The Taxation of Securities Transactions — I: Policy Analysis and Canadian Treatment

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Introduction

Capital gains form only a small portion of the tax base,[1] but they are an important component of the incomes of wealthy Canadians.[2] Securities transactions are a significant source of capital gains and losses.[3] Securities transactions not only involve large numbers of taxpayers but also account for a large percentage of the net gains and losses reported by taxpayers. Although only general breakdowns of income by source and income class are available, they provide an adequate basis for concluding that securities transactions are a major source of capital gains and losses. Since capital gains taxation was introduced,[4] securities transactions have been a major source of gain in an inflationary economy[5] and the major source of losses in a recession.[6]

The percentage of gain or loss from real estate transactions has been growing steadily since 1971, as taxpayers find it harder to delay disposition.[7] However, realizations of shares should continue to outstrip dispositions of real property, even though real property constitutes one of the major sources of wealth in Canada. One

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1 Figures are available only through 1976. In 1972, total net taxable capital gains amounted to .22% of all incomes reported. In 1973, the figure hovered around .3% and in 1975 jumped to 3.65% of all incomes. See App. 1.

2 *Ibid.*

3 Of all taxpayers who reported net gains or losses in 1975, 50% reported that these gains or losses resulted from the disposition of shares. In addition, 12% of all taxpayers who reported capital gains or losses realized gains or losses on bonds in that year. In comparison, only 28% of that class of taxpayers reported gains or losses on real estate and 18% on "other capital property", which consisted largely of personal use property. Comparable figures for share gains and losses in 1972, 1973 and 1974 are 65%, 50% and 48% respectively: see App. 2. App. 3 illustrates the same figures graphically.

4 *Income Tax Act*, S.C. 1970-71-72, c. 63 as am. [Unless otherwise noted, all references to the *Income Tax Act* refer to this version.]

5 In 1972, share transactions accounted for 89% of gains; in 1973, for 56%: see App. 4.

6 The share of loss attributable to shares alone grew from 29% in 1973 to 90% in 1974: see App. 4.

7 See App. 3.

reason is the cumbersome and expensive nature of real estate transactions. Another is the propensity of business to use its land as business premises, thereby ruling out frequent dealings. In addition, businesses are incorporated; a transfer of the business assets will frequently take the form of a share transaction. As well, almost all business real estate can be transferred with tax consequences deferred,[8] and owner-occupied real estate is exempted from capital gains taxation if the taxpayer treats it as a principal residence.[9]

Since the typical taxpayer is most likely to encounter the capital gains provisions through securities transactions, it is desirable that the rules governing those transactions reflect sound policy and be capable of administration with minimal public and private compliance costs.

I. History of the taxation of securities transactions

Until 1972, the taxation of securities transactions was governed by the general principles of taxation. If a gain or loss arose in the course of business or amounted to an adventure in the nature of trade, it was classified as an ordinary gain or loss. If it was on capital account, it was excluded from the tax base entirely. The tax consequences of classification thus placed considerable pressure on the distinction between capital and income transactions. The concept of adventure in the nature of trade[10] was designed to catch speculative gains on securities that would otherwise have been treated as capital assets.

When capital gains taxation was introduced in 1972, the adventure device could have been dropped in order to simplify the classification procedure. This was not done, but the few securities cases decided since 1972 indicate that the courts may be moving toward a concept of adventure that is more favourable to taxpayers.[11]

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[8] See, *e.g.*, *Income Tax Act*, ss. 85 and 86.

[9] See generally Seltzer, *The Nature and Tax Treatment of Capital Gains* (1966), 146-49 for a more detailed analysis of real estate gains which includes an explanation of their relative unimportance as a source of taxable gains in the United States. In Canada, it has been estimated that in 1975 alone the total capital gains sheltered by the principal residence exemption amounted to $5,100 million. There are no estimates of the magnitude of the gains sheltered by business rollovers. See Smith, *Tax Expenditures* (1979), 120-22.

[10] *Income Tax Act*, s. 248(1) states that "business" includes an adventure in the nature of trade.

[11] See *Hiwako Investments Ltd* v. *The Queen* [1978] C.T.C. 378; 78 D.T.C. 6281 (F.C.A.); *Chaffey* v. *M.N.R.* [1978] C.T.C. 253; 78 D.T.C. 6176 (F.C.A.).

Even though the tax consequences of classification are no longer so drastically different, classification has remained a difficult area. The tests and guidelines used by the courts to determine whether a securities transaction is capital or income in nature are unwieldy and difficult to apply, and Parliament has taken steps to make liability more certain. Since 1977, taxpayers can elect to treat all gains on certain securities as capital gains, so long as the statutory conditions are met.[12] For nonqualifying taxpayers and securities, however, the common law rules continue to govern classification.

II. Competing frameworks for analysis of speculative transactions

Because of the capital gains tax, and the more recent lifetime election on securities transactions, the taxation of speculative gains and losses on securities is in a period of transition. The language of the election shifts the focus of litigation from terms such as "capital gains" and "investment" to terms like "dealer" and "carrying on business". Because those terms have no fixed meaning, the courts are given the opportunity to define them. The courts and litigants face the major problem of formulating an analytical framework capable of yielding a predictable result in a multiplicity of circumstances. There are several competing frameworks: a cynical analysis, which claims that there is no such thing as capital; the common law business test; an economic realities or causation analysis; and a distributional analysis, which looks at the timing of cash flows.

A. *"There is no such thing as capital"*

"Capital" is a bundle of policy considerations that form the justification for giving some receipts preferential tax treatment. This fact is frequently obscured because the meaning of "capital" varies with usage. To an individual who is starting a business, "capital" is the entire fund of cash, borrowed money, property and expertise which will be dedicated to the enterprise. When the undertaking is established, "capital" will have the narrower connotation of specific depreciable assets; this includes intangible items which may not even constitute property in the conventional common law sense.[13] To a taxpayer without an established business, the term

[12] S.C. 1977-78, c. 42, s. 3 added s. 39(1)(c) to the *Income Tax Act*.

[13] "Eligible capital expenditure" is defined in *Income Tax Act*, s. 14(5)(b) as an expenditure which is for the purpose of gaining or producing income from the business and which is "on account of capital", but which does not bring

"capital" connotes a legal category which correlates with investment or nonbusiness use, and which carries with it a tax preference granted for reasons that are not articulated in the controlling legislation. The concept of capital pervades the way in which we think about commerce and property. In property law, "capital" is that part of an estate which is reserved for those with remainder interests.[14] Accounting practice follows business usage, and labels the initial fund of a business as "capital stock", while treating tangible and intangible property as "capital assets".

On a functional analysis, it can be said that "capital" takes on a meaning which is an outgrowth of the function assigned to the term in the particular context. A business person who applies a fund of capital to a new enterprise must determine whether the enterprise is productive of economic power; such a person will want to measure capital in monetary units so that there is some standard according to which increases or decreases in economic power may be assessed. Capital has the same function in accounting, an art which has developed in response to the business person's desire to measure increases in economic power against a static standard.

In contrast to business usage, property law has used capital to function as a regulator of the rights of the remainderman. While it is true that the business and property uses of the word coincide when they refer to a fund at the beginning of a period of receipts, the two usages diverge when specific types of receipts are considered. In property law, payments out of wasting assets, such as oil wells, are treated as returns of capital except for a small income element.[15] In the accounting or business context, however, the

into existence depreciable property. The capital which falls into this class will include such things as goodwill, rights over land for an indeterminate term, costs of improvements to another's property and similar expenditures. See Dept of National Revenue, Taxation, Interpretation Bulletins IT-143R (Dec. 29, 1975) and IT-386 (July 4, 1977).

As "property" is not an immutable concept, notions such as "eligible capital property" have had to be devised. See generally Jackson, *Principles of Property Law* (1967), 28; Ross, *Tû-Tû* (1957) 70 Harv. L. Rev. 812 (a sophisticated semantic and linguistic analysis that demonstrates that a term such as "property" has no independent substance but is merely "a tool for the technique of presentation serving exclusively systematic ends": *ibid.*, 825).

[14] For an interesting (albeit undocumented) account of the early development of the concepts of capital and income in property law and taxation, see Seltzer, *supra*, note 9, 25-29.

[15] See Waters, *Law of Trusts in Canada* (1974), 697-700; Cullity, *Trusts Inter Vivos: Duty to Convert Under-Productive Property* (1972) 50 Can. Bar Rev. 116. *Cf. Revised Uniform Principal and Income Act*, 7 Uniform Laws Annotated § 9

same receipt might be viewed wholly as a receipt of income except to the extent of a depletion allowance. To reduce the two usages to their simplest terms, capital serves as a measure of growth for the business person while keeping the *res* of the estate intact for the holder of the remainder interest.

The divergence of the property and accounting concepts of capital demonstrates that capital is an artificial category defined by the needs of the competing interests that bring it into issue.[16] Nonetheless, there is a tendency to assume that capital in the taxation context does have an immutable meaning — handed down, perhaps, from the House of Lords. However, different authorities have different definitions of capital for taxation purposes,[17] and in any one jurisdiction there is likely to be a collection of competing approaches which overlap and produce conflicting results.[18]

The root of this confusion lies in the fact that capital is created, not by the nature of the subject matter, but by the social and legal relations which surround it. If we could say that all land is capital for taxation purposes, then tax liability can be resolved by reference to whether the subject matter of a transaction is land. At present, however, a piece of land will be capital or a capital asset if it is owned for the purpose of producing a *usufruct*, or if it is held for a long time as a fund or holding place for economic power. If it is held for the purpose of resale or as inventory, it is not capital and its disposition will give rise to ordinary income. Every conceivable type of asset — whether it is property or not — has the potential to be either capital or inventory, and at any given moment in time, any asset can move from one category to another.

Since the capital/income classification depends on the way in which the asset is exploited, the classification must rely more on surmise than on fact. The only evidence which is truly objective is the asset's record of *usufruct*, and even then a subjective intention to sell a productive asset for a gain can still operate to classify the asset as inventory. "Capital" is not defined by objective and as-

(1962), under which the value of the wasting asset is amortized over its income-producing life and deducted from royalties to preserve the *corpus*, the balance being allocated to the income beneficiary.

[16] Conway & Smith, "The Law Concerning Capital Gains" in *Studies of the Royal Commission on Taxation* (1967), vol. 19B, 98-139.

[17] See, *e.g.*, American Law Institute, *Definitional Problems in Capital Gains Taxation* (1960 draft); Note, *A Spreading of Receipts Formula for Creating a Capital Gains/Ordinary Income Brightline* (1978) 87 Yale L.J. 729.

[18] See generally Grover & Iacobucci, *Materials on Canadian Income Tax* 3d ed. (1976), 228-53.

certainable facts: capital is a state of mind, an intention in a moment of time that may be modified again and again while the manifestation of the asset remains unaltered. Hence the argument that there is no such thing as capital; capital is only a function of intention without physical reality. The only physical manifestation of the existence of capital is a stream of receipts caused by the asset during the period of ownership, and proceeds of disposition when title is relinquished. The stream of receipts arising during ownership is easily classed as income; it is the proceeds of disposition which are troublesome. The presence or absence of an income stream does not affect the inherent quality of the proceeds of disposition; the gain on disposition will represent the same increase in economic power whether it is from the sale of an inventory item, a nonproductive asset whose classification is ambiguous or a productive asset.

