borrowings from the perspective of the debtor. See, for example, the debt forgiveness provisions in section 80.

20 This interpretation of the phrase would also support the Property Interpretation but, as I have already rejected that interpretation, I need not consider it.

Summary

[62] Based on all of the foregoing, I find that the contextual analysis of subsection 39(2) supports the Broad Interpretation and significantly undermines the Obligation Interpretation.

iii. Purposive Analysis

[63] The purposive analysis of subsection 39(2) supports the Broad Interpretation.

[64] Both parties agree that subsection 39(2) catches foreign exchange gains and losses arising from the satisfaction of obligations. There is a good policy reason why Parliament would want the subsection to do so. As set out above, such gains and losses are not caught by subsection 39(1) as they do not result from the disposition of property. If they were not caught by subsection 39(2), they would be left untaxed. The question is whether Parliament intended to limit the application of subsection 39(2) to obligations or whether it also wanted subsection 39(2) to catch foreign exchange gains and losses from the disposition of property?

Deeming Provision

[65] Subsection 39(2) is a deeming provision. Deeming provisions are designed to create legal fictions that differ from reality.[21] In the case of subsection 39(2), the subsection deems a foreign exchange gain or loss to be a capital gain or loss that arose from the disposition of currency. There are two parts to the deeming provision. The first part deems the gain or loss to be a capital gain or loss. The second part deems that capital gain or loss to be from the disposition of a certain type of property, namely a foreign currency. I will examine these two parts of the deeming provision separately.

(a) Deemed to be a capital gain or loss: The first part of the deeming provision deems a foreign exchange gain or loss to be a capital gain or loss. When dealing with obligations, the purpose of this part of the deeming provision is clear. As discussed above, obligations are not property so a gain or loss arising from satisfying an obligation is not caught by the definitions of capital gain or capital loss in subsection 39(1). Therefore, if Parliament wanted to tax the gain or loss as a

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21 *The Queen v. Verrette*, [1978] 2 SCR 838.

capital gain or loss, it needed to deem it to be a capital gain or loss. By contrast, when dealing with a disposition of property, the first part of the deeming provision is entirely redundant. A disposition of property already falls within the definitions of capital gain or loss under subsection 39(1) so there is no need to deem it to be a capital gain or loss. In summary, the first part of the deeming provision supports both the Obligation Interpretation and the Broad Interpretation. Both interpretations cover obligations, therefore both interpretations need to deem gains and losses from the satisfaction of those obligations to be deemed to be capital gains or losses. The fact that the first part of the deeming provision only affects some of the gains and losses caught by the Broad Interpretation does not mean it is unnecessary.

(b) Deemed to arise from the disposition of a foreign currency: The second part of the deeming provision deems the capital gains and losses to have arisen from the disposition of a foreign currency as opposed to some other type of property. I cannot see any purpose to this recharacterization if the foreign exchange gain or loss arises from the satisfaction of an obligation. Why would Parliament have needed to deem a capital gain or loss arising from an obligation to instead be from a specific type of property? Why not simply deem them to be from property in general? The lack of a clear explanation suggests that the second part of the deeming provision has a different purpose that is unrelated to obligations. The second part of the deeming provision has more meaning under the Broad Interpretation. Under the Broad Interpretation, subsection 39(2) also catches dispositions of property. Consequently, the second part of the deeming provision has the effect of deeming those dispositions to be dispositions of a foreign currency instead of dispositions of whatever property the taxpayer had actually disposed of. There is an arguable reason why Parliament would have wanted to do this. Parliament could have wanted to deem foreign exchange gains and losses arising from the disposition of property to instead arise from the disposition of currency in order to ensure that provisions of the Act designed to deal with specific types of property did not apply to the portion of a gain or loss caused by fluctuations in the Canadian dollar.[22] While there is no evidence that this was

[22] For example, Parliament could have wanted foreign exchange losses on loans or shares that would otherwise qualify as allowable business investment losses not to be treated as allowable business investment losses.

> Parliament's intent, the possibility at least provides meaning to the second effect of the deeming provision – meaning that is otherwise missing from both interpretations. I note that this is exactly the use of the deeming provision that BMO wants to occur in its case. It wants what would otherwise be a capital loss from the disposition of shares to be deemed to be a capital loss from the disposition of a foreign currency so that a provision of the Act (i.e. subsection 112(3.1)) specifically designed to deal with the disposition of shares does not apply. It would be circular reasoning if I were to use this potential application to justify the very interpretation that BMO needs in order to have the potential application apply. For that reason, I raise this example simply to illustrate how the second part of the deeming provision could have meaning under the Broad Interpretation, not to conclude that it does have that meaning.

[66] It is interesting to note that neither part of the deeming provision would have any effect if the property in question were foreign currency (as opposed to a property denominated in foreign currency). In that case, there would neither be a reason to deem the gain or loss to be a capital gain or loss nor a reason to deem it to be from the disposition of currency as both of these things would already be true. I highlight this anomaly because, as discussed in more detail below, it appears that Parliament intended subsection 39(2) to apply to gains and losses arising from the disposition of foreign currency.

[67] In summary, under the Obligation Interpretation, there is purposive support for the first part of the deeming provision but no purposive support for the second part of the deeming provision. Under the Broad Interpretation, there is purposive support for the first part of the deeming provision and potential, but unproven, purposive support for the second part of the deeming provision. Thus, the purposive analysis of the deeming provision slightly favours the Broad Interpretation.

$200 Exemption for Individuals

[68] Subsection 39(2) contains a $200 exemption. The first $200 of an individual's foreign exchange gains and losses under subsection 39(2) are excluded from his or her deemed capital gains and losses. The presence of this exemption strongly favours the Broad Interpretation.

