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FAX COVER PAGE

TO:	Bennett Jones LLP	DATE:	August 31, 2004
ATTENTION:	Curtis Stewart	FROM:	Joel A. Nitikman
FAX NO.:	403-265-7219	DIRECT LINE:	604-443-7115
NO. OF PAGES:	25 (incl. cover page)	FILE NO.:	304327-000401

MESSAGE:

Re: Glenn Wash

Mr. Stewart, I left you a voicemail message regarding your request. I have attached an Auditor's Report that I found for the 1998 and 1999 taxation years. If this enclosure is incorrect or if you require anything further, please do not hesitate to contact me.

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AUDITOR'S REPORT T-20

A. **Taxpayer's Name:** Glenn H. Walsh. **Years:** 1998 & 1999

Taxpayer's Address: 136 ST. Christopher Street, Valetta Malta

	Auditor	Group Head
Name	R. Grewal	Lisa McDonald
Signature	[signature]	[signature] Oct 11/02

Date: October 3, 2002

B **Type of Business:** Preferred shareholder of Conex Services Inc. that owned Tercon Contractors Ltd. and several other corporations.

C. **Other Files in Case:** None. (However, the taxpayer was an officer and the directing mind of the following corporations in 1998)

Type	Name	Relation	A/c #
T2			
T2	12 (1)		
T2			

D. **Extent of Audit**

The review of this file was initiated in conjunction with Tercon Contractors Ltd. Tercon was completed and processed as a separate case due to statute barred dates and also because this file encompassed certain material issues that required substantial audit work by Tax Avoidance as well as by International Audit section.

22 (1) (b)

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The following audit tests were conducted:

1 Examined net income of $5,152,518 reported from the Commodity Trading activities in light of substantial losses from this source in prior years; w/p A-1 to B-3-21. Based on the Tax Avoidance HQs' recommendation, this issue was dropped altogether; w/p 28 to 28-3.

2 Noted benefits related to cash withdrawals by the taxpayer from Tercon that were charged to Tercon's travel expenses in 1997 and 1998; w/p 15-2 & 15-3, 17-1 & 17-2, and 25-1 to 25-12. The resulting adjustment for 1997 year has already been processed. The 1998 adjustment is noted in the following section of this report.

3 Reviewed the taxpayer's claim for bad debt expense of $3,024,650 from money lending business reported on his 1998 tax return; w/p C-1 to C-8-7; the expense is now disallowed.

4 Reviewed the taxpayer's claim of interest expense deduction of $47,499,148.21 in 1998 recorded on Schedule 4 of the return and included in carrying charges; w/p D-1 to D-33-1. The taxpayer and his accountant, Jas Butalia, CA of BDO Dunwoody of Calgary provided very little information on this information. Gord Scott of our International Audit section gathered most of the information and evidence on this issue from the records of Canadian Imperial Bank of Commerce in Toronto. Upon his departure to Calgary TSO, Val Burgart of our International Audit section assisted in gathering and summarizing the information: he has also assisted significantly in researching and developing the various assessing positions for adjustment 3 noted in the following section of this report.

5 Identified the sources of 'other employment income' reported in 1998 and reconciled the amount to the payers' records; w/p E-1 to E-11.

E. Explanation of All Changes

1 Benefits relating to cash drawings charged to travel expense of Tercon

Mr. Walsh was a shareholder of Conex Services Inc. ("Conex") that owned Tercon. He withdrew $15,000 (6 payments of $2,500 each) from Tercon in 1998 calendar year and the amounts were charged to travel expense; w/p 15-3, 25-3. As the expense appeared to be unsupported, it was proposed to disallow the expense to Tercon (w/p 12-1**) and add the same as benefit to his income under subsection 246(1) and subsection 105(1); see w/p

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15-1. The taxpayer's accountant initially agreed with the disallowance of the expense to Tercon; w/p 16-1** but later on changed his mind; w/p 25**. Mr. David Horne, CA, controller of Tercon, submitted cash receipts and expense summary sheets supporting the travel expense and revised the expenses to $8,663,13; w/p 17-4.

The submitted receipts and summary sheets were reviewed and it was concluded that only a portion of the revised expense qualified as bona fide business expense to Tercon; w/p 25 to 25-3. Based on this review, the benefit was reduced from $15,000 to $12,717.44 and is now added to his 1998 income under subsection 246(1). In the alternative, the amount ($12,717.44) is added to his income under subsection 15(1) as Conex has conferred a benefit on Mr. Walsh by permitting its subsidiary (Tercon) to make the payments in excess of the bona fide business travel expenses.

2 **Bad debt expense – not allowable**

The taxpayer claimed a bad debt expense of $3,024,650 in computing his business income from money lending business in 1998. According to Mr. Butalia, the bad debt consists of principal ($2,814,049) representing certain loans to Erwin Braich and accrued interest thereon ($210,601) that was not paid: w/p 38-2 & 38-2-A.

Loan/Note 1: Promissory Note for US$1,000,000 x 1.4209 = $1,420,900 Cdn. (w/p 50-9) – wire transferred on March 3/98; w/p C-9.

Loan/Note 2: Promissory Note for 500,000 Sterling Pounds = $1,188,861 Cdn. (w/p 50-10). [Tercon wire transferred $9,000,000 + $2,000,160 to Hambros Private Banking in Guernsey (tax haven!!). GBP 500,000 were taken out from the Hambros bank a/c; $9,829,849.50 was returned to Toronto Dominion by telegraphic transfer; w/p 50-146]

Loan 3: US$70,000 = $110,258 Cdn, wire transferred to Lega InterConsult in Sofia, Bulgaria ; August 21/98; w/p 50-11 & 50-12.

Loan 4: US$60,000 = $94,030 Cdn, wire transferred to BTC Partners in Dallas Texas on August 29, 1998; w/p 50-13 & 50-14.

To decide whether or not the taxpayer is entitled to the claimed deduction, it is essential to review:

a) that the funds in fact were loaned to Erwin Braich;
b) that the taxpayer has established that the debts in question have become uncollectible;

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c) that the taxpayer's ordinary business included the lending of money and the loan was made in the ordinary course of the taxpayer's business of lending money.