The proposition that there is no such thing as capital may be restated in various ways. The *Carter Report* assumed that capital and income can be distinguished, but took the position that the economic power of a capital gain dollar and an income dollar are identical, so that arcane legal distinctions actually result in a discriminatory tax base.[19] Seltzer examined the causes or sources of capital gains and concluded that a significant proportion of capital gains can be attributed to ordinary income sources — personal services, use of capital, risk-taking — and should not be granted a preference merely on the basis of the form of the receipt.[20] Every time the proposition is restated, the issue is whether capital gains should receive any kind of preference (in which case differentiation is necessary) or whether all receipts should be fully included in taxable income.

The elaborate legal doctrine defining "capital" is tolerated only because the tax preference which is given to capital is thought to be economically desirable or necessary. The economic effects that indicate the need for this preference are "lock in", "bunching", inflation, change in the interest rate, and formation of capital.[21] In the end, it is the economic consequences of eliminating the preference which form the continuing rationale for the preference; if there is to be a preference, there must be some definition of the "capital" to which it attaches.

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[19] Royal Commission on Taxation, *Report* (1966), vol. 3, 325.

[20] Seltzer, *supra*, note 9, 4-5.

[21] See Brooks & Peltomaa, *The Case for Full Taxation of Capital Gains* (1979) 1 Canadian Taxation 7; Blum, *A Handy Summary of the Capital Gains*

1. Lock in and force out

When a taxpayer owns an asset which has increased in value, the taxpayer has three alternatives: (1) retain the asset, (2) sell the asset and spend the proceeds on current consumption or (3) sell the asset and reinvest the proceeds. If the second or third alternative is selected, then the increase in monetary value will be exposed to taxation and the after-tax proceeds of disposition prevent the taxpayer from acquiring a new asset of equal value to the old one. Over time, the taxpayer who holds only one asset — who is "locked in" — is in a much better position than the taxpayer who has changed investments frequently, and left a bit of the gain in the government's hands with each transaction. The magnitude of the lock-in effect depends in part on the extent to which capital gains are included in taxable income. Any exclusion of capital gains reduces the magnitude of the lock-in effect and the mobility of capital is greater.[22]

"Force out" is the opposite phenomenon; the present value of the tax benefit of an immediate disposition is greater than the present value of the future receipts that the asset is expected to generate. Force out will occur when an asset is in a negative gain position or when the tax system overcompensates for the lock-in effect.[23]

2. Bunching

Gains that are realized on the disposition of an asset frequently accrue over a period of time. When such gains are realized, however, they are included in taxable income in the year of realization (in the absence of relieving legislation) and increase the taxpayer's effective rate of taxation for that year.[24]

Arguments (1957) 35 Taxes 247 for a discussion of these and other justifications for the capital gains preference. The justifications discussed in the text were selected because they are the most compelling rationales developed in the literature.

[22] See American Law Institute, *supra*, note 17, 137, which presents a graphical illustration of the lock-in effect relative to the length of the anticipated future life of the asset.

[23] *Ibid.*, 138-39.

[24] S. 118(1) of the *Income Tax Act* grants some relief in the form of general averaging, which is available to all taxpayers regardless of the nature of their income sources, and s. 61 allows for forward averaging through the purchase of income averaging annuities. Under the latter, the maximum period of spreading is fifteen years, and the taxpayer's enjoyment of the gain is limited

3. Inflation

When all price levels move up or down, gains and losses are sometimes described as "illusory" because they do not represent an accretion to economic power but merely reflect changes in the monetary value of goods and services. Inflation is popularly cited as a justification for a capital gains preference, but it is interesting to note that when rates of inflation are increasing, theoreticians begin to suggest adjusting cost figures for inflation.[25] These suggestions themselves raise the possibility that the effect of inflation is not a sound rationale for the capital gains preference, or that the fifty per cent exclusion is not an adequate offset against inflation when rates of inflation exceed two to three per cent a year.

4. Changes in interest rates

When interest rates rise or fall, the price level of assets falls and increases, respectively. This effect can be seen most clearly in assets which bear a fixed rate of interest, such as bonds. A $100 face value bond bearing eight per cent simple interest will increase in value when the prevailing rate of interest falls to six per cent. Conversely, an increase in the prevailing interest rate to ten per cent will cause the market value of the bond to fall. In the first case, the receipt of interest at eight per cent actually represents a return of capital; in the second case, the taxpayer experiences a decrease in the value of the bond relative to the maturity value, so that the taxpayer who acquires it at its depressed price will receive a gain on maturity which compensates for the low interest rate received during the life of the obligation. Changes in interest rates affect price levels of capital assets in precisely the same way, but because the internal rate of interest yielded by assets used in an enterprise is not easily ascertainable and would be unstable, measurement of the effect is difficult.[26]

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to the amount of the annuity paid in each year. In comparison with the strictures of forward averaging, the deemed recognition proposals of the Carter Commission are more favorable to the taxpayer, since the Carter approach would effect spreading while the taxpayer continued to own and enjoy the asset: *supra*, note 19, 276-81. However, the value of the deferral that is generated by the present system is some compensation to the taxpayer.

[25] Bossons, *Implementing Capital Gains Tax Reforms* (1979) 27 Can. Tax J. 145; Bucovetsky, *Inflation and the Personal Tax Base: The Capital Gains Issue* (1977) 25 Can. Tax J. 79; Kelley, Hall & Aronsohn, *Indexing for Inflation* (1977) 31 Tax Lawyer 17.

[26] Seltzer, *supra*, note 9, 60-61 also notes that other factors have more influence on the price levels of assets, thus changes in the interest rates tend to be obscured.

5. **Capital formation**

"Capital formation" refers to the process of saving, instead of consuming, current income; it can be used interchangeably with "rate of investment" or "rate of saving". Capital formation is "impaired" or reduced when taxes increase, for after-tax incomes and the rate of saving are reduced. When taxes are reduced, then after-tax incomes are increased and the rate of saving also increases. Capital formation is also connected to the redistributive effects of the tax system: capital formation will be discouraged even when after-tax incomes rise, so long as those increases are limited to individuals who have no capacity to save. Thus a program of favouring capital formation envisions two effects: (1) reducing the overall tax load in order to make greater saving possible, and (2) tempering the redistributive aims of the system in order to grant the reduction to those who are able to save and defer consumption.[27]

The proposition that there is no such thing as capital has one major drawback: in a climate of increasing political and economic conservatism, any proposal to include all capital gains in the tax base is likely to be politically unacceptable. The best case for full inclusion was made in the *Carter Report*,[28] but the political atmosphere has since changed. Aided by the argument that inflation is eroding the fifty per cent preference, lobbyists are now pressing for an increase in the preference or for complete abolition of capital gains taxation.[29]

Outside Canada, full inclusion has been treated less seriously. The United States has moved to a tax on tax preferences in order to prevent wealthy taxpayers from taking excessive advantage of the partial exemption of capital gains.[30] While this can be interpreted

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[27] See David, *Alternative Approaches to Capital Gains Taxation* (1968), 2-5 and 192-97 for a discussion of the relationship between saving and growth.

[28] *Supra*, note 19, 337-82.

[29] Bossons, *supra*, note 25, 153-55 argues that suspension of the capital gains rules in relation to securities transactions would encourage corporate investment and Canadian ownership. Elimination of capital gains taxation on particular assets is becoming an increasingly popular demand by those who seek to justify preferential treatment as an economic panacea.

[30] I.R.C. § 301 as am. The minimum tax rate on tax preference items such as capital gains is 15%; tax preference items are exempt from the minimum tax if they are less than the greater of $10,000 or one half of the taxpayer's nonpreference tax liability for the year. There is also a maximum tax system which operates to lift the 50% ceiling on earned income to the extent that the taxpayer has tax preference income; in those cases, the tax rate on

as a move toward fuller inclusion, the more realistic view is that it further entrenches the preference. The tax preference tax touches a minuscule number of taxpayers who enjoy the preference. In Australia, the debate still focuses on whether capital gains should be recognized at all.[31] In England, the Meade Report advocated a shift to an expenditures based tax but recognized that some preference would have to be created for capital expenditures.[32]

The entrenchment of the capital gains preference makes any case for full inclusion seem idealistic; tax reform circles now seek an acceptable "second best" solution that remedies the worst defects of the present system while taking account of political realities. The second best alternatives that are considered in this paper are (1) the common law business test, (2) an economic realities model and (3) a redistributive model.

B. *Common law business test*

If a gain or loss on the disposition of property arises in the course of business or as an adventure in the nature of trade, the amount is classified as being on income account. This rough method of classification was imported from England and governed the tax treatment of all property dispositions until 1972. After 1971, the tax consequences of the classification were varied, but not the method of arriving at the classification. While it is difficult to make any general statements about the aggregate operation of the case law on business and adventure, it is fair to say that a court will hold that an activity is a business or an adventure if there is objective evidence of the conduct of a business or if evidence of the taxpayer's intention shows a profitmaking motive. Unpredictability is a major disadvantage of this method of differentiating capital and income. As well, the lack of system in the cases and the ease with which taxpayers can manipulate the type of evidence available to revenue agents and the courts cast doubt on the ability of the taxation

earned income can rise as high as 70%. See Rabinowitz, *Some Reflections on the Social and Economic Impact of the Tax Reform Act of 1976* (1977) 31 Tax Lawyer 163, 172-76 for details of the scheme.

[31] *Income Tax Assessment Act 1936,* Act No. 27, 1936, as am. S. 26(a) classifies property gains as taxable income where the property was acquired "for the purpose of profitmaking ... from the ... carrying out of any profitmaking undertaking or scheme" and s. 26AAA establishes a one year holding period for assets; gains on property sold within a year of acquisition are fully included in income as well.

[32] The Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation* (1978).

process to meet equitable or redistributional objectives in respect of property dispositions.

1. Origins of adventure

Adventure in the nature of trade is a classification which is used to justify a limited capital gains tax on speculative transactions in property. Classifying a transaction as an adventure results in full inclusion of the gain in taxable income. It can be characterized as a limited capital gains tax because the types of transactions it catches fall outside the scope of business income in the ordinary sense. The notion of adventure has been continued in the 1972 Act; in effect, there are now two types of capital transactions — speculative and nonspeculative.

The concept of an "adventure or concern in the nature of trade" and modern income tax legislation in Britain emerged contemporaneously. The 1688 revenue act[33] followed the usual pattern of imposing a levy on the annual value of personal estates and the profits of "offices or employments". No mention was made of trades, businesses or adventures. Shortly thereafter, the General Aid assessed one shilling in the pound on the "true yearly profit" from property in goods, merchandise, money and debts — a tax base which again omitted any direct reference to trades or adventures.[34] The first true "direct income tax" was the invention of William Pitt (the elder), who proposed it as a means of financing a lengthy war with France. The first income tax statute enacted under his influence came into effect in 1799, and here the phrase "Trade or Manufacture, or any Adventure or Concern" is found throughout the act.[35] When direct income tax legislation became permanent in 1842, the language was modified to its present form — "Trade, Manufacture, Adventure, or Concern in the Nature of Trade".[36]

As litigation arose over the scope of the source described as "trade, manufacture, adventure, or concern in the nature of trade", it became apparent that the entire formula did not have to be

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[33] *An act for a grant to their Majesties of an aid ... for the necessary defence of their realms*, 1688, 1 Wm & Mary, c. 20 (Imp.).