[69] The Obligation Interpretation would result in the exemption having anomalous results. Individuals who borrowed money in a foreign currency could actually find themselves worse off. Say a taxpayer borrowed US dollars to buy shares denominated in US dollars. Now say the value of the US dollar rose by the time the taxpayer sold the shares and repaid the loan such that the taxpayer had a $500 foreign exchange gain on the shares and a matching $500 foreign exchange loss on the repayment of the loan. Under the Obligation Interpretation, without the exemption, the gain and loss would net out. With the exemption, the taxpayer would actually be worse off. The $500 foreign exchange gain on the shares would be caught under subsection 39(1). As there is no $200 exemption in subsection 39(1), the taxpayer would have to report the full gain. By contrast, the $500 foreign exchange loss would be caught under subsection 39(2) where the exemption would deny the taxpayer the first $200 of his loss on the loan. The net result would be that the taxpayer would have a $200 capital gain. Conversely, if the exchange rate had moved in the other direction, the individual would have a $200 capital loss as a result of having had his $500 foreign exchange gain on the loan reduced by $200 and the full $500 foreign exchange loss caught by subsection 39(1). I cannot see any policy reason why Parliament would want either of these mismatched outcomes.

[70] The mismatched outcomes described above would not occur under the Broad Interpretation. This is because the taxpayer's foreign exchange gain or loss on the shares and his corresponding foreign exchange loss or gain on the loan would both be caught by subsection 39(2). As a result, the exemption would apply to both amounts. The gain (be it on the loan or the shares) would be reduced by $200 under paragraph 39(2)(*a*) and the loss (be it on the loan or the shares) would be reduced by $200 under paragraph 39(2)(*b*). The net result would be that the taxpayer would have neither a gain nor a loss. This is exactly the position that the taxpayer would have been in without the exemption.

[71] From a policy perspective, the $200 exemption makes little sense under the Obligation Interpretation. I cannot think of a viable policy reason why Parliament would have included the exemption if subsection 39(2) only applied to obligations. Why would Parliament create an exemption specifically designed for individuals who had incurred small foreign exchange gains or losses when repaying money that they had borrowed in foreign currencies? There simply does not seem to be a pressing need or policy reason for this type of exemption. Moreover, why would Parliament have felt that such an exemption should apply to those individuals but not to individuals who incurred small foreign exchange gains or losses disposing of property?

[72] The presence of the $200 exemption makes much more sense under the Broad Interpretation. Under the Broad Interpretation, the exemption applies to more types of foreign exchange gains and losses and thus relieves a larger number of individuals from the burden of calculating, tracking and reporting those gains and losses on their returns. The extent of this relief becomes particularly evident when one focuses on one specific type of property that is commonly held and disposed of by individuals resulting in foreign exchange gains and losses – foreign currency itself. Individuals regularly dispose of small amounts of foreign currency, particularly when travelling. In doing so, they incur small gains or losses from fluctuations in the Canadian dollar. One can understand why Parliament might want to exempt the first $200 of those gains and losses from the application of subsection 39(2). Such gains and losses would be extremely difficult to track and audit. Furthermore, individuals would be unlikely to realize that they had to track and report these gains and losses and unsure how to do so. Asking a taxpayer to record her daily dispositions of British pounds, French francs and German deutschmarks in order to ensure that she can correctly calculate her foreign currency gains and losses on her return from her European vacation would hardly have been a politically popular move.[23] With the exemption in place, most taxpayers would never have to worry about gains or losses from the disposition of a foreign currency for the simple reason that they would be unlikely to dispose of enough foreign currency in a given year to exceed the exemption. Subsection 39(2) was introduced in 1972. The amount of the exemption has not changed since that time. Accordingly, what seems like a reasonable exemption by today's standards would actually have been relatively generous in 1972 dollars. For a taxpayer who disposed of $1,000 USD to realize a foreign exchange gain or loss in excess of $200, the Canadian dollar would have had to have moved by more than $0.20 since she acquired the foreign currency. Even a disposition of $10,000 USD would only have exceeded the exemption if the dollar had moved by more than $0.02.

[73] In summary, under the Obligation Interpretation, the exemption both lacks any apparent policy reason and leads to anomalous results. The most compelling policy explanation for the $200 exemption is that it exempts gains and losses arising from the disposition of foreign currency itself. However, the exemption would only catch foreign currency under the Broad Interpretation since foreign currency is a form of property and, as a result, would not be caught under the Obligation Interpretation. Based on all of the foregoing, I find that the presence of the $200 exemption strongly supports the Broad Interpretation.

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[23] Subsection 39(2) was introduced long before the introduction of the Euro.

Summary

[74] In summary, the purposive analysis strongly supports the Broad Interpretation. The deeming provision slightly favours the Broad Interpretation and the $200 exemption strongly favours it.

iv. Conclusion

[75] Based on all of the foregoing, I find that the Broad Interpretation of subsection 39(2) is the correct interpretation. The text of the subsection is ambiguous. It supports either the Obligation Interpretation or the Broad Interpretation. The contextual analysis reveals significant weaknesses in the Obligation Interpretation and supports the Broad Interpretation. Finally, the purposive analysis strongly favours the Broad Interpretation.