A complete discussion on these topics is noted below:

a) Were the funds in fact loaned?
As the taxpayer was engaged in sophisticated tax planning including becoming a non-resident in 1998, and the loans were made through wire transfers and without any verifiable security taken, it is essential to determine that the funds in question were in fact advanced to Mr. Braich. As the wire transfer had left no verifiable trail of the recipient of the funds, it is conceivable the funds could have been deposited in the taxpayer's offshore bank account/s directly or indirectly. The taxpayer has been requested to provide us with documentary evidence from the transferring bank/s about the recipient of the funds i.e. name and address of the bank where the funds were transferred to, and the name/s and address/es of the account holder/s receiving the funds; w/p 56. [Due to the fast approaching statute barred date, the file is written up without waiting for any representation that Mr. Butalia might make in the near future].

We also find the contents of both the promissory notes (Loan 1 & 2) incomplete and/or incorrect. The promissory note dated March 18, 1998 (Loan 2) does not contain the amount of interest "as agreed"; the space between the brackets was left blank. The second promissory note (Loan 1) dated March 3, 1998 was payable on March 23, 1998 but the stated amount of interest on the principal does not correspond with the interest rate of prime plus 2% for the 20 days. It is hard to accept that someone would lend such a large sum of money on the basis of promissory notes that were not even worded accurately and without obtaining adequate security. With respect to the two smaller amounts of US$70,000 (Loan 3) and US$60,000 (Loan 4), we have not received any loan documentation outlining the interest rate, terms of repayment, the maturity date and details of security taken etc. Accordingly, we are not in a position to accept these two amounts as loans. The submitted documents [Tercon's internal memos and the data entry for the outgoing funds (w/ps 50-11 to 50-14)] do not support the borrower and lender relationship between the taxpayer and the recipient of the funds.

b) Did the taxpayer establish that the debts have become uncollectible?
We have reviewed all the correspondence submitted on the collection efforts made by the taxpayer on the debt; w/p 50 to 50-143. Item 5 of Mr. Butalia's Memorandum dated July 12, 1999 addressed and faxed to McLean Saba Armstrong refers to Mr. Braich providing security on his property in upstate New York; w/p 50-52 & 50-53. He has not provided any details and documentation of the mentioned security and what action/s were taken by Mr. Walsh to realize on the security. Under item 10 of the same memo (w/p 50-53), we note that Mr. Braich was willing to pay the full amount along with the interest charges in

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the later part of December of 1998. Furthermore, in items 2 and 3 of Mr. Butalia's Memorandum dated January 25, 1999 (w/p 50-59) that documents his conversation with Mr. Walsh, it is noted that Mr. Braich, in his conversation of January 21, 1999, was willing to return the capital with the appropriate return on the use of funds and Mr. Walsh could walk away from the deal. We also note in the memo that he (Mr. Butalia) had recommended to Mr. Walsh to call for the funds to be returned.

Keeping in mind Mr. Braich's willingness to repay the capital along with the interest thereon in the early part of 1999 and that no formal demand was made on the promissory notes until April 26, 1999 (w/p 50-70, 50-74), it is our view that Mr. Walsh has not established that the debts in question were even doubtful in the 1998 taxation year. Furthermore, a letter from McLean Saba Armstrong dated April 7, 1999 further confirms that Mr. Walsh had not formally demanded the payment of Loan 1, 3 and 4 as of that date (w/p 50-113).

Accordingly, it is our conclusion that Mr. Walsh has not established that the funds, if they were in fact loaned, were uncollectible in 1998.

c) Did the taxpayer's ordinary business include the lending of money?

The taxpayer did not specify the provisions under which the deduction was claimed; but it is evident that it must have been claimed either under paragraph 20(1)(l) or paragraph 20(1)(p) since it included the principal. Thus it became essential to determine whether or not the taxpayer's ordinary business included the lending of money and that the funds that became uncollectible were loaned in the ordinary course of the money lending business. Several relevant court cases in this regard were reviewed and a questionnaire was designed; w/p C-1 to C-8-7 and 40-3 to 40-5.

It is noted that from 1995 to 1997 inclusive, the taxpayer has reported business losses from commodity trading. Such trading was done, presumably at his direction, by Refco Futures (Canada) Ltd. ("Refco"). During these years, he also reported employment income or employment related benefits. Accordingly, until the end of 1997, he had no transaction or income from the business of lending money. In 1998, most of his reported income was from Employee Profit Sharing Plans set up by the various companies he had controlled directly or indirectly. He also reported net income from commodity trading in 1998 – again the transactions were conducted by Refco. Thus it is debatable whether he was engaged in commodity trading in 1995 to 1998 since the actual trading was done by Refco. His money lending activities in 1998 involved only these four loans/ notes receivable at issue.

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From the taxpayer's response to our questionnaire, it is decided that the taxpayer's ordinary business did not include the lending of money and the funds were not loaned in the ordinary course of money lending business; w/p 50-3 to 50-5. Our decision is based on the following reasons:

i) The taxpayer had no business license from the City of Kamloops supporting that he was carrying on a money lending business.
ii) He did not advertise his business and he was not known to the general public that he was carrying on a business of lending money. His advances to companies in which he had personal interest through shareholdings were not known to public and were made to related corporations.
iii) He had no systematic way of obtaining applications from potential borrowers and assessing the credit risk by conducting a credit check on their previous credit history.
iv) No indication that he had even considered lending money to any other party other than Mr. Braich. No records had been maintained to whom he had denied lending money.
v) Two loans (Loan 1 & 2) were advanced on the basis security of promissory notes. No money lending business could survive on such security.
vi) There were no other loans advanced to arm's length parties that were in good standing at the end of 1998.
vii) He did not have the necessary regulatory approval to be in the money lending business.

As noted in the case of Lowman Warehousing Ltd. v. The Queen; 99 DTC 1113; w/p C-4-2, some effect must be given to the word 'ordinary': it implies that the business of lending money be one of the ways in which the company (or taxpayer) as an ordinary part of its business operations earns its income: it also implies that the lending of money be identifiable. Also, ordinary business requires significant involvement of a person, refers to his center of routine where he has the responsibility and or the duty to conduct and or manage most aspect of the business. In this case, Mr. Walsh lacked the volume and frequency of transactions, the turnover of the investments and he had no systematic way of assessing credit risk and he did not obtain any tangible security in case the debt became impaired. He did not proceed in an orderly businesslike way and in the way that a businessperson normally be expected to do. The courts usually use such a criteria in determining similar issue; see Langhammer v. The Queen, 2001 DTC 49; w/p C-8-4.