[34] See Coffield, *A Popular History of Taxation* (1978), 78.

[35] *An act to repeal the duties imposed by an act ... for granting an aid and contrelation for the prosecution of the war; and to make more effectual provision for the like purpose, by granting certain duties upon income in lieu of the said duties*, 1799, 39 Geo. III, c. 13, ss. 82, 83 (U.K.). Thorson, P., in *M.N.R.* v. *Taylor* [1956-60] Ex. C.R. 3, erroneously pinpointed the first appearance of "adventure" in the 1803 Finance Act.

[36] *The Income Tax Act, 1842*, 5-6 Vict., c. 35, ss. 101, 120 (U.K.).

reiterated in giving reasons for decision in each case, and the judicial tradition of using one or another aspect of that phrase in giving reasons developed. In 1926, argument by counsel in *C.I.R.* v. *Livingston* led Lord President Clyde to consider the possibility that an isolated transaction might not be taxable because of its isolation.[37] In order to overcome this proposition as forcefully as possible, Lord Clyde reasoned that an isolated transaction could not be "in the nature of trade" where the trade consisted of buying property in the hope and expectation of a rise in value, but that an isolated transaction could be an adventure if the transaction is "of the same kind" and "carried on in the same way" as transactions which are "characteristic of ordinary trading in the line of business in which the venture was made".[38]

Lord Clyde's reasoning has proven devilishly difficult to apply. The difficulty exists because his Lordship was convinced that his test described something very different from trade in its ordinary sense; the facts of the case, however (which must be taken to illustrate the guidelines he propounded), support a finding of ordinary trade.[39] In the same case, Lord Sands concluded that the taxpayers, in converting the vessel for resale, were engaged in "a manufacturing process which changed the character of the article",[40] and he exhibited no reluctance in concluding that the taxpayers had engaged in ordinary trade. He did not agree that the transaction should be described only as an adventure. Of the two judgments, Lord Sands' is to be preferred; it is illogical to consign such an elaborate undertaking to the category of a mere adventure.

A few years later, Lord Clyde had another opportunity to apply his concept of adventure in the nature of trade in *Rutledge* v. *C.I.R.*[41] The taxpayer in that case was a moneylender and a business person with divergent interests. While he was on an overseas business trip, he purchased a large quantity of toilet paper from a

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[37] (1926) 11 T.C. 538 (Ct Sess., Scot.). In this case, three tradesmen — a ship repairer, a fish salesman and a blacksmith — purchased an old ship, refitted it and sold it for a profit.

[38] *Ibid.*, 542.

[39] See also McDonald, *Capital Gains and Losses in Canada* (1951) 29 Can. Bar Rev. 907, 912-13; Shinder, *The Taxability of Capital Gains in Canada* (1961) 19 U. of T. Faculty L. Rev. 87, 94-95.

[40] *Supra*, note 37, 544. "Economic transformation" as a basis for treating gains from property as business profits instead of capital gains was brought to the attention of Canadian tax specialists at least once, but it has never gained much acceptance. See McDonald, *supra*, note 39, 912, n. 16, referring to Miller, *The Capital Asset Concept* (1949) 59 Yale L.J. 837 & 1057.

[41] (1929) 14 T.C. 490 (Ct Sess., Scot.).

bankrupt, took it back to London and immediately sold the entire lot to a single buyer. Instead of simply recognizing that there are entrepreneurs who take every available opportunity to turn a profit, Lord Clyde went through his elaborate rationale to conclude that the taxpayer had behaved like a toilet paper dealer, and that the resulting profit was from an adventure in the nature of trade, not from an ordinary trade. This time there was no dissenting opinion to point out that the transaction was an ordinary trade even though it was rather singular.

We are not concerned here to criticize what British judges have done with the concept of adventure in the nature of trade.[42] Rather, we are tracing the factors that influenced the Canadian concept of adventure. Of all of the British decisions on the scope of Schedule D of the *Income Tax Act, 1918*,[43] *Livingston* and *Rutledge* were the only cases that attempted to differentiate ordinary trade and adventure, and for that reason these judgments received serious consideration when adventure came to be construed in the Canadian context.

2. Development of adventure in Canada

The first permanent income tax legislation in Canada spoke of the components of income in general terms. Section 3 of the *Income War Tax Act*[44] defined income as "annual net profit or gain", including "profits from a trade or commercial or financial or other business or calling" or "from any trade, manufacture or business". There was no mention of "adventure or concern in the nature of trade" in that Act.

(a) *Tax Review Board*

In interpreting the scope of "trade, manufacture or business", the Board has been visibly influenced by the *Rutledge* and *Livingston* cases. In *Gordon* v. *M.N.R.*, Mr Monet held that the purchase of 110 airplane fuselages which the taxpayer crushed and then sold as scrap aluminum was a "trade venture, the profit of which constitutes taxable income".[45] Mr Monet relied on an analogy with *Rutledge* in reaching this decision, although the operation was a

[42] See "Taxation", 33 *Halsbury's Statutes* (3d) 155-56 for cases collected on the point.

[43] 8-9 Geo. V, c. 40 (U.K.).

[44] S.C. 1917, c. 28.

[45] (1951) 4 Tax A.B.C. 231, 232; 51 D.T.C. 230, 231. [References *infra* are cited to Tax A.B.C.]

manufacturing operation in the sense described by Lord Sands in *Livingston*. Mr Monet did buttress his result with the alternative ratio that the purchase, crushing, and sale of the metal was "the operation of a business in carrying out a scheme for profit-making".[46]

Encouraged by Mr Monet's characterization of the transaction as a "trade venture", the Minister attempted to include gains on the purchase and resale of timber limits in income, on the ground that they were adventures in the nature of trade, in two subsequent cases. Mr Fisher held in *Johnson* v. *M.N.R.* that section 3 of the *Income War Tax Act* did not contain an "expansion of the meaning of the word 'trade' ... which would include an adventure in the nature of trade".[47] In reaching this conclusion, he alluded to a body of English decisions upon which counsel had relied, but he presented no direct authority to support his conclusion. Factually, however, the case presents facts which have become characteristic of Canadian adventures. The taxpayer in question had been active in the lumber industry for a considerable time through the instrumentality of a controlled corporation, and he had formed a syndicate with other members of the local industry to purchase the limits, since his corporation could not afford it. Strict observance of the separate legal personality of the corporation led Mr Fisher to view the transaction as being an isolated one. On Lord Clyde's analysis, an isolated transaction does not come into "trade or business" unless aided by a statutory formula such as "adventure or concern in the nature of trade".

In *Whiteside* v. *M.N.R.*,[48] the other timber limit case, the Minister also relied on *Gordon*. Mr Fordham distinguished that decision on the basis that the taxpayer was already in the wrecking business and that the recycling of the airplane fuselage in that case was simply an exercise of his trade skills, novel only as to subject matter.[49] Mr Fordham thought that the transactions in *Gordon* and *Livingston* could have constituted businesses even without the addition of "adventure", but he did not think that "trade or business" alone was broad enough to include the timber limit transactions. He also thought that the addition of "adventure" to the definition of "business" would expand the scope of business.

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[46] *Ibid.*, 234.
[47] (1951) 5 Tax A.B.C. 71, 72-73; 51 D.T.C. 355, 356-57.
[48] (1951) 5 Tax A.B.C. 165, 51 D.T.C. 401.
[49] Mr Fordham also distinguished *C.I.R.* v. *Livingston*, *supra*, note 37.

Mr Fordham confirmed his view of the relationship between investment, adventure and business in *No. 412* v. *M.N.R.*[50] The taxpayer had entered into three significant real estate transactions during the years 1948 through 1952. Effective in 1949, the statutory definition of "business" in the Act was modified to include "an adventure or concern in the nature of trade",[51] an obvious attempt to supersede the Board's conception of "business". Mr Fordham accordingly concluded that each of the three transactions was an adventure, but that the 1948 gains were exempt from taxation because the amendment was not then applicable.

(b) *Court decisions*

The leading Canadian court decision on adventure is *M.N.R.* v. *Taylor*,[52] in which President Thorson not only adopted, without modification, Lord Clyde's view of business and adventure, but also ignored the warning in Lord Sands' opinion. The taxpayer was an employee of a corporation that used lead in its manufacturing processes; as a hedge against impending shortages, he bought twenty-two carloads of lead which he immediately resold to his employer. The company's policy had precluded it from making the purchase directly, and the taxpayer made a profit on the transaction. It was argued for the Minister[52a] that the gain was income from an adventure in the nature of trade, or alternatively that it was income from an office or employment. Thorson P. chose to resolve the case on the first ground. He took the view that adventure and business are distinguishable categories because, first, it was plain from the wording that they are not synonymous expressions;[53] second, Lord Clyde had taken the view that trade and adventure were distinguishable in *Livingston* and *Rutledge*;[54] and third, Lord Normand had approved Lord Clyde's position in *C.I.R.* v. *Fraser*.[55]

Although he himself had noted the dangers of importing British tax jurisprudence without regard to statutory differences,[56] Thorson P. did not consider that the relationship between business and ad-

[50] (1957) 17 Tax A.B.C. 52, 57 D.T.C. 203.

[51] *Income Tax Act*, S.C. 1948, c. 52, s. 127(1)(e), defining "business" for the purposes of the Act.

[52] *Supra*, note 35.

[52a] By Mr Jackett (as he then was).

[53] *Supra*, note 35, 13.

[54] *Ibid.*, 14.

[55] (1942) 24 T.C. 498 (Ct Sess., Scot.).

[56] *Supra*, note 35, 14. Thorson P. was there considering the nature of an appeal from the British commissioners' rulings.

venture in the nature of trade might be different from the relationship between trade and adventure. Even if an isolated transaction does not constitute a trade (which has been defined as requiring repetition, organization and frequency of transactions[57]), "business" is a term of wider import that suggests risk of loss along with potential for profitmaking, control of the enterprise and participation in the proceeds.[58] Such a concept of business does include an adventure in the nature of trade, at least as the term was defined by Lord Clyde. It would have been more appropriate in the *Taylor* case for the Minister's counsel to have argued for judicial recognition of the proper scope of business instead of rigidly insisting that adventure play the same role in Canada that it has in England, where it operates to broaden the meaning of "trade".

Having decided that adventure expands the natural meaning of business, however, Thorson P. was forced to adopt the components of adventure from the United Kingdom jurisprudence. The resulting "tests" are largely negative propositions and restatements of Lord Clyde's reasons in *Livingston* and *Rutledge.* Thorson P.'s negative propositions are:

(1) a transaction may be an isolated transaction and still be classed as an adventure;
(2) the lack of business organization does not preclude it from being an adventure;
(3) a transaction may constitute an adventure even if no manufacturing operation was performed on the commodity;
(4) the inexperience of the taxpayer or the lack of connection with his or her regular undertaking does not preclude the transaction from being classified as an adventure; and
(5) lack of intent to sell the property at a profit does not negative categorization of the transaction as an adventure.[59]

To this set of negative propositions, Mr Justice Martland later added three others:

(1) the use of borrowed money to finance the acquisition of shares is not indicative of the character of the transaction;
(2) the fact that the acquisition does not promise an immediate return on invested capital is not dispositive; and

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[57] *Grainger & Son* v. *Gough* [1896] A.C. 325 (H.L.), relied upon by President Thorson in the *Taylor* case.