[76] Having concluded that the Broad Interpretation is the correct interpretation, it follows that subsection 39(2) applies to foreign exchange gains and losses arising from the disposition of property. Since the disposition of the NSULC common shares was a disposition of property, I find that subsection 39(2) applied to deem the capital loss on the disposition of those shares to be a capital loss from the disposition of currency rather than a capital loss from the disposition of shares. As mentioned above, subsection 112(3.1) grinds losses from the disposition of shares, not losses from the disposition of currency. Therefore, even if the NSULC preferred shares had never been created or used to distribute dividends, subsection 112(3.1) would not have applied to grind the loss on the NSULC common shares. BMO could not have received a tax benefit by avoiding a grind that would never have occurred. Accordingly, I find that BMO did not receive a tax benefit.

v. Post-Period Amendments

[77] Subsection 39(2) was amended in 2013.[24] I have not relied on those amendments or the accompanying explanatory notes in reaching the above conclusion. I am aware of the dangers of relying on subsequent amendments to interpret a predecessor provision.[25] That said, having already reached my

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[24] The amendments generally had effect for taxation years ending after August 19, 2011.

[25] *The Queen v. Oxford Properties Group Inc.*, 2018 FCA 30, at para. 86.

conclusion as to the proper interpretation of subsection 39(2), it is interesting to note that the Department of Finance appears to agree with me.

[78] The explanatory notes that accompanied the amendments to subsection 39(2) make it clear that the Department of Finance intended to significantly alter the existing scheme of subsections 39(1) and (2) to move away from the Broad Interpretation towards an even narrower version of the Obligation Interpretation. The first amendment is described as follows:[26]

> . . . subsection 39(2) will now apply only to debt and similar obligations that are denominated in foreign currency. Thus, foreign exchange gains and losses in respect of asset dispositions, including dispositions of foreign currency, will now be determined . . . exclusively under subsection 39(1). Also, amended subsection 39(2) will have no application to foreign exchange gains made, or losses sustained, by a corporate taxpayer in respect of shares of its capital stock.

[79] This amendment makes it clear that the Department of Finance believed that the prior version of subsection 39(2) applied to both dispositions of property and the satisfaction of obligations. In other words, it makes it clear that the Department of Finance believed that the Broad Interpretation applied.

[80] At the same time that subsection 39(2) was amended, Parliament introduced a new subsection. The explanatory notes for subsection 39(1.1) state:[27]

> New subsection 39(1.1) . . . is being added consequential to the removal from subsection 39(2) of the rule that reduces the net amount of an individual's gains and losses for a taxation year from certain foreign currency fluctuations by $200. As noted below, subsection 39(2) will no longer apply to dispositions of foreign currency (i.e. money). Since the intent of the $200 carve-out rule for individuals was to provide a *de minimis* amount in respect of holdings of foreign currency, this objective will now be better achieved through a separate rule that contemplates only foreign exchange capital gains and losses from dispositions of foreign currency. New subsection 39(1.1) also ensures that this carve-out rule does not apply to trusts.
>
> [Emphasis added.]

[81] This note makes it clear that the Department of Finance believed both that the existing version of subsection 39(2) applied to dispositions of foreign currency and that the intent of the $200 exemption had always been to help individuals

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26 Department of Finance Explanatory Notes, October 24, 2012.

27 Department of Finance Explanatory Notes, October 24, 2012.

holding foreign currency. In other words, it again makes it clear that the Department of Finance believed that the Broad Interpretation applied.

[82] Again, I emphasize that I have included the foregoing comments on the explanatory notes for the simple purpose of demonstrating that the Department of Finance appears to agree with my conclusions. I have not relied on them in reaching those conclusions.

C. Abuse

[83] Having concluded that BMO did not receive a tax benefit, there is no need for me to consider whether there was an abuse of subsection 112(3.1). I would, however, like to thank counsel for their very detailed and helpful submissions on that complex issue.

D. Conclusion

[84] Based on all of the above, the appeal is allowed and the matter referred back to the Minister for reassessment on the basis that the GAAR does not apply to the transactions in question.

E. Costs

[85] Costs are awarded to BMO. The parties shall have 30 days from the date hereof to reach an agreement on costs, failing which BMO shall have a further 30 days to file written submissions on costs and the Respondent shall have yet a further 30 days to file a written response. Any such submissions shall not exceed 10 pages in length. If the parties do not advise the Court that they have reached an agreement and no submissions are received within the foregoing time limits, costs shall be awarded to BMO as set out in the Tariff.

Signed at Ottawa, Canada, this 12th day of September 2018.

"David E. Graham"

Graham J.

Appendix "A"
Partial Agreed Statement of Facts

Court File No.: 2016-445(IT)G

TAX COURT OF CANADA

BETWEEN:

BANK OF MONTREAL

Appellant

– and –

HER MAJESTY THE QUEEN

Respondent

PARTIAL AGREED STATEMENT OF FACTS

The Appellant and the Respondent agree to the following facts, provided that such admissions are made for the purpose of these proceedings only, and the parties are permitted to adduce additional evidence which is not contrary to these agreed facts.

Background

1. The Bank of Montreal ("**BMO**") is a chartered bank named on Schedule 1 of the *Bank Act*. BMO's year-end is October 31.

2. BMO G.P. Inc. ("**BMO GP**") is a Canadian wholly-owned subsidiary of BMO.

3. BMO Funding L.P. ("**Funding LP**") is a Nevada limited partnership which has elected to be treated as a corporation for US tax purposes.

4. BMO (NS) Investment Company ("**NSULC**") is a Nova Scotia unlimited liability company. NSULC was a disregarded entity for US tax purposes.

5. BMO (US) Funding LLC ("**LLC**") is a Delaware limited liability company. LLC was a disregarded entity for US tax purposes.

6. The Harris Group is a US group of companies wholly-owned by BMO, carrying on an active banking business in the US, primarily with US-based clients.