There are many indications in the documents provided to us by Mr. Butalia that Mr. Walsh was to participate in the deals or to be a part owner of the projects; see w/p 50-55, item 2 & 3 on w/p 50-59, w/ps 50-72 and 50-111. Mr. Butalia has also stressed this point as well, on page one of his letter dated August 2, 2002; w/p 50. However, he provided no details of the deals and Mr. Walsh's participation in the profit from the projects and also about the securities that possibly could have been obtained in Canada or abroad; w/p 50-

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134 and 50-141. Accordingly, the loans at issue, if proven to have been made were investments and were not loans made in the ordinary business of lending money. Therefore, the deduction claimed for bad debts is not allowable under paragraphs 20(1)(I) or 20(1)(p).

3 Interest expense claimed as carrying charges – not allowable

This issue is discussed under the following headings:

a) Quantum of the deduction and background
b) Purpose and strategy
c) Details of loans arrangement
d) Why the claimed deduction is not allowable

a) Quantum of the deduction and background

The taxpayer claimed interest expense of $47,499,148.21 on Schedule 4 of his 1998 tax return and the amount was included in the carrying charges on page 2 of the return. The claimed interest expense represents interest from June 15, 1998 to December 31, 1998 on a loan of US$694,852,318 ("Primary Loan") borrowed from Canadian Imperial Bank of Commerce (New York Agency), (hereinafter noted as CIBC). The Primary Loan was arranged for the period from June 15, 1998 to January 15, 1999; please refer to a copy of the promissory note ("the CIBC Note") outlining the details of this loan: w/p D-19 to D-19-2. The taxpayer ceased to be a resident of Canada on December 29, 1998 as per his 1998 tax return. He arranged another loan, called 'Bridge Loan' of US$30,664,395.23 from CIBC to pay for the interest on the Primary Loan to December 31, 1998. The principal of the Bridge Loan was claimed as deduction for interest expense in 1998; w/ps D-21-4 to D-21-6: US$30,664,395.23 x 1.549 = $47,499,148.21 Cdn.

Please refer to audit program filed under w/p D-1 and D-1-1 as a start up on this issue and to familiarize with the documentary evidence on file. The user of this report is strongly recommended to review in detail all the evidence gathered during the audit: w/ps D-2 to D-27-4.

b) Purpose and strategy

The purpose and scheme was outlined in a document called Departure Trade Overview, prepared by CIBC Wood Gundy – Toronto ("the bank") and was attached to Application for Corporate Credit; w/p D-2 to D-2-6. The strategy was marketed by the bank and its overview (from w/p D-2-5) is noted below:

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"The Client is an individual, is a resident of Canada for tax purposes, and has recognized (or expects to recognize) significant taxable income in the current year. For tax purposes, the Client recognizes interest income and expense on a cash basis (i.e. as interest received or paid), not on an accrual basis. The Client seeks to offset the recognized income by recognition of comparable interest expense, which interest expense will be incurred (underlining is ours) to make an investment, which is expected to provide comparable interest income in the following taxation year. De facto, the Client defers recognition of the taxable income from the current taxation year to the next one.

The client achieves this result by: (i) borrowing funds on which interest is payable in the current year and (ii) using these funds to make an investment whose return will be received in the following year. Taken together, these transactions must provide the Client with the 'reasonable expectation of profit'; otherwise the deductibility of the Client interest expense may be disallowed".

To achieve the above noted strategy, the bank would lend funds under a fixed-rate U.S. dollar term loan. Interest expense would be payable twice; on the last business day of the current year (e.g. December 31, 1998) and on the loan's maturity date. The bank would back into the amount by determining what quantity of funds must be advanced so that the amount of the first interest payment equals the amount of income recognition that the client wants to offset. [See Mechanics on w/p D-2-5]

[Note that the taxpayer had already planned to become a resident of Malta, a tax haven country; thus, any investment income received in 1999 would not be subject to taxation in Canada. He realized Employee Profit Sharing Plan (EPSP) income of $29,554,200 in 1998 from three companies with whom he was not dealing at an arm's length: (a) Conex (b) Tercon (c) Elbee. Refer to Addendum –1 attached for details of EPSP income. He also reported business income of $5,152,518 from commodity trading in 1998].

The taxpayer, his lawyers, Mr. Butalia and the bank were all involved in the negotiation and execution of the strategy. The strategy was fine-tuned and the amount of loan was changed to meet the taxpayer's needs. Final strategy was outlined in a document called Departure Trade "GW" Deal Bible and was executed as noted therein with the exception of the quantum of the Primary Loan; see w/p D-13 to D-13-13. Also, the details and chronology of the transaction were summarized as noted in the bank's documents; w/p D-16 to D-16-3.

c) Details of the loans arrangement

The contents of the Deal Bible, as executed, are summarized below:

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- The taxpayer borrowed US$694,852,318 under the Primary Loan at 8.74% on June 15, 1998 evidenced by a promissory note, called the CIBC Note.

- The taxpayer directed all the funds of the Primary Loan to Falcon Enterprises Inc. ("Falcon"). Falcon was a wholly owned, limited-purpose, private company resident in the Cayman Islands that was incorporated by the taxpayer. He owned 100% of the voting common shares. [See w/p D-13 and D-20]. The shares of Falcon were pledged with CIBC as security for the Primary Loan; w/p D-19-3 and D-13-2.

- Falcon directed the taxpayer to pay the proceeds of the Primary Loan to Phoenix Corporation ("Phoenix") in exchange for Preference Shares of Phoenix; w/p D-20. Phoenix was a limited-purpose private company set up by CIBC in the Cayman Islands. CIBC owned 5% of the voting common shares; the remaining 95% were held in trust for The Red Cross by QueensGate SPV Services Limited ("QSPV); w/p D-13.