[58] See Cary, *Cases and Materials on Corporations* 4th ed. (1969), 1177.

[59] *Supra,* note 35, 24-26.

(3) an intention to dispose of the commodity at a profit "as soon as reasonably possible" itself is an adequate basis for finding that a transaction is an adventure.[60]

President Thorson's positive tests are just as elusive: the taxpayer is engaged in an adventure if the transaction is conducted in the same manner as a dealer or trader in that commodity would employ, or if the "nature and quantity" of the subject matter of the transaction precludes the possibility that the purpose of the transaction was investment.[61] Despite innumerable applications of these two positive tests, the courts have yet to articulate a meaningful description of adventure that can be applied to varying fact patterns.

(c) *Tara Exploration and beyond*

The next significant development came in the Exchequer Court decision in *Tara Exploration & Development Co.* v. *M.N.R.*[62] The taxpayer corporation, formed in Ontario by Ontario shareholders, carried on the business of prospecting for minerals in Ireland. All of the corporate directors and officers resided in Ireland and all board meetings were held there. In 1965 and 1966, the corporation realized gains on the disposition in Canada of mining shares which it had held for two years, and the Minister took the position that the gains were taxable as business income and that the taxpayer was resident in Canada because it was carrying on business by virtue of the share transactions. In an unorthodox tactic, Jackett P. assumed that the transactions amounted to an adventure in the nature of trade, and disposed of the appeal on the basis that an adventure alone did not constitute "carrying on business" for the purpose of the statutory jurisdictional test.[63] In an *obiter dictum*, Mr Justice Abbott agreed with the assumption that the facts depicted an adventure, but decided the case under the Canada-Ireland tax convention on the lack of a permanent establishment in Canada.[64] This ground of decision made it unnecessary to deal with the issue of the taxability of the gains.

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[60] *Irrigation Industries Ltd* v. *M.N.R.* [1962] S.C.R. 346, 350.

[61] *Supra*, note 35, 29; approved in *Irrigation Industries, supra*, note 60, 351-52 *per* Martland J.

[62] [1970] C.T.C. 557, 70 D.T.C. 6370 (Ex.) *per* Jackett P., *aff'd on other grounds* [1972] C.T.C. 328, 72 D.T.C. 6288 (S.C.C.) *per* Abbott J. [References *infra* are cited to C.T.C.]

[63] Now S.C. 1970-71-72, c. 63, s. 2(3).

[64] [1972] C.T.C. 328, 331 (S.C.C.).

There are two problems raised by *Tara Exploration.* One is whether Jackett P.'s view (that "carrying on business" and "adventure" are two separate categories) is correct. The other is whether the assumption that the share transactions were adventures is consistent with the decision in *Irrigation Industries Ltd* v. *M.N.R.,* in which the Supreme Court of Canada held that a similar share transaction by a corporation was not an adventure.[65]

There are several technical ways of reconciling the obvious conflict between *Tara Exploration* and *Irrigation Industries.* First, Jackett P. and Abbott J. assumed that the transaction constituted an adventure, but they resolved the dispute by relying on other grounds; thus, the conclusion that the transactions amounted to an adventure can be classed as *obiter dicta* in both judgments. A second approach is to assume that there was some evidence (such as the employment of insider information or special industry knowledge) that made a finding of adventure inevitable.[66] This approach is preferable, for it bypasses the weaknesses of technical arguments and confronts the fact that the decisions demonstrate a belief that the transactions were adventures.[67]

The other point — whether an adventure constitutes the conduct of business — is dealt with by *Tara* consonantly with the decisions in *Livingston, Rutledge* and *Taylor,* for all these cases take the position that adventure and trade or business are distinguishable concepts.[68] However, not all cases in which adventure is invoked

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[65] *Supra,* note 60. In this case, the taxpayer corporation was formed in order to operate a mill, but six years passed before it took any steps to accomplish its purpose. It then borrowed money to finance the purchase of mining shares. When the overdraft became payable, the corporation sold some of the shares. The rest of the shares were sold a few months later to pay off a loan relating to another transaction. Reviewing the Exchequer Court's conclusion that the share transactions amounted to an adventure in the nature of trade, Mr Justice Martland stated that even if the shares were of a speculative nature, the mere intention "to dispose of the shares at a profit so soon as there was a reasonable opportunity of so doing" did not constitute an adventure. The overriding reason for Mr Justice Martland's conclusion seems to be that he regarded capital investment in business corporation shares to be so thoroughly stamped with an investment character and so different from "articles of commerce" that the mere intention to sell at a profit — usually sufficient to establish an adventure — was discounted: 352-55.

[66] *Supra,* note 64, 329-30.

[67] The conflict can also be resolved by reading Mr Justice Abbott's decision as refraining from commenting on the correctness of President Jackett's conclusions on adventure because the case could be decided on other grounds.

[68] See also *Stekl* v. *M.N.R.* [1956-60] Ex. C.R. 376 *per* Thorson P.

support the proposition that adventure and business are mutually exclusive,[69] and recently doubt has been cast on the authority of *Tara Exploration* by *Birmount Holdings Ltd* v. *The Queen*.[70]

The facts in *Birmount Holdings* were similar to those in *Tara Exploration*. A nonresident bought a tract of undeveloped land near metropolitan Toronto through an Ontario corporation formed for the occasion; eleven years later the corporation sold the land for a profit of about one million dollars. Sweet D.J. treated the corporation as a nonresident[71] and framed the same issues as arose in *Tara Exploration*: (1) was this an isolated transaction? (2) was it a taxable transaction even if isolated? and (3) did the transaction constitute carrying on business in Canada, rendering the corporation subject to Canada's taxing jurisdiction? In reasoning that is not particularly clear, Sweet D.J. ruled that the gain was taxable because it arose from a "transaction ... in the nature of trade".[72] (The elliptical phrase probably refers to an "*adventure* in the nature of trade".) In ruling on the residence issue, Sweet D.J. held that the taxpayer "carried on business in and with the land"[73] because the corporation "performed the very *business* function anticipated by the wording of its letters patent".[74]

Sweet D.J. noted that the share trading gains in *Tara Exploration* were not taxable income because the transactions were peripheral and unrelated to the business purpose for which the corporation was formed, whereas the transaction in *Birmount Holdings* was

[69] See, *e.g.*, *M.N.R.* v. *Rosenberg* [1962] C.T.C. 372, 62 D.T.C. 1216 (Ex.); *M.N.R.* v. *Mandelbaum* [1962] CT.C. 165, 62 D.T.C. 1093 (Ex.); *M.N.R.* v. *Minden* [1962] C.T.C. 79, 62 D.T.C. 1044 (Ex.), decisions in which President Thorson held that gains on the realization of discounted mortgages were business income because the taxpayers' operations constituted both a business in the ordinary sense and adventures in the nature of trade. President Thorson gave no explanation for the two-pronged *ratio*: most likely he was simply discouraging the possibility of appeal that may have been taken had he selected one or the other basis.

[70] [1977] C.T.C. 34, 77 D.T.C. 5031 (F.C.T.D.) *per* Sweet D.J., *aff'd on other grounds* [1978] C.T.C. 358, 78 D.T.C. 6254 (F.C.A.) *per* Heald J. [References *infra* are cited to C.T.C.]

[71] On accepted United Kingdom authority, the corporation was not managed in Canada because it was in reality controlled by a nonresident. See *Unit Construction Co.* v. *Bullock* [1960] A.C. 351 (H.L.), which looked to the "real" geographic location from which corporate policy emanated, though in contravention of the constitutional powers of the directors.

[72] *Supra*, note 70, 44 (F.C.T.D.).

[73] *Ibid.*, 46.

[74] *Ibid.* [emphasis added].

the business of the corporation and was its only business.[75] Realizing that he was implicitly relying on the effect of incorporation to get him over the fact that Canadian tax law does not treat the purchase and sale of one piece of real estate as the conduct of a business, Sweet D.J. attempted to rationalize the anomaly:

> In my opinion, it is not open to a person to have a corporation controlled by him acquire only one parcel of land, and no other asset, have that corporation perform no function other than something associated with that land, and then, that land having been sold by the corporation in one piece, claim that the corporation having had only one purchase and sale, is entitled to a tax advantage merely because there was a single transaction. I do not think that the cases wherein a single transaction has been held not to be carrying on business are necessarily in conflict with that view.[76]

While *Birmount Holdings* and *Tara Exploration* can be distinguished on the differences in their corporate constitutions, Sweet D.J. did not give any substantive reason for refusing to treat the real estate transaction as an investment. The Supreme Court has rejected the "charter powers" doctrine in order to treat *de facto* businesses as businesses, and this imposes a requirement on the courts to classify a transaction on its merits alone.[77]

Historically, Canadian courts have classified real estate transactions entered into by experienced business people as business operations while treating securities transactions by experienced business people as investment transactions.[78] This is an uneasy reconciliation, similar to that required by the conflict between *Tara Exploration* and *Irrigation Industries.* The tension is reduced somewhat by the fact that entirely different grounds were substituted by the appellate court in *Birmount Holdings* in reaching its conclusion that the corporation was subject to Canadian taxation on the gain, which both courts agreed derived from at least an adventure.[79] In ruling that the transaction was an adventure and a

[75] *Ibid.*

[76] *Ibid.* Sweet D. J. also distinguished *M.N.R.* v. *Valclair Investment Co.* [1964] C.T.C. 22, 64 D.T.C. 5014 (Ex.) on the basis that the real estate transaction in that case augmented share transactions which clearly were of an investment nature, since they were held for the revenue that they produced.

[77] See *Sutton Lumber & Trading Co.* v. *M.N.R.* [1953] 2 S.C.R. 77, 83.

[78] *E.g., Glaspie* v. *M.N.R.* (1963) 33 Tax A.B.C. 274, 63 D.T.C. 828.

[79] Heald J. distinguished *Unit Construction Co.* on the facts, and applied *Bedford Overseas Freighters Ltd* v. *M.N.R.* [1970] C.T.C. 69, 70 D.T.C. 6072 (Ex.) to conclude that the legal power and duty to manage the corporation lay with the Canadian directors and to dismiss the actual power of the controlling shareholder. Thus the corporation was a resident on the common law test and the "carrying on business" test did not have to be met.

business transaction, Heald J. rejected the view that Lord Clyde and Thorson P. had so carefully constructed:

> The fact that, as distinguished from an investment, certain activities have been found to constitute an adventure in the nature of trade, does not, of itself, preclude a finding that those activities amount to carrying on business. The activities of this appellant are carefully considered and analyzed [by the trial judge]. Were it necessary for me to decide this question, I would see no basis for interfering with that finding since, in my view, such a conclusion was reasonably open to him on the evidence.[80]

(d) *Conclusions*

The impact of *Birmount Holdings* has not yet been measured but the implications are clear. An adventure in the nature of trade is not a trade, but both adventures and ordinary trades are contemplated by the term "business". It is not easy to impose this framework on the various components of business after nearly fifteen years of adjudication which has taken as a starting point Thorson P.'s negative and positive tests of adventure. Usage has generated acceptance of the view that the introduction of adventure expanded business beyond its natural borders, whereas in fact Canada had been developing an unnaturally narrow concept of business.