7. The following entities were members of the Harris Group at the relevant times:

   (a) Harris Financial Corp. ("**HFC**") a US resident corporation and direct wholly-owned subsidiary of BMO. HFC is a holding company for the Appellant's US operations;

   (b) Harris N.A., a national bank incorporated under the laws of the US and a subsidiary of HFC;

   (c) BMO Capital Markets Financing, Inc. ("**CMFI**"), formerly known as Harris Nesbitt Financing, Inc., a US resident lending company and a subsidiary of HFC.

Transactions in 2005

8. In 2005, BMO carried out a series of transactions in relation to a US financing.[1]

9. On April 20, 2005, Funding LP was established as a Nevada limited partnership with BMO GP as the general partner with a 0.1% interest and BMO as a limited partner with a 99.9% interest. On the formation of Funding LP, BMO GP made a capital contribution of USD $1 and BMO made a capital contribution of USD $999.[2]

10. On May 5, 2005, NSULC was incorporated as an unlimited company and wholly-owned subsidiary of Funding LP.[3]

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[1] Copy of the Index of the Closing Agenda, Tab 1

[2] Limited Partnership Agreement of Funding LP, Tab 2; Minutes of a Meeting of the Board of Managers of Funding LP, dated April 26, 2005, Tab 3

[3] Memorandum of Association for NSULC, Tab 4; Resolution of the sole director of NSULC dated June 6, 2005, Tab 5

11. On the incorporation of NSULC, Funding LP subscribed for one common share of NSULC for USD $1,000.[4]

12. On May 12, 2005, LLC was formed by NSULC as a Delaware limited liability company.[5]

13. On the formation of LLC, NSULC made an initial capital contribution of USD $1,000 for one common share of LLC.[6]

14. On May 12, 2005, NSULC and LLC entered into a Share Exchange Rights Agreement.[7]

15. On May 12, 2005, LLC and Funding LP entered into a Share Subscription Rights Agreement. Funding LP paid LLC USD $1,000 as consideration for entering into this agreement.[8] BMO and BMO GP made additional capital contributions to Funding LP in the amounts of USD $999 and USD $1 respectively, to fund this payment.

16. On June 6, 2005:

    (a) The sole director of NSULC passed a resolution that, among other things, authorized Preferred shares, Series 1, which were to consist of 100,000 shares with a redemption value set at USD $1,000 per share, plus all declared and unpaid dividends thereon.[9]

    (b) The Limited Liability Company Agreement of LLC was amended to, among other thing, authorize Series 1 and Series 2 of both Class A shares and Preferred shares, and to set the minimum dividend payable on the Series 1 and Series 2 of the Preferred shares.[10]

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[4] NSULC's Shareholder's Register and Shareholder's Ledger, Tab 6

[5] Limited Liability Company Agreement of BMO (US) Funding LLC, Tab 7

[6] Minutes of meeting of the Board of Directors of LLC held on May 12, 2005, Tab 8

[7] Share Exchange Rights Agreement dated May 12, 2005 between NSULC and LLC, Tab 9

[8] Share Subscription Rights Agreement dated May 12, 2005 between Funding LP and LLC, Tab 10; Minutes of a meeting of board of directors of LLC, held on June 6, 2005, Tab 11

[9] Resolution of the Sole Director of NSULC dated June 6, 2005, Tab 12

[10] Amendment to Limited Liability Company Agreement of LLC dated June 6, 2005, Tab 13

(c) LLC and HFC entered into a senior loan agreement.[11]

(d) LLC and HFC entered into a subordinated loan agreement.[12]

17. On June 7, 2005:

(a) BMO, acting through its Chicago Branch, borrowed USD $150,000,000 from arm's length lenders (the "Senior Note"). The Senior Note was due June 16, 2010.[13]

(b) BMO subscribed for common shares of BMO GP for USD $149,460.

(c) BMO GP made a capital contribution of USD $ 149,460 to Funding LP. [14]

(d) BMO used part of the proceeds of the Senior Note to make a capital contribution of USD $149,310,000 to Funding LP.[15]

(e) Funding LP subscribed for 149,220 common shares of NSULC for USD $149,220,000.[16]

(f) NSULC subscribed for 149,170 common shares of LLC for USD $149,170,000.[17]

(g) NSULC exchanged its 149,170 common shares of LLC for 149,170 Preferred Shares, Series 1 of LLC pursuant to the Share Rights Exchange Agreement.[18]

(h) Funding LP subscribed for 149,170 Class A Shares, Series 1 of LLC for USD $149.17.[19]

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[11] Senior Loan Agreement, Tab 14

[12] Subordinated Loan Agreement, Tab 15

[13] The term sheet for the Senior Note, Tab 16

[14] Minutes of the meeting of the Board of Managers of Funding LP held on June 6, 2005, Tab 17

[15] Minutes of the meeting of the Board of Managers of Funding LP held on June 6, 2005, Tab 17

[16] Subscription form dated June 7, 2005, Tab 18

[17] Subscription form dated June 7, 2005, Tab 18

[18] Share Exchange Agreement dated June 7, 2005, Tab 19

[19] Share Subscription Agreement dated June 7, 2005, Tab 20

18. On June 9, 2005:

(a) Funding LP borrowed USD $1,250,000,000 from arm's length banks (the "Euro Notes"). The Euro Notes were due June 16, 2010.[20]

(b) Funding LP used part of the proceeds of the Euro Notes to subscribe for 1,247,130 common shares of NSULC for USD $1,247,130,000.[21]

(c) NSULC subscribed for 1,247,130 common shares of LLC for USD $1,247,130,000.[22]