- Phoenix directed the funds to purchase a US$694,852,318 note issued by Canadian Imperial Holdings Inc. ("CIHI"); hereinafter called the CIHI note. The CIHI note was pledged to CIBC to guarantee the obligation of the taxpayer in relation to the CIBC Note for the Primary Loan; w/p D-20-1, D-13-2, D-13-8, D-16-2, and D-13-9. The CIHI note was set to earn interest the greater of (i) 8.02223% or (ii) 1 month USD LIBOR plus 1.57%, compounding on the 15th of each month; w/ps D-19-7-5 & 6.

- CIHI further invested the funds with the CIBC Caymans that in turn invested the funds with CIBC New York Agency (referred as CIBC – the starting point of the Primary Loan); see w/p D-13-9.

- CIBC expected that the USD LIBOR would not fluctuate significantly during the term of the CIHI note: thus the interest earned on the CIHI note would be less than the interest payable by the taxpayer on the Primary Loan. To cover the shortfall, CIBC required the taxpayer to make a collateral deposit of US$3,460,208; w/p D-13-9. The collateral deposit earned interest at .25%. [The taxpayer wire transferred this amount ($5,000,000 Cdn.) from Tercon; the amount was debited to his shareholder's loan account with Tercon; see w/p 50-1, 50-144 and 50-147].

- As the taxpayer did not have the required funds to pay interest on the Primary Loan on December 31, 1998, CIBC advanced him an additional loan ("Bridge Loan") of US$30,664,395.23 to enable him to make the first interest payment see w/p D-21-4 to D-21-6. [The amount of this loan, in Canadian dollars, was claimed as interest expense in 1998].

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- CIBC and CIHI further entered into swaps with FP USD Swaps and FP USD Exotics respectively to offset the interest rate exposure; w/p D-13-1 and D-13-9. Further, both the FPs entered into another swap with each other; w/p D-13-2 and D-13-9.

Upon maturity of the CIHI note:

- On January 8, 1999, Phoenix declared dividends on its Preference Shares for an aggregate payment of US$34,304,826.82 – representing profits (basically interest earned on the CIHI note); payable on January 15, 1999; w/p D-34. Phoenix also approved the redemption of the Preference Shares for an aggregate price of US$694,852,318 on January 15, 1999.

- Phoenix also directed all amounts of the principal and interest earned on the CIHI note to pay Falcon in respect of dividends declared on the Phoenix Preference Shares and the redemption or repurchase of those shares; see w/p D-20-2 and D-13-2.

- Falcon directed Phoenix to pay all amounts to the taxpayer in respect of the dividends declared on the Phoenix shares and the redemption or repurchase thereof; w/p D-20-2.

- The taxpayer, the sole shareholder of Falcon passed a resolution and approved the repurchase of Falcon shares; w/p D-35.

- The taxpayer directed Falcon to pay to CIBC all amounts payable to him in respect of the aforementioned dividends and redemption of Preference Shares; w/p D-20-2. He also directed CIBC to apply all such amounts in satisfaction of his debts to CIBC that included the CIBC Note and the interest thereon; and to pay any excess back to him; D-16-2.

- Upon receiving the payment, CIBC was to retire all the indebtedness of the taxpayer and remit any excess to him. CIBC was then to release Phoenix and the taxpayer from their guarantees and pledges; w/p D-16-2.

- After January 15, 1999, CIBC and QSPV were to dissolve Phoenix and the taxpayer was to dissolve Falcon; w/p D-16-2.

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From the schematic diagram (Addendum – 2) and details noted above, it is clear that the entire loan process was a circular arrangement. The amount for the Primary Loan and the Bridge Loan never left CIBC and CIBC never relinquished control of the funds. This conclusion is further supported by the bank's own documentation that:

a) the net funding requirement for the transaction was zero; see item 4 (Funding requirement) on w/p D-13-11.
b) no funds will be released to the client (taxpayer); all money will be offset by the bank; w/p D-2-1 and D-16-1

Thus it is quite evident that CIBC accommodated the interest expense deduction for a fee earned through the interest rate spread (8.74% less 8.02223% = 0.71777%) on the Primary Loan and in part by utilizing the collateral proceeds without paying interest at the going market rate.

d) Why the claimed deduction is not allowable

The claimed interest expense deduction is disallowed under the various provisions and positions noted below. The application of these provisions and the positions are not mutually exclusive and all should be considered and/or litigated (if warranted):

(1) The financing arrangement was a sham
(2) The interest expense is not allowable under paragraphs 18(1)(a) and 18(1)(h)
(3) The taxpayer is not entitled to claim the interest expense under paragraph 20(1)(c)
(4) Application of General Anti-Avoidance Rule, section 245.

(1) The financing arrangement was a sham

The entire financing exercise is viewed as circular arrangement, achieved with the creation of various documents with pre-set direction by the parties involved to direct the funds by one party to the next. The amounts for the Primary Loan and Bridge Loan never left CIBC and CIBC never relinquished control of the funds. Upon maturity of the CIBC Note and CIHI note, the transaction unwound, again with pre-set directions to repay by one party to the other resulting in no movement of funds outside CIBC. The parties that were dealing at an arm's length with CIBC obtained neither control nor possession of the funds, even for one moment. The entire arrangement was undertaken to create a tax deduction, had no bona fide business purpose and was not profitable from the very beginning. The entire arrangement is viewed as a sham when considered in light of comments made about Moloney v. The Queen, 92 D.T.C. 6570, cited in the recent Supreme Court of Canada case of Walls v. Canada. Even without considering the comments of the Supreme Court of Canada in the Wall's case, these transactions would

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be reviewed as a sham as they purport to create obligations and rights that simply are not there. This is a sham in the classic sense. Accordingly, the claimed deduction is not allowable under the provisions of paragraph 18(1)(a) and the taxpayer is not entitled to claim the deduction under paragraph 20(1)(c).