However, *Birmount Holdings* threatens to displace the adventure/business dichotomy only in cases in which the scope or nature of the taxpayer's business is in question. *Birmount Holdings, No. 412, Gordon, Livingston,* and *Rutledge* all dealt with the same fact pattern: the taxpayer, whether incorporated or unincorporated, directly engaged in a business as well as in a "sideline",[81] and because of differences between the subject matters of the business and the sideline, adventure was used to bring the gain into income. The better approach in such cases is the approach suggested in *Birmount Holdings* — adventure is within the scope of business.

Other decisions disclose a second fact pattern in which adventure remains distinguishable from business. The unifying characteristic of *Johnson, Whiteside, Taylor,* and *Tara Exploration* is that neither the business in which the taxpayer is involved nor the adventure are directly owned by the taxpayer; they are separated by legal fictions that have been created for purposes other than those of tax law. For example, the taxpayers in *Johnson* and *Whiteside* owned lumber businesses indirectly through corporations, and thus they did

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[80] *Supra*, note 70, 372 (F.C.A.).

[81] The term is taken from McDonald, *Capital Gains and Losses in Canada, supra*, note 39.

not "have" a business in the ordinary sense, although as controlling shareholders they did "have" a business in a real sense. As sidelines isolated from the taxpayers' businesses by a legal fiction, Canadian law treated these transactions as adventures.

Taylor offers another version of the same theme. As early as 1948, the Supreme Court of Canada had established that a person who had the status of an employee under the *Income War Tax Act*[82] was not carrying on business even though his responsibilities included the conduct of his employer's business.[83] The taxpayer in *Taylor*, then, was engaged in a business which required lead, and the purchase and sale of the twenty-two carloads of lead would have fallen into the scope of that business — if it had been "his". Instead, the purchase was considered to be a sideline to employment, and was classified as an adventure. *Tara Exploration* presents the converse situation: the underlying business of the corporate shares the taxpayer purchased was mineral exploration, but that undertaking was separated from its own by the legal fiction of the separate legal personality of corporation and shareholder, and hence the share transaction was a sideline, an adventure.

Where legal fictions operate to separate a taxpayer's ordinary business from a sideline that employs many of the same types of human wealth, Canadian judges have used adventure to justify bringing sideline gains into ordinary income. This was a natural development in light of the artificially narrow scope of business before adventure was added in 1948, and in light of the separation of business and employment sources. Where the subject matter of the sideline transaction is the same commodity that forms the subject matter of the taxpayer's ordinary business, then it is not difficult to conclude that the sideline is in its "true nature" a business undertaking. Where the subject matter of the outside transaction is shares, it is harder to accept as a business undertaking. A corporate share represents an investment interest in the underlying business, and unless a gain in the value of the shares is expected, any gain arising would be a capital gain. It may be said generally that expected gains are gains which are the end product of personal effort or of the application of human wealth. Thus, when human wealth takes the form of special knowledge about that underlying business or about market behaviour, Canadian courts have employed the concept of adventure to bring these speculative investments into ordinary income.

[82] S.C. 1917, c. 28.

[83] *Argue* v. *M.N.R.* [1948] S.C.R. 467.

The Canadian judiciary has had little success in dealing with isolated and speculative transactions. Unworkable concepts, such as intention and similarity to ordinary business undertakings, have generated unworkable precedents. The judges who have participated in the process of applying the legislation are not entirely to blame; when adventure was introduced into Canada, it was already apparent that adventure did not constitute a clear test for exempt transactions.

The concepts of business and adventure as applied by the case law are inadequate as alternatives to the full inclusion of capital gains and losses. The gains that are caught by adventure do resemble income more than do gains that are exempted, but case by case litigation achieves justice at the expense of certainty. Thirty years after its introduction, the meaning of "adventure" is still in a state of flux, and still cannot be developed into a workable standard.

C. *An economic realities analysis*

Lawyers use the term "capital" to include a wide array of assets. Capital encompasses assets which are held for personal and non-personal use; it contemplates such things as paintings, a home, investment obligations and assets used in an enterprise. Economists define capital by reference to the stream of receipts which can be attributed to it.[84] The future income stream can take the form of actual receipts (in cash or kind) or imputed income.[85]

Classical economists categorize capital gains according to causation, as unexpected or expected gains. Unexpected gains are sometimes referred to as pure or windfall gains, and are not motivated by gainful activity. Expected gains are motivated by the desire for remuneration, however unrealistic the expectation may be. The difference between expected and unexpected gains is the degree to which the gain can be attributed to activities that can also generate ordinary income.

Seltzer subdivides expected capital gains into real capital gains and capitalized ordinary income (also referred to as pseudo or false capital gains).[86] The difference between real gains and capitalized income in many cases is the difference between future and

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[84] Reynolds, *Economics: A General Introduction* 4th ed. (1973), 247-48.

[85] Imputed income is frequently valued at the opportunity cost of the wealth invested in the asset: *ibid.*, 242.

[86] Seltzer, *supra*, note 9, 71. The discussion in this section draws heavily upon Seltzer's analysis of causation.

present rights. Real gains are valued by capitalizing the future stream of receipts associated with the asset; the capitalization factor is usually the present rate of interest applied to estimated receipts. Pseudo gains are valued by aggregating the value of present rights to receipts to obtain the value of the so-called capital.

1. **Unexpected gains**

Seltzer describes windfall gains as falling outside the contemplation of organized exploitation:

> A pure capital gain is functionless. It serves neither to overcome the reluctance of investors to take risks nor to allocate this scarce and valuable disposition, and the other resources associated with it, among the fields competing for them.[87]

In the context of securities transactions, a windfall gain or loss results from unforeseeable changes in the rates of capitalization applied to an asset or unexpected changes in disposition toward risk-taking.[88]

(a) *Changes in the rate of capitalization*

The process of valuing assets which have the potential to produce a stream of receipts is highly speculative. Simple capitalization formulas discount expected future receipts by the present rate of interest. Even a small shift in the interest rate can effect a noticeable change in the present value of an asset.[89] Generally,

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[87] *Ibid.*

[88] *Ibid.*, 54. Seltzer also lists unexpected changes in interest rates, but capitalization formulas take this cause into account.

[89] The formula for present value (PV) is

$$PV = \frac{Y}{1+x} + \frac{Y}{(1+x)^2} + \frac{Y}{(1+x)^3} + \ldots + \frac{Y}{(1+x)^n}$$

where Y is the amount in dollars of the future receipt, x is the present rate of interest expressed as a decimal and n is the number of productive years of the asset.

On day 1 assume future receipts of $10 annually, a present interest rate of 8% and a productive life of 5 years. The present value of the future receipts is $39.93:

$$\frac{10}{1.08} + \frac{10}{(1.08)^2} + \frac{10}{(1.08)^3} + \frac{10}{(1.08)^4} + \frac{10}{(1.08)^5} = \$39.93.$$

On day 2, assume an unexpected shift in the interest rate to 7%. If the taxpayer disposed of the asset on day 2, the taxpayer would receive proceeds of disposition equal to its new present value of $41.00.

$$\frac{10}{1.07} + \frac{10}{(1.07)^2} + \frac{10}{(1.07)^3} + \frac{10}{(1.07)^4} + \frac{10}{(1.07)^5} = \$41.00.$$

The rate of interest is not the only variable; if the present rate of interest remained at 8% but the amount of income expected each year were to rise capitalization formulas simplify the elements that interact in making the projection of an asset's future production. This simplification creates an aura of certainty around the calculation of present value — a certainty that is not realistic. In fact, future receipts depend on demand for the product of the asset as well as on general price levels, two items which can be forecast on a short term basis but which are matters of mere conjecture on a long term basis. Estimates as to the productive life of an asset are stable only for fixed term obligations. Fluctuations of interest rates compound the uncertainties. Thus, it is possible to treat gains in present values as "expected" and "unexpected", depending on their foreseeability, the general level of knowledge and expertise possessed by the taxpayer and other factors which are familiar to Canadian tax specialists. In the economists' view, the existence of windfall gains is subjective, being based on the content of the taxpayer's mind when selecting or timing an acquisition.

(b) *Changes in disposition toward risk taking*

All of the factors in the capitalization formula are subject to change, except for incomes or terms fixed by contract or other legal device. Where the rate of return on an asset is uncertain, the range of possible future yields may well include possibilities that are unacceptably low to some taxpayers. While possibilities of low returns are frequently coupled with the possibility of an extremely high rate of return, some individuals will not knowingly expose themselves to certain levels of risk. The inclination to take on certain levels of risk manifests itself in mass behaviour as well as on an individual basis, and a mass repugnance or predisposition to risk is an important component of market conditions. Where there is a mass repugnance to risk, securities with modest income possibilities but little risk of unacceptably low returns or even of loss will become more desirable. The increase in demand will drive present values up and the holders of such securities will experience windfall gains. When attitudes become more favourably inclined toward risk of low return or loss, then the premium awarded to

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to \$12, then the present value of the asset would climb from \$39.93 on day 1 to \$47.92 on day 2:

$$\frac{12}{1.08} + \frac{12}{(1.08)^2} + \frac{12}{(1.08)^3} + \frac{12}{(1.08)^4} + \frac{12}{(1.08)^5} = \$47.92.$$

If the expected life of the asset were extended by a year, a similar gain would be experienced.

$$\frac{10}{1.08} + \frac{10}{(1.08)^2} + \frac{10}{(1.08)^3} + \frac{10}{(1.08)^4} + \frac{10}{(1.08)^5} + \frac{10}{(1.08)^6} = \$46.93.$$

taxpayers disposed to take on risk can be reduced without impairing the supply of investment capital.

2. Expected gains

Putting aside the problematic fact that expectation is a matter of subjective response to widely divergent fact situations, "real" gains are based on the taxpayer's expectations concerning the stream of receipts to be derived from an asset. In an economic as well as a legal sense, there is a vast difference between a receipt that is equal to an amount already earned on account of personal services, use of property or risk taking, and a receipt that is equal to the present value of a stream of receipts which the transferee of the property expects to receive. The first type of payment is ordinary income and it must be included in taxable income when it is received or receivable. The second type of payment is measured by the present value of the future receipt of ordinary income, but the amount of the receipt is calculated in a manner that reflects the contingent nature of that stream of future income. The reasonableness of the expectation varies from security to security. One security might have a solid record of producing income at a certain rate, while another may have no record of income production and uncertain prospects for the future.

The amount of the capital receipt for disposition of such securities is derived from the application of a capitalization formula, and capital gains or losses arise when some factor in the capitalization formula changes. These factors are the present rate of interest, the income yield of the security and the risk associated with the transaction.[90]

In short, the difference between expected and unexpected gain can be traced to the relationship between the cause of the gain (change in interest rates, income yield or risk factors) and the efforts and accomplishments of the taxpayer in question. These efforts and accomplishments encompass the entire range of human activity.[91]

(a) *Inflation*

Inflation and recession can drive general price levels up or down without effecting any change in the value of the security relative to other securities. Gains attributed to inflation are some-

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[90] See Seltzer, *supra*, note 9, 55 for an illustration of this process.