(d) NSULC exchanged its 1,247,130 common shares of LLC for 1,247,130 Preferred Shares, Series 2 of LLC pursuant to the Share Rights Exchange Agreement.[23]

(e) Funding LP subscribed for 1,247,130 Class A Shares, Series 2 of LLC for USD $1,247.13[24]

19. On June 7 and 9, 2005, LLC made loans to HFC and Harris N.A. totaling USD $1,396,215,000 ("LLC Loans") as follows:

(a) LLC made four senior loans to HFC in the aggregate principal amount of USD $896,215,000.[25]

(b) LLC made a subordinated loan to HFC in the principal amount of USD $250,000,000.[26]

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[20] Offering Circular for the Euro Notes, Tab 21

[21] NSULC's Shareholder's Register and Shareholder's Ledger, Tab 6; Subscription form dated June 9, 2005, Tab 22

[22] Subscription form dated June 9, 2005, Tab 22

[23] Share Exchange Agreement dated June 9, 2005, Tab 23

[24] Share Subscription Agreement dated June 9, 2005, Tab 24

[25] Senior Loan Agreement, Tab 14; Promissory Note in the amount of USD $896,215,000, Tab 25

[26] Subordinated Loan Agreement, Tab 15; Promissory Note (Subordinated) in the amount of USD $250,000,000, Tab 26

(c) LLC made a loan to Harris N.A. in the principal amount of USD $250,000,000.[27]

20. On June 9, 2005, HFC made a loan to CMFI (under its former name Harris Nesbitt Financing Inc.) in the principal amount of USD $545,000,000.[28]

21. On October 28, 2005, NSULC paid a stock dividend of USD $100,000 on its common shares, satisfied by the issuance of 100 Preferred Shares, Series 1 of NSULC to Funding LP.[29]

22. On November 28, 2005, the board of directors of LLC approved a non-binding dividend policy.[30]

23. On November 28, 2005, the board of directors of NSULC approved a non-binding dividend policy.[31]

Quarterly Transactions between 2005 and 2010

24. On a quarterly basis, the following payments were made:

(a) LLC received interest in USD from the Harris Group under the respective LLC Loans. The interest received by LLC was deemed to be active business income in the hands of LLC under subparagraphs 95(2)(a)(ii)(A) and/or 95(2)(a)(ii)(D) of the *Income Tax Act*. LLC's interest income from the LLC Loans was reported as, for each year:

2005	US$21,014,972
2006	US$72,946,023
2007	US$79,635,514
2008	US$53,048,391
2009	US$22,762,182
2010	US$4,537,654

[27] Promissory Note in the amount of USD $250,000,000, Tab 27

[28] Promissory Note in the amount of USD $545,000,000, Tab 28

[29] NSULC's Shareholder Register and Shareholder's Ledger, Tab 6; Resolution of the Sole Director of NSULC dated September 12, 2005, Tab 29

[30] Minutes of the meeting of the Board of Directors of LLC held on November 28, 2005 with attached Dividend Policy as Exhibit A, Tab 39

[31] Resolution of the sole director of NSULC held on November 28, 2005 and attached Dividend Policy, Tab 30

Total	**US$253,944,736**

(b) LLC paid dividends, in USD, on its Preferred Shares, Series 1 and Series 2 to NSULC out of the interest received from the Harris Group.[32] For the purpose of computing its taxable income, NSULC deducted these dividends pursuant to paragraph 113(1)(a) of the Act as they were paid from LLC's exempt surplus. The CAD equivalent amount of the dividends from LLC that NSULC reported as income in its Canadian tax return was, for each year:

2005	CAD$22,927,092
2006	CAD$76,761,000
2007	CAD$78,044,000
2008	CAD$51,833,000
2009	CAD$27,971,000
2010	CAD$24,512,000
Total	**CAD$282,048,092**

(c) NSULC paid dividends, in USD, on its Preferred Shares, Series 1 to Funding LP out of the dividends received from LLC. The total CAD-equivalent amount of dividends reported for Canadian income tax purposes was $288,054,558.[33] Other than the stock dividend of USD $100,000 it paid on its common shares on October 28, 2005, NSULC did not pay dividends on any other class or series of shares in its share capital.

(d) Pursuant to the terms of its Limited Partnership Agreement, 99.9% of Funding LP's income was attributed to the Appellant, and 0.1% was attributed to BMO GP.[34] The CAD equivalent amount of dividends received from NSULC that the Appellant

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[32] Copy of the financial statements of NSULC for taxation years ending October 31, 2005 to October 31 2011, Tabs 31 to 37 incl.; Minutes of the meetings of the Board of Directors of LLC, Tabs 38 to 55 incl.

[33] Resolutions of the Sole Director of NSULC with respect to quarterly dividend payments, Tabs 12, 29, 30, 56 to 73 incl.; Minutes of meetings of the Board of Manages of Funding LP, Tabs 74 to 89 incl.

[34] Copy of excerpts of the financial statements of Funding LP for the taxation years ending October 31, 2006 to October 31, 2009, Tab 90

reported as income (and for which it requested corresponding subsection 112(1) deductions) in its Canadian tax return was, for each year:

2005	CAD$23,114,221
2006	CAD$82,506,898
2007	CAD$77,965,956
2008	CAD$51,777,414
2009	CAD$27,942,736
2010	CAD$24,459,278
Total	**CAD$287,766,503**

(e) Funding LP paid interest, in USD, on the Euro Notes out of the dividends received from NSULC.

(f) BMO's Chicago branch paid interest on the Senior Note in USD.

25. On September 21, 2009, Harris N.A. prepaid a USD $250,000,000 loan from LLC. On or about the same day, LLC used the proceeds of the loan repayment to loan USD $250,000,000 to CMFI.