(2) Interest expense not allowable under paragraphs 18(1)(a) and 18(1)(h)

The only purpose of the Primary Loan was to create an interest expense for Mr. Walsh in the 1998 calendar year so as to offset the income that he had realized or was planning to realize. As noted earlier, the entire financing arrangement was of short duration and was neither profitable nor undertaken for the purpose of earning income from business or property. Thus, it is our position that the Primary Loan was taken for Mr. Walsh's personal use and benefit: any expense related thereto is considered his 'personal and living expenses' under the definitions in subsection 248(1) and is therefore, not allowable under the provisions of paragraphs 18(1)(a) and 18(1)(h).

Our conclusion is not inconsistent with the discussion and guidelines recommended in the Supreme Court of Canada's decision of Stewart v. Canada; (w/p D-31). In that case, the court has recommended a two-stage approach to determine whether a taxpayer's activities constitute a source of business or property income:

(i) is the taxpayer's activity undertaken is pursuit of profit or is it a personal endeavour?
(ii) if it is not a personal endeavour, is the source of income a business or property?

In addition to the two-stage approach, the court has also recommended a 'Source of Income Approach' in paragraph 48 to 56 of the case; w/ps D-31-13 to 15. In paragraph 54, the court has expanded the question posed in the first stage; see w/p D-31-15.

> "Does the taxpayer intend to carry on an activity for profit and is there evidence to support that intention? This requires the taxpayer to establish that his or her predominant intention is to make a profit from the activity and that the activity has been carried out in accordance with objective standards of businesslike behaviour".

Our answer to the first question is that the financing at issue was a personal endeavour; it was planned to discontinue after January 15, 1999 and it was not profitable from the inception. The taxpayer was fully aware of this and he proceeded with the Primary Loan just to create an expense deduction to minimize his tax liability. There is no need to distinguish between the sources of income in the second question, as the taxpayer had no source of business or property income for the application section 3 or 9 of the Act: please refer to paragraph 49 and 50 of the court case.

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Our conclusion to disallow the interest expense under paragraph 18(1)(a) is also consistent with the comments made by the learned judge J.A Hugessen in the court case of Moloney V. The Queen, 92 DTC 6570:

"While it is trite law that a taxpayer may so arrange his business as to attract the least possible tax[1], it is equally clear in our view that the reduction of his own tax cannot by itself be a taxpayer's business for the purpose of the Income Tax Act".

(3) Not entitled to claim the interest expense under paragraph 20(1)(c)

In paragraph 28 of the court case of Shell Canada Limited v. Queen (Supreme Court of Canada 99 DTC 5669), the court has cited four essential elements for interest expense to qualify as a deduction under paragraph 20(1)(c); see w/p D-39:

(i) the amount must be paid in the year or be payable in the year in which it is sought to be deducted;
(ii) the amount must be paid pursuant to a legal obligation to pay interest on borrowed money;
(iii) the borrowed money must be used for the purpose of earning non-exempt income from a business or property and
(iv) the amounts must be reasonable, as assessed by reference to the first three requirements.

The deduction at issue does not satisfy the conditions (i) and (iii) noted above.

(i) The first payment of interest on the Primary Note was not payable until December 31, 1998 as noted in paragraph 2 of the first page of the CIBC Note; w/p D-19. The taxpayer ceased to be resident of Canada on December 29, 1998 – per his 1998 tax return. Under section 114, he was entitled to deductions that can reasonably be considered wholly applicable to the period for which he was resident of Canada. As the interest on the Primary Loan was not payable in the period during which he was resident of Canada, the claimed deduction is not allowable.

(iii) In this case, the sole purpose for undertaking the transactions was to avoid taxation by creating an interest expense deduction to offset known income inclusion. In the court case of **Novopharm (2002 DTC, 1307)**, it was concluded that transactions undertaken for tax avoidance purposes are considered not to have been entered into for the purpose of earning

[1] See Duke of Westminster's case [1936] ACI

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income. In paragraph 52 of this court case, Justice Bowie has referred to Estey, J in Stubart v. the Queen:

"Today there is only one principal or approach, namely the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act and the intention of the Parliament.

Commenting on this statement of the law, Iacobucci, J said in Antosko v. The Queen:

"It is principal that must prevail unless the transaction is a sham or is so blatantly synthetic as to be effectively artificial".

[Paragraph 52 continues]: "Sham is not an issue in this case, but in my view the second half of this sentence describes accurately the tax avoidance arrangement ...devised... It is not, in my opinion, necessary to do more than apply the ordinary grammatical meaning of the words of subparagraph 20(1)(c)(i) to find that the borrowing does not meet its requirement. If I am wrong in that, I would certainly construe the words "used for the purpose of earning income from a business or property" as not being intended to include the use of borrowed funds to implement schemes which have no purpose other than tax avoidance". [End of paragraph 52]

In the taxpayer's case, the situation is distinguishable from those of Shell Canada, Ludco and Singleton. In each of those cases, the taxpayer had an income-producing goal; they all arranged their affairs in the way that accomplished that goal most effectively for them. In the present case, there was no income-producing goal: the only goal the taxpayer had, was to create a deduction to avoid his tax liability. Accordingly, the borrowed funds were not used for the purpose of earning income from business or property, therefore, the claimed deduction under paragraph 20(1)(c) is not allowable.

(4) <u>Application of General Anti Avoidance Rule (GAAR)</u>

The interest expense is considered not allowable under the provisions of General Anti-Avoidance Rule and is explained under the following headings:

A) Facts
B) Nature and quantum of tax benefit
C) Primary purpose of the transaction/s
D) Misuse and or abuse of the provisions of the Act
E) Conclusion

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A) Facts

The taxpayer had planned to become a non-resident of Canada in 1998 and obtained a residency permit from Malta dated February 20, 1998; w/p D-36. He drained the surplus of three corporation with whom he was not dealing at an arm's length through the Employee Profit Sharing Plans expense; see Addendum -1. Such an expense required no withholding or source deduction. To shelter his income, he arranged to borrow significant sum of money from a bank. The borrowed funds were indirectly invested with the same bank. The deposit with the bank matured at a time when he was a resident of a tax haven country and was no longer a resident of Canada. The borrowing generated sufficient interest expense to shelter his income in the year of his departure. Please refer to item b) and c) on page 7 and pages 8 to 10 respectively of this report for complete details.