[91] For a comprehensive discussion of all factors of causation, see Seltzer, *ibid.*, 69.

times called illusory gains because they do not represent a real accretion to wealth or economic power. However, not all securities rise or fall in value at the same rate. By careful effort, a taxpayer can generate a real gain relative to other holdings by nullifying in part or in whole the effect of general price level movements. The effort employed in such manoeuvres consists of researching, selecting and timing investments which will perform better than the majority of securities. This kind of effort is the same as that employed to generate real gains caused by an increase in demand, but it is distinguished from those real gains because it usually takes the form of a reduction of inflationary loss rather than an arithmetic gain.

(b) *Demand*

Increased demand is the other force which can affect the price levels taken into account in capitalization formulas, and the taxpayer can manipulate or create demand in order to produce a gain on the disposition of securities. Personal effort in manipulating the demand factor would manifest itself much as trading on inflation does: the study of demand patterns and cycles, product development, demographic investigation and cultural trends yields the information needed to select and time securities transactions. Where such personal effort is employed in generating gain, it is difficult to ascertain and quantify that part of the gain attributable to personal efforts and risk taking. From the legal perspective, it is difficult to see how evidence of intended and unintended causes is to be weighed. This problem is further complicated by the fact that not all expectations are fulfilled, and "dumb luck" can cause a gain in a situation where the taxpayer had intended to cause the gain through personal efforts.

Personal effort need not take the form of trading on demand; effort can be devoted to creating demand. Seltzer gives several typical illustrations: the taxpayer who induces others to build on contiguous land so that the taxpayer's land becomes more valuable; the taxpayer who assembles a block of land which has a greater value in the aggregate than do its component parts; the taxpayer who negotiates "a profitable long-term contract for a corporation in which he [or she] owns a large stock interest"; and the taxpayer who through delaying tactics drives up the takeover bid price and thus the value of the shares.[92] To this list may be added other

[92] *Ibid.*, 70.

examples that reflect the peculiar nature of securities. Demand for corporate shares will increase when the corporation's goodwill increases in value, and goodwill is created by the conduct of the corporation's business. Other kinds of corporate assets, such as patents, copyrights and know-how, are essentially memorials of personal efforts and their creation within the corporate entity increases its earnings potential and thus the demand for its shares. The same can be said of corporate profits, whether reinvested in additional assets or held by the corporation, and of the assembly of the corporation itself.

Control over a corporation or other issuer is not crucial to the identification of personal effort as the source of increased demand for the securities. Shareholders of corporations whose shares are widely dispersed still enjoy changes in price levels which are caused by some of the situations described. Where there is a measure of control on the part of the shareholder, however, the personal efforts of the shareholder can directly cause the increase in value. Control of an allied supplier or channel of distribution by the shareholder of the corporation in question can reduce operating expenses, increase profits and thus increase the demand for shares. A controller who also acts as a promoter for the remainder of the shares will be increasing the value of all shares. A controller who has acquired business acumen and expertise in a parallel enterprise may place that talent at the disposal of a corporation for less than fair return. In all of these cases, the demand for shares will increase as the result of personal effort.

The difficulty in applying an economic realities analysis to the taxation of securities transactions is that the separate strands of causation are hard to isolate, and once isolated, they are even harder to quantify.[93] Canadian courts have attempted to improve the business and adventure tests by injecting a type of economic realities analysis, and in some cases they may have come closer to distributional justice with this approach. However, this approach is still unpredictable, and the alternative approach to the taxation of securities transactions which is finally adopted should be more certain and predictable in its result.

[93] For a description of the U.S. treatment of the causation problem, see Surrey, *Definitional Problems in Capital Gains Taxation* (1959) 2 Tax Revision Compendium 1203, 1205-6.

D. *The distributional model*

By its use of progressive rates of taxation, the *Income Tax Act*[94] adopts redistribution of income as one of its policy objectives. Redistribution is incompatible with a simplistic notion of equity; equity demands similar tax burdens for all taxpayers, while redistribution requires higher tax burdens for taxpayers with higher incomes. The notions of horizontal and vertical equity resolve this conflict; equity is achieved if persons in similar positions pay appropriately similar taxes, and if persons in dissimilar positions pay appropriately dissimilar taxes. Equity also requires a comprehensive tax base so that taxpayers cannot nullify redistribution by manipulating the form their gains take.

A distributive model of income would disregard the form of receipts and would focus on the timing of receipts. Short-term gains could be brought into income through the use of an arbitrary period such as the taxation year. This approach can be refined by the addition of a diminishing scale of inclusion that reflects the probable effect of inflation on a long-term holding. For example, a gain on a security that is held for more than one year and less than two years would receive a ten per cent exemption, with a further ten per cent exemption for each year of holding. The existing fifty per cent floor would avoid severe lock-in problems, and the taxpayer would have a substantial degree of certainty as to the tax result. Since holding periods of more than a year are inconsistent with blatant speculation, the one-year holding period would end litigation in those types of cases. As the taxpayer's holding period increases, the likelihood of a predominantly speculative motive decreases; by the fifth year, when the capital gains preference reaches its maximum, the transaction would be unlikely to attract litigation. The common law business test would still serve to bring blatantly speculative long term gains into ordinary income.

While in each particular case there would be a trade-off between absolute justice and ease of compliance, an approach which manages rough justice with virtually no uncertainty might be welcomed by both administrators and taxpayers. The holding period concept has been used successfully in the United States: securities which are held for a period which exceeds a designated holding period are deemed to be capital property held for investment, while securities which are disposed of within the holding period are

[94] S.C. 1970-71-72, c. 63 as am.

deemed to be sales in the course of business and give rise to ordinary income.[95]

Canada already uses a limited version of the holding period approach which permits certain employees to acquire shares under options and obtain capital gains treatment of the benefit if the shares are held for at least two years.[96] In this type of provision, there is no need to use terms like "investment", "dealer", "trader", "carrying on business" or other language that is designed to separate the investors and the business people. The holding period is two years, which will work no real hardship on employees of controlled Canadian private corporations. One year might be more appropriate as a holding period for most securities, since taxpayers who acquire and dispose of securities within the taxation year will be in the same economic position as those who receive traditional income. The fact that one taxpayer is an investor and another is a securities professional does not alter the economic realities of their positions. However, if a shorter holding period is thought to be conducive to investor flexibility, then six months or less could be used.

A holding period approach raises collateral issues. Should a holding period rule form the only basis for separating capital and business transactions, or should it be used in conjunction with a presumption that all taxpayers except securities professionals are engaged in investment? Should transactions which are caught within the holding period be treated as ordinary gains or losses, or should a class of short term gains and losses be created with special rules governing inclusion of gain and application of losses? What provision should be made for cases of hardship, where the taxpayer's investment intent is obvious yet supervening forces necessitate an accelerated disposition within the holding period?

With a short holding period, it becomes possible for a securities professional to qualify for long term treatment by happenstance. If a short period were selected, it would then be wise to augment the holding period scheme with a detailed exclusion for "securities dealers who hold securities for sale to customers". In addition, there would be no reason to exclude highly active "traders" who trade on their own account: the character of the taxpayer is irrelevant so long as the character of the transaction can be de-

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[95] I.R.C. § 1223, as am.

[96] *Income Tax Act*, s. 7(1.1), added by S.C. 1977-78, c. 1, s. 3, applicable to agreements entered into after March 31, 1977.

termined with accuracy, and a simple holding period rule makes accuracy possible. If a longer holding period is employed, then the need for an exclusion for professionals diminishes. If frequent adjustment of the holding period is anticipated, however, it would be desirable to establish a simple prohibited category and alleviate the harshness of the prohibition by registration rules such as those employed in the United States.[97]

The precise treatment to be accorded short term gains and losses is another facet of the scheme which can be adjusted from time to time. These gains are economically indistinguishable from the ordinary income of professionals, so full inclusion of gains and full application of losses is indicated. The chief advantage of treating holding period gains and losses as capital gains and losses in the United States is that such losses have limited application in practice. Short term losses can be set off only against capital gains; if there is any excess of loss over gain, a small amount may be applied to other income while the balance may be used only on a carry-over basis.[98] Thus taxpayers who receive short term gains have to include them fully in income, but unless short term losses nearly balance gains, they are as ineffective to reduce tax liability as long term capital losses. This treatment is arguably appropriate where large losses can be used to shelter income from other sources from taxation and disproportionately reduce revenue.

Where the distribution of capital gains and losses correlates with income class and occupation, as in Canada, the fear that revenue will be lost is not as compelling as the inequities that result from the limited application of losses.[99] Those taxpayers who are the first to incur losses — those in the lower income classes — are the least likely to have gains against which the losses can be offset. In effect, these taxpayers receive less loss relief than taxpayers who

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[97] See I.R.C. § 1236.

[98] See I.R.C. §§ 1211(b), 1212.

[99] The record of gains and losses on share transactions over the period 1972-1975 provides an illustration. In 1972 and 1973, years in which share prices were generally rising, virtually all income classes reported net gain on share transactions. In 1974 and 1975, years reflecting weakened share values, all but the highest income classes reported net losses. Taxpayers in the $40-50,000 and over-$100,000 income classes reported the only total gain in 1973, and in 1974 that gain was restricted to the over-$50,000 income class. To restate the proposition, 7% of all taxpayers who engaged in share transactions in 1974 (9% in 1975) reported 100% of the gain. At the other end of the income scale, 9% of the taxpayers reported 18% of the loss realized on share transactions. See App. 4.

have gain as well, and to give holding period losses capital treatment would have a harsher effect on low income taxpayers.

The business investment loss provisions indicate a willingness on the part of the government to go beyond the narrow application of capital losses which has characterized the North American approach to the taxation of capital gains. If a holding period scheme for separating capital and business transactions were to be employed, it would be appropriate to grant taxpayers the right to apply the full amount of any loss to income from other sources. Full application of losses would also encourage greater investor response to loss, for taxpayers would have more reason to cut losses short and let profits run.

Whether the holding period rules can be suspended for hardship is a delicate question. Although arbitrary rules are becoming increasingly acceptable as the tax base takes account of diverse situations, a hardship rule, especially if based on intention, would be as difficult to administer as the present system. On the other hand, to refuse a hardship exception would bring about unintended results in some cases. Cases of sudden loss or financial embarrassment are within the realm of foreseeability and should not be granted relief. Sudden illness, unique financial emergency or demands for ransom come closer to qualifying for real hardship, and here an administrative tribunal might usefully exercise some discretion. The only clear cut case of hardship is death, which could easily be excepted.[100]

III. Canadian treatment of speculative transactions

A. *Judicial trends*

An important feature of a security is that its value to its holder depends on the success of the underlying enterprise.[101] The type of involvement that an investor may choose in attempting to maximize gain can range from reading the financial columns in the newspaper or taking the advice of a broker to purchasing shares in a corporation of which the taxpayer is shareholder and manager, supplier and customer. This section takes a closer look at the kinds of in-

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[100] *E.g., Income Tax Act*, s. 7(1.1) sets up a two year holding period for shares acquired under employee options, but it sanctions a shorter holding period if it ends on the taxpayer's death.

[101] The concept of "security" used throughout this paper derives from Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?* (1967) 18 Case W. Res. L. Rev. 367, 377.

volvement which render the purchase of investment securities a business *via* adventure in the nature of trade — even though the transactions do not constitute trading. This class of cases is important because it marks the leading edge of tax liability for nontrading securities transactions.