Transactions in 2010

26. In June 2010, the following transactions occurred.[35]

27. On June 7, 2010:

(a) The sole director of NSULC passed resolutions which outlined a step plan for the repayment of the Euro Notes.[36]

(b) NSULC and Funding LP entered into a Transfer of Assets and Assumption of Liabilities Agreement.[37]

28. On June 15, 2010:

(a) The Harris Group repaid all outstanding principal and interest on the LLC Loans.

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[35] Closing Agenda, Tab 91

[36] Resolutions of the Sole Director of NSULC, Tabs 73, 92

[37] Transfer of Assets and Assumption of Liabilities Agreement, Tab 93

(b) LLC paid final dividends to NSULC in the amount of USD $2,238,657 on the Preferred shares, Series 1, and in the amount of USD $18,716,210 on the Preferred shares, Series 2. A paragraph 113(1)(a) deduction was claimed by NSULC on the CAD $ equivalent of the paid dividends.

(c) NSULC paid final dividends to Funding LP in the amount of USD $20,927,375 on its Preferred Shares, Series 1. A section 112 deduction was claimed by BMO and by BMO GP on the CAD $ equivalent of their respective partnership allocation.

29. On June 16, 2010:

(a) LLC was wound up and its assets consisting of USD $1,396,424,911 in cash were distributed to its shareholders, NSULC and Funding LP, in the respective amounts of USD $1,396,300,000 and USD $124,911.

(b) NSULC was wound up and its assets consisting of USD $1,396,474,316 in cash were distributed to its sole shareholder, Funding LP.

(c) Funding LP repaid the Euro Notes in the principal amount of USD $1,250,000,000 together with final interest.

(d) BMO repaid the Senior Note in the principal amount of USD $150,000,000.

30. All of the transactions described above constitute a series of transactions.

BMO's 2010 Taxation Year

31. The CAD/USD exchange rate was 1.2550 on June 9, 2005 and 1.0236 on June 16, 2010.

32. BMO realized a foreign exchange gain of $33,357,326 on repayment of the Senior Note. The gain was on capital account.

33. For the 2010 taxation year, Funding LP reported a net capital loss of $32,379,865.[38] The computation of this amount included:

    (a) a capital gain of $289,250,000 on the repayment of the Euro Notes;

    (b) a capital loss of $321,755,973 in respect of the NSULC common shares; and

    (c) a capital gain of $126,108 in respect of the Class A shares of LLC.

34. In reporting its income for the 2010 taxation year, BMO reported its proportionate share (99.9%) of Funding LP's net capital loss, being $32,347,485.

The Minister's Reassessment

35. The Minister of National Revenue (the "Minister") reassessed BMO's 2010 taxation year (the "Reassessment").[39]

36. By way of the Reassessment, the Minister:

    (a) included an amount in BMO's income in respect of a capital gain on the Senior Note;

    (b) made no adjustment to the capital gain realized by Funding LP on the repayment of the Euro Notes;

    (c) reduced BMO's share of the loss in respect of the NSULC common shares by the amount of $287,766,503, being BMO's share of the cash dividends paid by NSULC on its Preferred Shares, Series 1 after conversion to Canadian dollars.

37. The Reassessment is based solely on the general anti-avoidance rule in section 245 of the *Income Tax Act*.

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[38] Information Return of Partnership Income of Funding LP for the year ending on October 31, 2010, Tab 94

[39] Notices of Reassessment of November 5, 2015 and December 30, 2015 in respect of BMO's 2010 taxation year, Tabs 95, 96. In auditing BMO, the CRA prepared an Audit Report (Tab 97), and sent a proposal letter dated April 22, 2015 (Tab 98) and a letter dated November 19, 2015 (Tab 99).

DATED at Toronto, in the Province of Ontario this 31st day of May, 2018

DATED at Montreal, in the Province of Québec this 31st day of May, 2018

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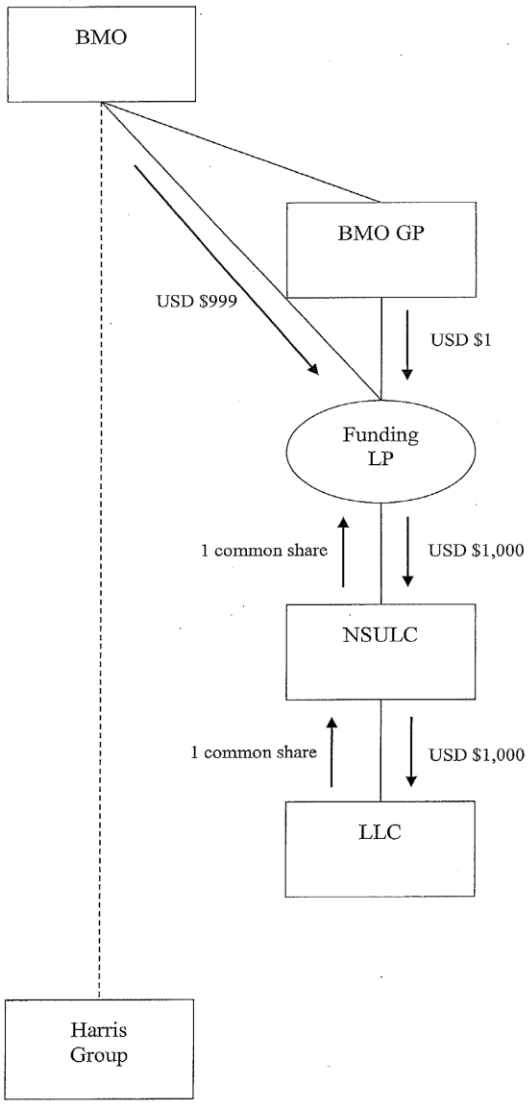
Appendix "B"
BMO's Simplified Diagrams