B) Nature and quantum of tax benefit

The borrowing from CIBC generated interest expense of $47,499,148.21 that the taxpayer had claimed as carrying charges. This was the main and primary benefit he had received and the entire financing exercise was undertaken for this purpose.

With the imposition of Falcon and Phoenix, the two offshore corporations, he was able to convert the accrued gain on the invested funds (CIHI note) from interest income to capital gains. [An estimated amount of capital gain of $9,991,347,08* was reported on the deemed disposition of Falcon shares under the provisions of paragraph 128.1(4)(b)]. This benefit was a by-product of the entire scheme: we do not believe that the financing was primarily undertaken for this secondary benefit.

C) Primary purpose of the transaction/s

The only purpose of obtaining the Primary Loan from CIBC was to create interest expense deduction to shelter taxpayer's substantial income that he planned/expected to realize in 1998. Please refer to item b) on page 7 and 8 of this report for details. It had no other purpose other than to obtain a deduction in 1998. The borrowing of funds and reinvesting them with CIBC (through the imposition of Falcon and Phoenix) was not profitable from the beginning. The taxpayer's accountant, Mr. Butalia was aware of that and he outlined his concern to Wood Gundy in a letter - how to convince Revenue Canada that the taxpayer had an expectation of profit; see item 2 of w/p D-6. For this reason, the floating interest rate on the CIHI note was brought into the scheme.

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* See the last adjustment in this section of the report – the quantum of the gain is also being redetermined by this reassessment.

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Under the definitions in subsection 245(1): "transaction" includes an arrangement and "tax benefit" means a reduction, avoidance or deferral of tax. Since all the transactions were not primarily undertaken for bona fide purposes other than to obtain the tax benefit, the transactions are considered avoidance transactions under subsection 245(3).

D) Misuse and or abuse of the provisions of the Act

In the landmark decision of OSFC Holdings Ltd. v. The Queen, the technical meaning of the words 'Misuse and Abuse' was discussed in the context of the application of subsection 245(4). In paragraph 61 of the case, the court has referred to Professor Vern Krishna:

> What constitute a "misuse" of the Act depends upon the object and spirit of the particular provision under scrutiny. What constitute an "abuse" of the Act as a whole is a wider question and requires an examination of the inter-relationship of the relevant provisions in context.

Furthermore, under paragraph 65 of that case, the court has noted:

> Determining whether a particular provision of the Act has been misused or whether the Act read as a whole has been abused, requires an examination of the purpose ("object and spirit") of the particular provision or scheme of provisions. It is not sufficient merely to rely on the technical language of the particular provision or scheme of provisions to determine whether there has been a misuse of the Act or an abuse of the Act read as a whole.

The purpose of paragraph 20(1)(c) is to provide deduction for interest expense where the funds have been genuinely used for the purpose of earning income from a bona fide business or property. This provision for the deduction of interest provides a substantial incentive for Canadians to accumulate capital, which would then produce taxable income[2]. The provision contemplates that the business or property for which such an expense is incurred would generate income that would be included in a taxpayer's income under the various provisions of the Act; ensuring matching of expenses with revenue (timing) and taxing the net income (not gross income) generated therefrom. This concept also corresponds with the matching principle under the generally accepted accounting principles. The courts have found that the application of paragraph 20(1)(c) to implement a tax avoidance arrangement is inconsistent with this purpose[3]. Transactions not in accordance with normal business practice, such as those undertaken in the subject case, have been found to be tax avoidance arrangements for fiscal manipulation without commercial reality[4]. Accordingly, the taxpayer has misused the provisions of paragraph 20(1)(c).

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[2] Bronfman Trust v.Q [1987] 1 SCR 32
[3] 722540 Ontario Inc. [2001] FTR 36927, para. 58
[4] Ibid of para 59, referring to Canwest

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By interposing Falcon and Phoenix, the taxpayer has converted the accrued interest income on the CIHI note into capital gain that the taxpayer has voluntarily reported** on the deemed disposition of Falcon shares; therefore, he appears to have misused the provisions of paragraph 128.1(4)(b). Also, by interposing Falcon between the taxpayer and Phoenix and by choosing taxation year-ends of these two offshore corporations subsequent to the date of his becoming a non-resident, he has circumvented the possible application of Foreign Accrual Property Income rules under the provisions of section 95 of the Act; see item 5 on w/p D-13-10.

Also, we consider that the taxpayer, in collaboration with CIBC Wood Gundy, undertook non-commercial, tax-driven transaction that took advantage of timing differences permitted by the Act with respect to interest expense and investment income reporting as well as the differences in taxation of residents and non-residents. It is questionable whether our Parliament would have considered that a taxpayer would undertake such complex, non-commercial transactions in collaboration with a major Canadian bank in order to use these particular provisions in this manner. Thus, the avoidance transactions have resulted in an abuse of the Act read as a whole.

E) Conclusion

The interest expense deduction of $47,499,148.21 claimed in 1998 should be denied under the provisions of subsection 245(2). Our Headquarters (Tax Avoidance and Special Audits Division) has also approved the use of GAAR as a secondary position in the event that a reassessment pursuant to paragraph 20(1)(c) is not sustainable; see Addendum - 6.

4 Proceeds of Falcon Shares understated

As noted earlier, the taxpayer has reported a capital gain on the disposition of Falcon shares in his 1998 tax return. Mr. Butalia, in his letter of June 11, 2002 has explained that the reported proceeds were determined on an estimated basis; but he has made no reference to any provisions of the Act under which the disposition was reported. It is known that the subject shares were still held by the taxpayer when he became a non-resident on December 29, 1998. Accordingly, it appears that the disposition was reported under paragraph 128.1(4)(b).

We note that the increase in the value of Falcon shares was basically attributable to the accrued interest income earned on the CIHI note purchased by Phoenix from the proceeds of Preference Shares issued to Falcon. Phoenix and Falcon were not carrying on any

** Mr. Butalia has not identified the provision under which the taxpayer has reported the proceeds of Falcon shares; also, the proceeds are estimated.

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business; their only income-earning asset was the CIHI note held by Phoenix. Both Falcon and Phoenix were limited-purpose companies, incorporated to accommodate the Departure Trade strategy and were to be dissolved after January 15, 1999. Therefore, it is our position that the increase in the value of Falcon shares was equivalent to the accrued interest earned on the CIHI note. Please refer to Addendum – 3 attached for calculations of accrued interest earned on the CIHI note from June 15, 1998 to December 29, 1998.