Those adventures which are referred to as speculative transactions in shares can be categorized according to the form taken by the personal services element of the transaction. In one category, the taxpayer exercises his or her ordinary business skills in a transaction concerning the same subject matter; in a second, the taxpayer exercises business acumen in an area related by knowledge or subject matter; in a third, shares are sold as a substitute for the underlying subject matter; in a fourth, the sale of shares is accompanied by promotion activities. A fifth category uses the taxpayer's interest in one enterprise to foster the value of his or her other shares; a sixth employs an agent's skills as a substitute for the taxpayer's personal expertise. In a seventh, the taxpayer expends energy to ascertain primary trends in the absence of sophisticated information or ability.

1. Subject matter the same as in ordinary business

In cases where the taxpayer turns pre-existing business skills to his or her own account in transactions concerning the same subject matter, gains from the sideline will be treated as income from business or income from an adventure. Even where the subject matter of the transaction is "property", the existence of a business or adventure will preclude capital gains treatment. Because of the strong relationship between the business and sideline in this category, "business" is a more appropriate categorization than "adventure", but the courts' reluctance to ignore the legal fictions of employment and incorporation has aggravated the tendency to use adventure as the basis for tax liability unless the sideline itself clearly constitutes the conduct of a business.

For example, in *Whittall* v. *M.N.R.*, Gibson J. held that a stockbroker's share transactions on his own account were adventures.[102] However, Mr Justice Martland affirmed the result on the ground that the taxpayer's activities constituted a business and that the stockbroker was in a fiduciary relation at all times, availing himself of the opportunity to make trading profits as a result.[103] Access

[102] [1964] C.T.C. 417, 64 D.T.C. 5266 (Ex.).
[103] [1968] S.C.R. 413.

to insider information sets *Whittall* apart from similar decisions, although the dividing line between business and adventure is blurred. The taxpayer in *Falconer* v. *M.N.R.*[104] was a geological engineer and an officer of a petroleum company which extended share options to him. He and some associates exercised the option and disposed of the shares shortly thereafter. Without expressly designating ordinary business or adventure as the basis for liability, this transaction was described in the Tax Appeal Board decision as "an undertaking closely related to his particular calling".[105]

Although it is unnecessary to employ adventure to bring sidelines into the scope of unincorporated businesses, several cases have done so. In *Lansdell* v. *M.N.R.*,[106] a financial consultant participated in underwriting a block of speculative shares. After the underwriting was completed, he disposed of his allotment of shares from that issue and took the position that the resulting gain was capital. He was held to have engaged in an adventure in the nature of trade because of the similarity between his business operations and the so-called investment.[107] The taxpayer in *No. 924* v. *M.N.R.*[108] was a scrap metal dealer and the special industry knowledge that he possessed was the reason that his transactions in shares of a scrap metal company were held to be adventures.

Cases that fall into this category are not difficult to analyze, as the elements of business in the ordinary sense are so clearly present. The only question is whether these cases are appropriately classed as adventures when the facts closely reflect the attributes of business.

2. Subject matter loosely related to ordinary business

An elderly lawyer who acquired mortgages at discount and then held them to maturity in order to realize the discount was held to be engaged in adventures in *Scott* [*No. 2*] v. *M.N.R.*[109] The same conclusion was reached in respect of an elderly businessman who acquired discounted mortgages and later turned the management

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[104] [1961] Ex. C.R. 353; *aff'd* [1962] S.C.R. 664.

[105] (1959) 23 Tax A.B.C. 114, 118; 59 D.T.C. 622, 626. See also *Ladin* v. *M.N.R.* [1977] C.T.C. 2604, 78 D.T.C. 1007 (T.R.B.) (taxpayer who was employed to purchase cattle earned business income on cattle futures transactions).

[106] [1972] C.T.C. 74, 72 D.T.C. 6057 (F.C.T.D.).

[107] See also *Nasso* v. *M.N.R.* (1960) 26 Tax A.B.C. 111, 61 D.T.C. 127.

[108] (1958) 18 Tax A.B.C. 412, 58 D.T.C. 124.

[109] [1963] S.C.R. 223, *aff'g* [1961] C.T.C. 451, 61 D.T.C. 1285 (Ex.) *per* Thorson P.

of the obligations over to an agent.[110] Each taxpayer relied on general business contacts in the real estate industry, built up over years of conducting business, to aid in selecting sound mortgages. A large number of transactions was involved in each case.

The loose relationship between the taxpayer's ordinary business and the sideline increases the tendency for the courts to treat the sideline as isolated from the ordinary business, and to class the sideline as a business *per se* or an investment; the sole basis for making the distinction seems to be the volume and frequency of the transactions.[111]

3. Promotion of property

"Promotion" is a broad concept which encompasses not only the traditional concept of a promoter of a corporation and its shares but also more subtle arrangements in which the taxpayer has control of an enterprise which directly or indirectly increases the value of other property owned by the taxpayer. Shares disposed of by a promoter in the first sense will almost inevitably be regarded as income from business; adventure need not be invoked.[112] In the case of indirect promotions, however, it is likely that the courts will give capital treatment to property whose value is affected by the success of a related enterprise. This is the result reached in *Chaffey* v. *M.N.R.*,[113] where the taxpayer had an interest in real estate and in the corporation formed to operate a tourist attraction on the land. The shares produced a loss, and the taxpayer argued that the attraction was designed to spark the value of the land. LeDain J. concluded that the shares had been acquired on their own

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[110] *M.N.R.* v. *MacInnes* [1963] S.C.R. 299 *per* Judson J., *rev'g* [1962] Ex. C.R. 385 *per* Thurlow J.

[111] Volume and frequency of transactions is an unsatisfactory basis for determining tax consequences. There is no way to make rules on this basis which are both easy to administer and logical. In *M.N.R.* v. *Spencer* [1961] C.T.C. 109, 61 D.T.C. 1079 (Ex.), the taxpayer had entered into more than 140 mortgage transactions over the years, which led President Thorson to conclude that he was engaged in the operation of a scheme for profit making. In *Wood* v. *M.N.R.* [1969] S.C.R. 330, however, similar transactions were held to be investments. The taxpayer in *Wood* had entered into a total of eleven transactions over the years, with an average of 1.5 mortgages maturing each year.

[112] See, *e.g.*, *McAdam* v. *M.N.R.* [1973] C.T.C. 215, 73 D.T.C. 5189 (F.C.A.); *Angle* v. *M.N.R.* [1969] C.T.C. 624, 69 D.T.C. 5423 (Ex.); *Morgan Securities Ltd* v. *M.N.R.* [1967] C.T.C. 1, 67 D.T.C. 5015 (Ex.); *Davidson* v. *M.N.R.* [1964] Ex. C.R. 48.

[113] *Supra*, note 11, *per* LeDain J.

merits, on the balance of the evidence, and that the loss was not from an adventure. LeDain J. did observe that on the evidence before him the decision could have gone the other way at trial. A similar issue arose in *Cooper* v. *M.N.R.*,[114] in which LeDain J. held that "promotion" is simply the "carrying on of a campaign to sell shares to the public":

> A "campaign" to sell shares is a course of action that involves not only juridical acts but non-juridical activity of an organizational and promotional nature. The juridical act of sale is the culmination of an effort to create and develop a market for the shares and to induce persons to purchase them. It is that effort that is the campaign.[115]

4. **Securities sold as a substitute for the underlying property**

Where a taxpayer with established ability in a particular line of endeavour, such as real estate development, tries to obtain capital gains treatment for the transaction by incorporating the property and selling the shares instead of the developed property itself, the courts have attributed the commercial intent of the taxpayer to the share transactions as well, and have frequently invoked "adventure" in order to explain the result. The anti-avoidance implications of this treatment are obvious, and it is possible that the inclusion of capital gains in the tax base renders this response unnecessary today.

Sears v. *M.N.R.*[116] illustrates this reasoning. The taxpayer had engaged in a real estate transaction which evidently would have been an adventure in the nature of trade if a corporation had not been interposed. Instead of selling the real estate at a profit, the shares of the company that owned it were sold instead; this also was held to constitute an adventure because selling the shares was simply another way of turning the real estate to account.[117]

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114 [1977] C.T.C. 107, 77 D.T.C. 5099 (F.C.A.) *per* LeDain J. [References *infra* are cited to C.T.C.]

115 *Ibid.*, 117. See also *Appleby* v. *M.N.R.* [1975] 2 S.C.R. 805, discussed by LeDain J. in *Cooper*, 115-17.

116 [1970] Tax A.B.C. 388, 70 D.T.C. 1272.

117 See also *Siebens* v. *M.N.R.* [1971] C.T.C. 557, 71 D.T.C. 5310 (F.C.T.D.); *Slater* v. *M.N.R.* [1966] C.T.C. 53, 66 D.T.C. 5047 (Ex.); *Ellis* v. *M.N.R.* (1965) 37 Tax A.B.C. 337, 65 D.T.C. 107; *Majerle* v. *M.N.R.* [1970] Tax A.B.C. 781; *Greer* v. *M.N.R.* [1967] Tax A.B.C. 297, 67 D.T.C. 227. *Greer* presents an interesting set of facts. The taxpayer formed two corporations — a vegetable oil manufacturing company and a brokerage firm. The broker corporation undertook to sell the taxpayer's shares in the other company for him, which the taxpayer had received for transferring some land to the company, and the Minister assessed the gain as income because it resulted from an adventure.

5. **Employment of an agent; acting on primary trends**

Where none of the features discussed above appear in securities transactions, it is unlikely that the transaction will be classed as a business or an adventure. The personal efforts of an agent are capable of bringing the principal's securities gains into income,[118] but ordinarily the employment of an agent will not have this effect. Energetic study of the market appears insufficient to transform securities transactions into an adventure or a series of adventures; the cases disclose that the courts have required some evidence of special knowledge and effort before classifying such a transaction as an adventure. Where the evidence merely demonstrates vigour, the transaction is classed as business if there is enough activity, otherwise as an investment.

The securities industry is the beneficiary of a broader concept of investment than that applied to most industries. It is difficult to retain the characterization of investment for real estate if even the slightest step is taken to increase its value while keeping the possibility of sale open.[119] Only recently has it begun to appear that the courts will give credence to the intention to hold developed real estate for income production.[120] Securities have different stature. For some time the courts have taken the position that in the absence of other factors, the purchase of shares in the hope and expectation that they will rise in value and be sold at a gain even shortly after purchase is not enough evidence to support the finding of an adventure.[121]

This proposition was given cogent expression in *Geddes* v. *M.N.R.*,[122] a recent administrative ruling which considered the treatment of gains on grain futures by an individual who was engaged in the grain elevator business. Mr Frost refused to treat the taxpayer's gains as ordinary income, and drew attention to the vast difference between professional trading and acting on primary trends:

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[118] *E.g., M.N.R.* v. *Minden, supra,* note 69.

[119] *Regal Heights Ltd* v. *M.N.R.* [1960] S.C.R. 902.

[120] *Hiwako Investments Ltd* v. *The Queen, supra,* note 11. Chief Justice Jackett ruled that the acquisition of profit-producing real estate as a hedge against inflation was not an adventure in the nature of trade, presumably because there is no presumption that developed real estate is speculative property. He did not discuss whether raw land could constitute such a non-speculative hedge against inflation.