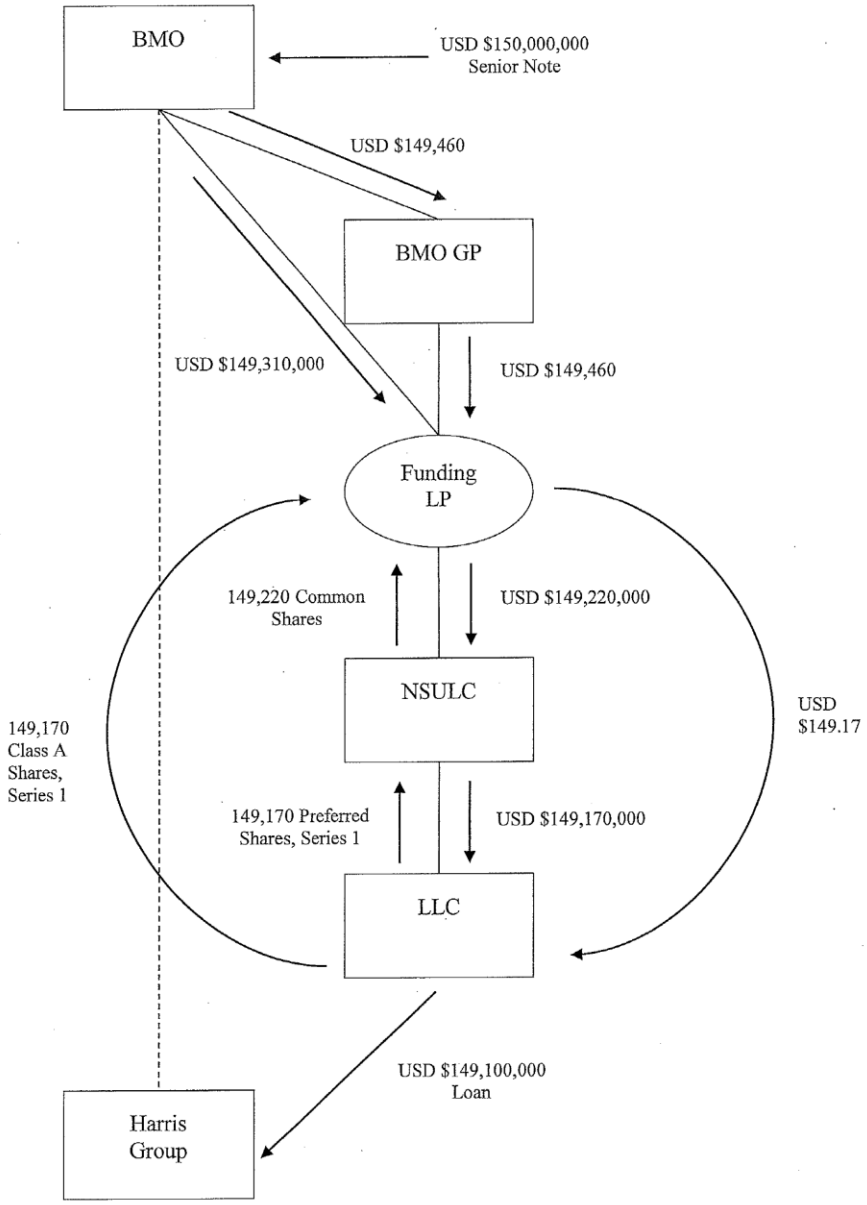
SCHEDULE A: SIMPLIFIED CHART – INITIAL INVESTMENTS

APRIL 20 – JUNE 6, 2005 (Partial Agreed Statement of Facts, paras 9-13)