Revised proceeds of Falcon shares		$48,128,299
Less: Proceeds as previously reported		10,000,000
Increase in capital gain	(A)	38,128,299
Increase in taxable capital gain: 75% of (A)		$28,596,224

This adjustment should be reversed in the event the CCRA is successful in the disallowance of the carrying charges discussed in adjustment 3 above and the time period to file an appeal has expired and the taxpayer has lost all his rights to file an appeal to the next higher level. It is processed in order to protect the Minister's position since could not be done at a later stage.

Penalty under subsection 163(2) is not applied, as the adjustments are technical in nature.

F & G. Taxpayer's Representation & Concurrence

All the adjustments noted above (including the alternate positions for adjustment 3) were outlined in writing. Representations made by the taxpayer's accountants and his lawyer are noted below:

Adjustment 1

Mr. David Horne, CA, controller of Tercon has disagreed with the benefits; particularly relating to taxpayer's travel to and stay in Vancouver. He maintains that the travel expenses were incurred on behalf of Tercon for general business development and the expenses were a necessity if Tercon wished to do any significant business in British Columbia; w/p 26.

We have noted that Mr. Walsh's common law spouse (Diane L Chiasson) was living in Vancouver at that time in a condo owned by Tercon; w/p 30 to 30-3. It is our position that the purpose of his travel to Vancouver was to live with her. [Such expenses were disallowed to Tercon as being Mr. Walsh's personal expenses; thus a benefit in his hands]. We were unable to vouch the nature of business conducted by Mr. Walsh in Vancouver, as no invoices (billing by third parties or correspondence with them) have been made available

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Adjustment 2
Mr. Butalia has not responded (yet) to our proposal to disallow the taxpayer's claim of bad debts; accordingly, concurrence is not known. However, he has indicated that the taxpayer was in the business of lending money; w/p 50.

Adjustment 3
The taxpayer's lawyer, Mr. Joel Nitikman disagreed with the various positions we have taken; w/p 37-1. He has stated that in light of recent decisions of the Supreme Court of Canada and the Federal Court of Appeal, it was his view that:

- a taxpayer's motivation in entering into a transaction is irrelevant for tax purposes, even under GAAR;
- REOP is no longer a valid test if a taxpayer had an income-earning purpose:
- so long as a taxpayer might have earned a gross income from an investment interest on money borrowed to acquire that investment is deductible.
- to apply GAAR the Minister must state a clear and unambiguous policy of the Act that has been violated
- to apply GAAR the objective purpose of the transaction must have to receive the tax benefit, regardless of the taxpayer's subjective motivations

In response to our inquiry that a taxpayer's motivation is irrelevant even under GAAR, Mr. Nitikman has responded in legal and technical terms; see w/p 47-1 & 47-2. As we feel pretty solid on our position, it was decided not to respond to his last letter dated July 22, 2002; w/p 47-1.

H. Referrals:

A formal referral to our Tax Avoidance Headquarters was made for the application of GAAR; see Addendum – 5 attached.

The file has also been referred to our collections section because of the large amounts involved and the potential collections problem; w/p 64.

I. Matters To Be Followed Up: None.

J Other Items:

(1) Based on the direction received from T/A headquarters, the adjustment with respect to commodity losses for 1996 and 1997 taxation years has now been dropped; w/p 28 to 28-3 and 31.

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(2) A possible benefit for the use of the condo in Vancouver is not pursued as the writer became aware of this at a later stage of the file. Tercon had already sold the condo in its 1999 fiscal year and thus is no longer ongoing issue.

(3) As a result of the adjustments to 1998 year, the carry forward of non-capital losses of $5,934,640 from 1998 to subsequent years has now been eliminated. The 1999 tax return is also now being reassessed to reduce the application of non-capital losses from $1,502,197 to $247,920. [The losses being allowed in 1999 year were incurred in 1996 and 1997; they are now used up in their entirety. The taxpayer has been advised about this on the 1999 T7W-C.

(4) Actual amount of interest on the Primary Loan from June 15 to December 29, 1998 appears to be higher**. No attempt is made to calculate the exact amount of interest expense as the adjustment deals with the disallowance of the amount claimed in 1998.

(5)

22 (1) (b)

** Using simple interest calculation (not compounding):
US$694,852,318 x 8.74% x 197 days/360 days = US$33,232,856 OR
US$33,232,856 x 1.549 = $51,477,694 Cdn.

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Addendum - 3

CALCULATION OF INTEREST ON THE CIHI NOTE AND
INCREASE IN TAXABLE CAPITAL GAIN ON SHARES
OF FALCON ENTERPRISES INC.

Period	No. of Days (A)	Principal (B)	Interest Rate (C)	Interest Amount (A)x(B)x(C) / 360 Days	Principal + Interest
1998 Year					
June 15 to July 15	30	$ 694,852,318	8.02%	$ 4,643,930	$ 699,496,248
July 16 to August 15	31	699,496,248	8.02%	4,830,799	704,327,046
August 16 to Sept. 15	31	704,327,046	8.02%	4,864,161	709,191,207
Sept. 16 to Oct. 15	30	709,191,207	8.02%	4,739,761	713,930,969
Oct. 16 to Nov. 15	31	713,930,969	8.02%	4,930,487	718,861,455
Nov. 15 to Dec. 15	30	718,861,455	8.02%	4,804,391	723,665,846
Dec. 16 to Dec. 29	14	723,665,846	8.02%	2,257,033	725,922,879
	Total Interest earned on the CIHI Note:			$ 31,070,561	
	Converted to Cdn dollar @ 1.549			$ 48,128,299	

The interest receivable earned on the CIHI Note increased the value of preferred shares of Phoenix Corporation, that in turn increased the value of shares of Falcon Enterprises Inc.