[121] See, *e.g., Irrigation Industries Ltd* v. *M.N.R., supra,* note 60. *Cf. Rutledge* v. *C.I.R., supra,* note 41; *Gordon* v. *M.N.R., supra,* note 45.

[122] [1976] C.T.C. 2449, 76 D.T.C. 1338 (T.R.B.). [References *infra* are cited to C.T.C.]

> To say that a taxpayer can trade successfully on fundamentals is to deny the realities of trading and the principles which traders use. ... [N]othing that the appellant did resembled a genuine trading operation. Such submissions as "scheme of profit making" or "whole course of conduct" do not apply in any real sense to trading in futures on an organized exchange. I do not mean that a non-professional cannot trade. He certainly can, but he must trade in a technical sense, watch the market, cut his losses and not merely rely on a primary trend to bail him out... . [A]lthough he is far removed from being a mere dabbler, his gains are not profit from a business ... .[123]

This decision is consistent with authority which takes the view that mere frequency of transaction does not render securities transactions a business if the operator is only an energetic amateur.[124]

6. Summary

"Adventure", as it has been developed in Canada, has certain recognizable features which distinguish it from trading, though not from business in the general sense. The components of adventure drawn from the cases in which adventure has been in issue can be restated in terms of the economic elements of investment and business. An adventure is a transaction which meets all of the following criteria: (1) it is a speculative investment; (2) there is some risk of loss of initial value which is associated with the acquisition of the subject matter of the transaction; (3) the employment of human wealth in the motivation or timing of the transaction operates to reduce that risk of loss relative to other taxpayers; and (4) the transaction does not constitute a "trade" as that term is used to describe a type of business enterprise. Even though these generalizations can be extracted from reported cases, they are of little use in predicting the ultimate disposition of a given case. By injecting an economic analysis into their approach, the courts have achieved a measure of justice in recent years, but the cost of that justice in terms of litigation expenses and uncertainty is probably too high.

B. *Legislative response*

It is impossible to state that all adventures, as described by Canadian courts, fall neatly into the category of either business

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[123] *Ibid.*, 2451.

[124] See, *e.g.*, *Glaspie* v. *M.N.R.*, *supra*, note 78, *per* Fisher (corporation with $1.5 million portfolio managed by a professionally trained financial specialist was not carrying on business); but see *Graham* v. *M.N.R.* [1970] Tax A.B.C. 1185, 70 D.T.C. 1747 *per* Fordham (investment of $250,000 in mortgages was an active business).

or investment. Securities are consistently thought of as investment vehicles, and where security transactions are in question, it is appropriate to think of adventure as connoting speculative investment.[125] When securities adventures are thought of as speculative investments instead of as business undertakings, the proposition that all securities transactions should enjoy capital treatment has some merit.[126] In the United States, this attitude toward securities has crystallized into specific rules which guarantee securities holders capital gains treatment under every circumstance, unless the taxpayer is a dealer in securities.[127]

Recent legislation permits unincorporated taxpayers to treat all gains or losses arising on the disposition of certain Canadian securities as capital gains and losses, regardless of the circumstances surrounding the disposition.[128] The main limitation on the right to elect this treatment is that dealers and traders in securities may not make the election. The purpose of the election is to confer some certainty on nonbusiness transactions.

The earlier discussion in this paper established criteria for legislation in the difficult area of speculative securities transactions. An ideal model which disregards the distinction between capital and income transactions is politically unfeasible because there are numerous policy arguments for a preference, and those arguments have widespread popular support. Case by case litigation applying the concept of adventure in the nature of trade is a costly device for implementing policy, since the standard is too subjective and too easily manipulated. An economic realities approach leads us closer to distributive justice but again the cost in terms of un-

[125] Andrews, *A Consumption-Type or Cash Flow Personal Income Tax* (1974) 87 Harv. L. Rev. 1113 describes "speculative investments" as the acquisition of property which has no established pattern of earnings. "Speculation" exists when future yield is "highly conjectural" and the "concept of what a willing buyer would pay a willing seller may be highly abstract and quite hypothetical": *ibid.*, 1145. Mere speculation is generally inadequate to transform an acquisition into a business venture; hence it is by default characterized as an investment, even though it is not an investment which is productive of income.

[126] Tresilian, *The Capital Gains Scare* (1955) 3 Can. Tax J. 396; Gordon, *Capital Gains are Sometimes Taxed* (1955) 3 Can. Tax J. 399.

[127] I.R.C. § 1221(1) restricts the scope of noncapital assets for securities holders to stock in trade, inventory and property held for sale to customers. Thus, all securities transactions are treated as capital transactions unless reported by a "dealer". Mere trading in securities will not affect the capital asset treatment of the property. Even dealers may segregate investment securities from inventory, permitting dealers some enjoyment of the capital treatment. See I.R.C. § 1236.

[128] *Income Tax Act*, s. 39(4), (5), (6), added by 1977-78, c. 1, s. 16(2).

certainty and litigation is too high. A distributive model that seeks to give to gains that approximate income the same treatment as ordinary income would remove most of the uncertainty while achieving a rough measure of justice.

In seeking certainty, the guaranteed capital gains election has managed to combine the worst features of the common law business and the economic realities models. It substitutes unworkable concepts like "dealer", "trader", and "carrying on business" for the unworkable concepts of "adventure", "capital", and "investment" and has merely shifted the focus of litigation. It narrows the range of cases in which the courts can employ their newly devised economic analysis. This will increase the number of cases in which taxpayers who generate gains that resemble income flows will be treated as if the gain was unexpected and therefore deserving of a tax preference. It also defeats distributive objectives by expanding the scope of the capital gains preference. It is likely that many taxpayers who will generate gains that resemble income flows will be entitled to take advantage of the election if a narrow concept of dealer or trader is developed by the courts.

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APPENDIX 1

Percentage of Income Derived from Capital Gains, by Income Class (1972-1976)

	1972	1973	1974	1975	1976
Loss and nil	—	—	—	—	—
$1 - 1000	.04	—	—	.26	.20
$1000 - 2000	.05	.09	.10	.10	.12
$2000 - 3000	.008	.13	.03	.17	1.40
$3000 - 4000	.08	.13	.11	.20	.20
$4000 - 5000	.05	.10	.13	.20	.27
$5000 - 10,000	.05	.09	.11	.15	.23
$10 - 15,000	.09	.15	.13	.14	.19
$15 - 20,000	.28	.32	.25	.22	.25
$20 - 25,000	.50	.60	.45	.40	.39
$25 - 50,000	.97	1.00	.80	.86	1.00
$50 - 100,000	1.90	1.80	1.40	1.60	2.40
$100 - 200,000	3.50	3.90	2.60	2.60	4.30
over $200,000	8.90	9.60	5.70	6.50	8.90
overall	.22	.32	2.80	3.65	5.00

Source: Revenue Canada, Taxation, *Taxation Statistics* (1974-1978), Table 2.

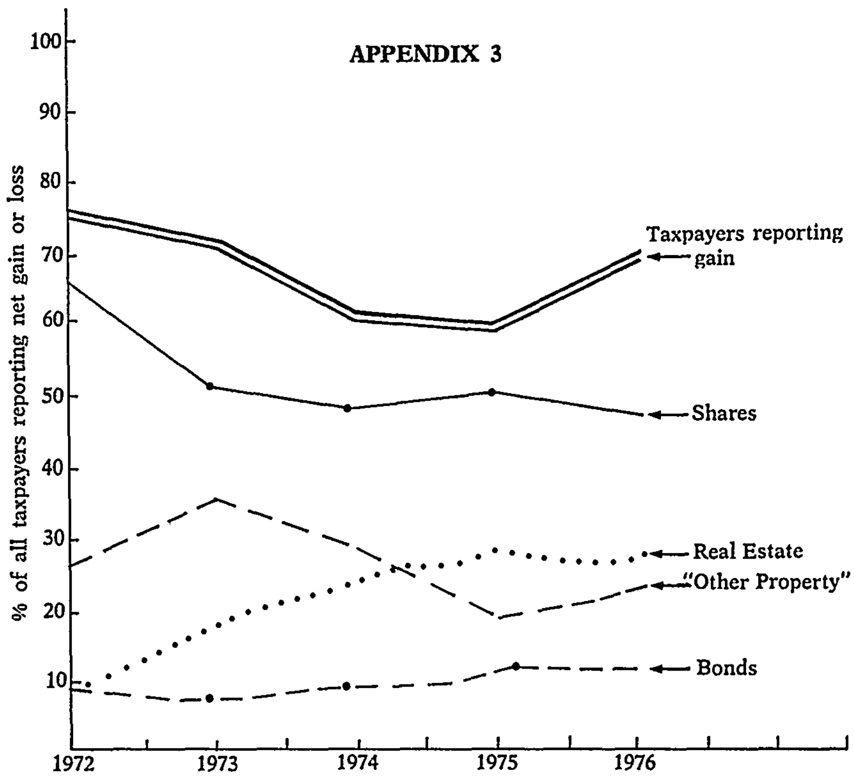
APPENDIX 2

Number of Individuals Reporting Gain or Loss by Asset Type, Expressed as a Percentage of All Individuals Reporting Gain or Loss (1972-1976).

	1972		1973		1974		1975		1976	
	No. Reporting	%	No. Reporting	%	No. Reporting	%	No. Reporting	%	No. Reporting	%
Shares	200,121	65	208,027	50	187,021	48	171,092	50	188,918	48
Bonds	27,425	9	34,423	8	37,709	9	41,076	12	48,699	12
Real Estate	27,604	9	69,809	17	92,198	24	94,655	28	103,419	26
Other Capital Property	78,534	26	145,696	35	114,605	29	61,448	18	95,767	24
Total Reporting Gain	230,862	75	302,584	72	238,773	61	201,608	59	272,264	68
Total Reporting Loss	75,098	25	115,075	28	152,724	39	131,858	41	126,634	32
Total Reporting	305,960		417,659		391,497		339,466		398,898	

Source: Revenue Canada, Taxation, *Taxation Statistics* (1974-1978), Table 18.

APPENDIX 3



Source: Revenue Canada, Taxation, *Taxation Statistics* (1974-1978), Table 18.

APPENDIX 4

Amount of Gain or Loss by Asset Type, Expressed as a Percentage of Net Gain and Loss Reported by Individuals (1972-1976)

	1972				1973				1974				1975				1976			
	net gain		net loss		net gain		net loss		net gain		net loss		net gain		net loss		net gain		net loss	
	$	%	$	%	$	%	$	%	$	%	$	%	$	%	$	%	$	%	$	%
Shares	209,354	89	14,556	31	170,769	56	3,687	29	28,121	6	205,079	90	63,773	8	102,441	90	240,729	19	43,290	89
Bonds	2,679	1	9,228	20	—	—	8,071	63	3,932	.8	23,483	10	3,582	4	12,001	10	22,973	1.8	5,244	11
Real Estate	1,095	.5	22,789	49	101,923	33	1,146	8	393,520	86	—	—	661,438	86	—	—	952,839	75	—	—
Other Capital Property	22,764	9	—	—	32,551	11	—	—	28,656	6	—	—	41,925	5	—	—	48,143	3.8	—	—
Total Net Gain/Loss Reported	235,892		46,583		305,243		12,904		454,229		228,562		770,718		114,442		1,264,684		48,534	

Source: Revenue Canada, Taxation, *Taxation Statistics* (1974-1978), Table 18.