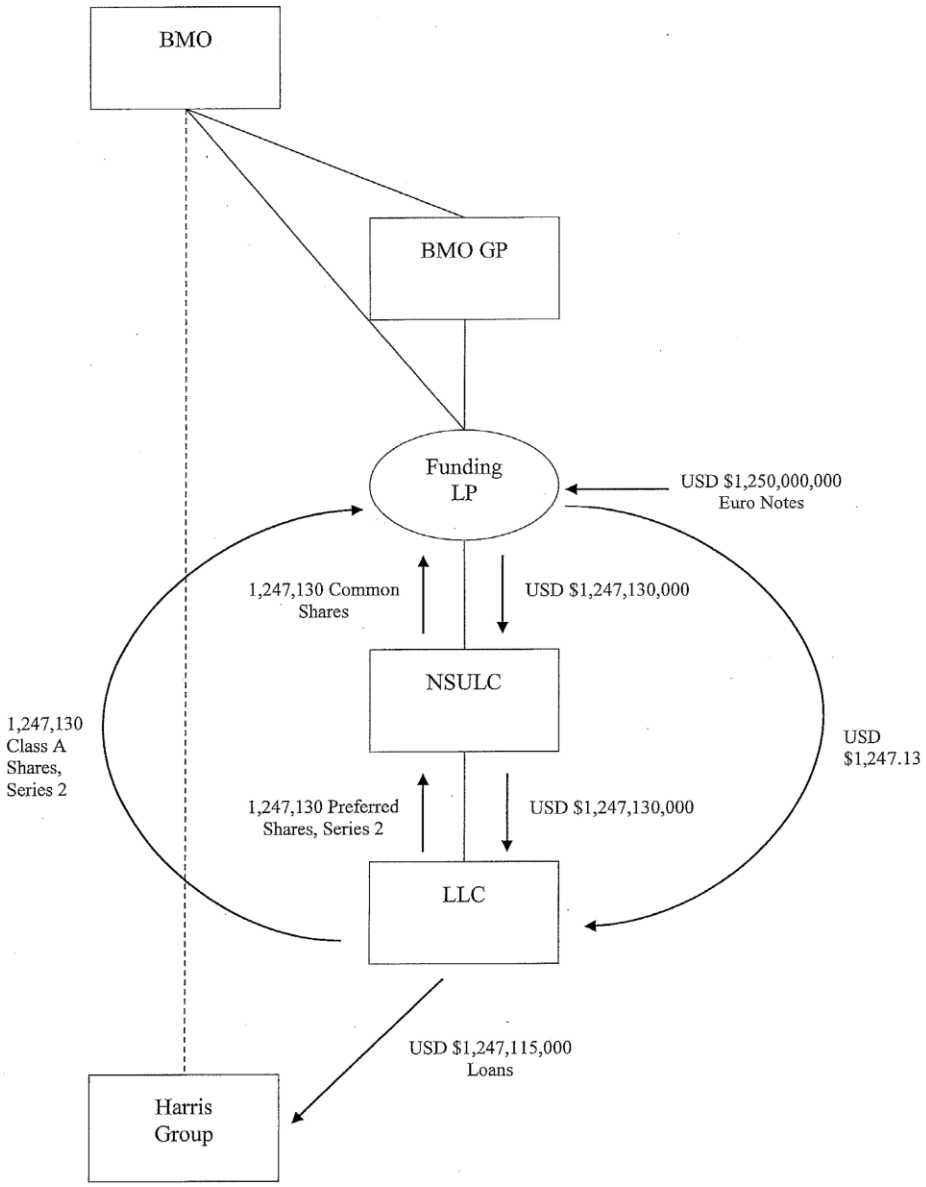
SCHEDULE B: SIMPLIFIED CHART - SENIOR NOTE FUNDING

JUNE 7, 2005 (Partial Agreed Statement of Facts, paras 17 & 19)



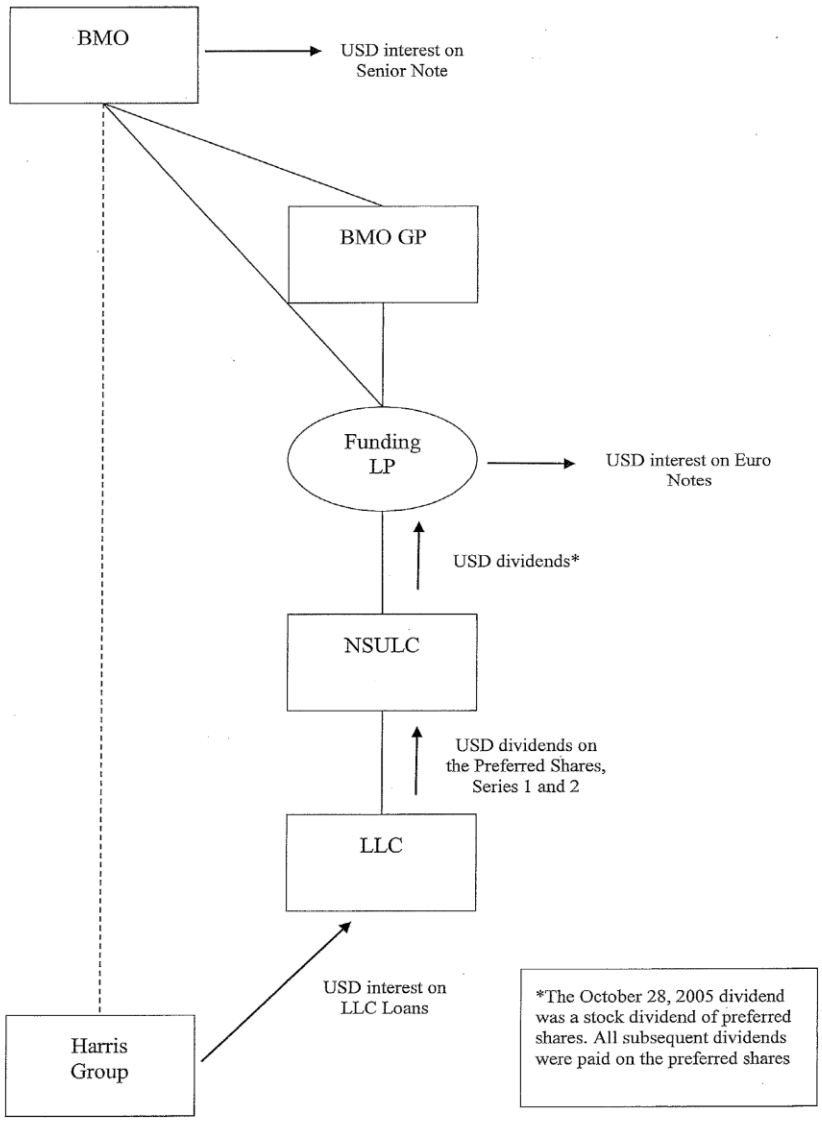
SCHEDULE C: SIMPLIFIED CHART – EURO NOTES FUNDING

JUNE 9, 2005 (Partial Agreed Statement of Facts, paras 18-19)



SCHEDULE D: SIMPLIFIED CHART - QUARTERLY TRANSACTIONS

(Partial Agreed Statement of Facts, para 24)



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DATE OF JUDGMENT:	September 12, 2018

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