Increase in the value of Falcon shares - as calculated above	48,128,299
Less: Adjusted cost base - as previously reported	8,653
Revised capital gain	48,119,646
Capital gain as previously reported	9,991,347
Increase in capital gain (A)	38,128,299
Increase in taxable capital gain; 75% of (A)	$ 28,596,225

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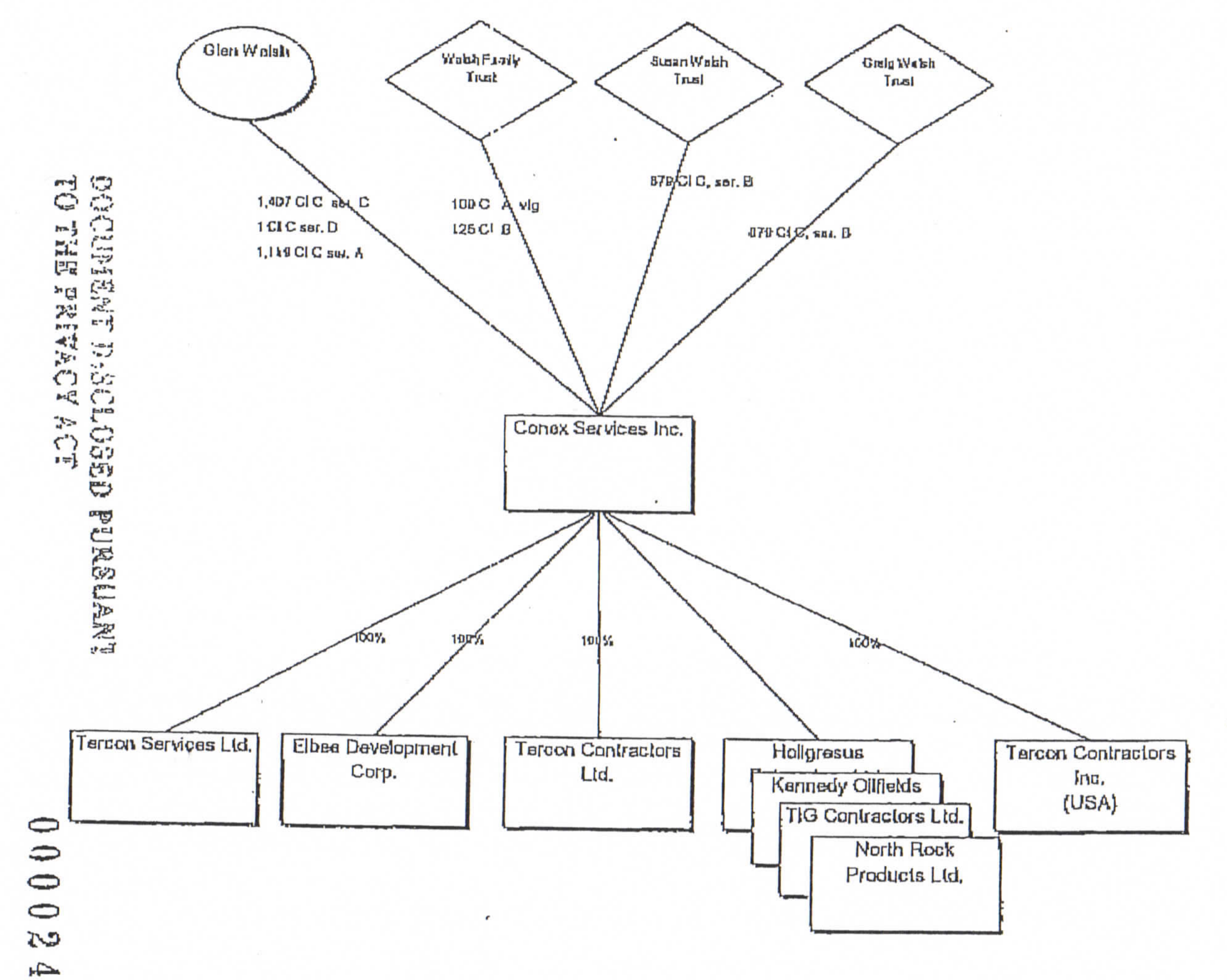
ADDENDUM - 4

Position Oct 14, 1998 after transactions of that day.



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Addendum -1

DETAILS OF EPSP PAID OR PAYABLE BY VARIOUS CORPORATIONS

Name of the Payor Corp.	Fisc. Year end	Amount	Remarks
Tercon Contractors Ltd.	Sept. 30, 1997	$ 2,334,200	Not reported on 1997 T-1; appears to be included in 1998; there is difference of $150,000; see Note-1 below.
Tercon Contractors Ltd.	Sept. 30, 1998	24,540,000	Appears to have been included in the T4PS attached to 98 T-1
Conex Services Inc.	Nov. 30, 1998	0	
Conex Services Inc.	Nov. 30, 1998	1,375,000	Appears to not have been reported by Mr. Walsh in 1998. Reported in 1999; OK
Tercon Services Ltd.	Sept. 30, 1997	0	
Tercon Services Ltd.	Sept. 30, 1998	0	
Elbee Development Corp.	Sept. 30, 1998	2,830,000	
AEL Equipment Corp.	30-Jun-97	0	
	30-Jun-98	0	
TAG Construction Ltd.	31-May-97	0	
	31-May-98	0	
Fraser Bay Development	Oct. 31, 97	0	
Inc.	Oct. 31, 98	0	
Kennedy Oilfield Services	Sept. 30, 1998	0	
Northern Rock Products	31-Jul-97	0	
Ltd.	31-Jul-98	0	
Holigresus Ent. Inc.	31-Jul-97	0	
	31-Jul-97	0	
Kamvan Ent. Inc.	Feb. 28, 98	0	
	Feb. 28, 99	0	
TOTAL (A)		31,079,200	
Amount reported on 98 T1		29,554,200	
Amount reported on 99 T1		1,525,000	
TOTAL REPORTED (B)		31,079,200	
Difference (A) - (B)		Nil	

Note - 1:

EPSP expensed by Tercon - 1997	$ 2,334,200	
EPSP expensed by Tercon - 1998	24,540,000	
Total	26,874,200	
Amount reported on T4PS	26,724,200	
Difference - underreported	$ 150,000	Not payable till Jan. 99; per 98 AJE # 24 of Tercon; w/p A-4-9. Ok reported in 1999.

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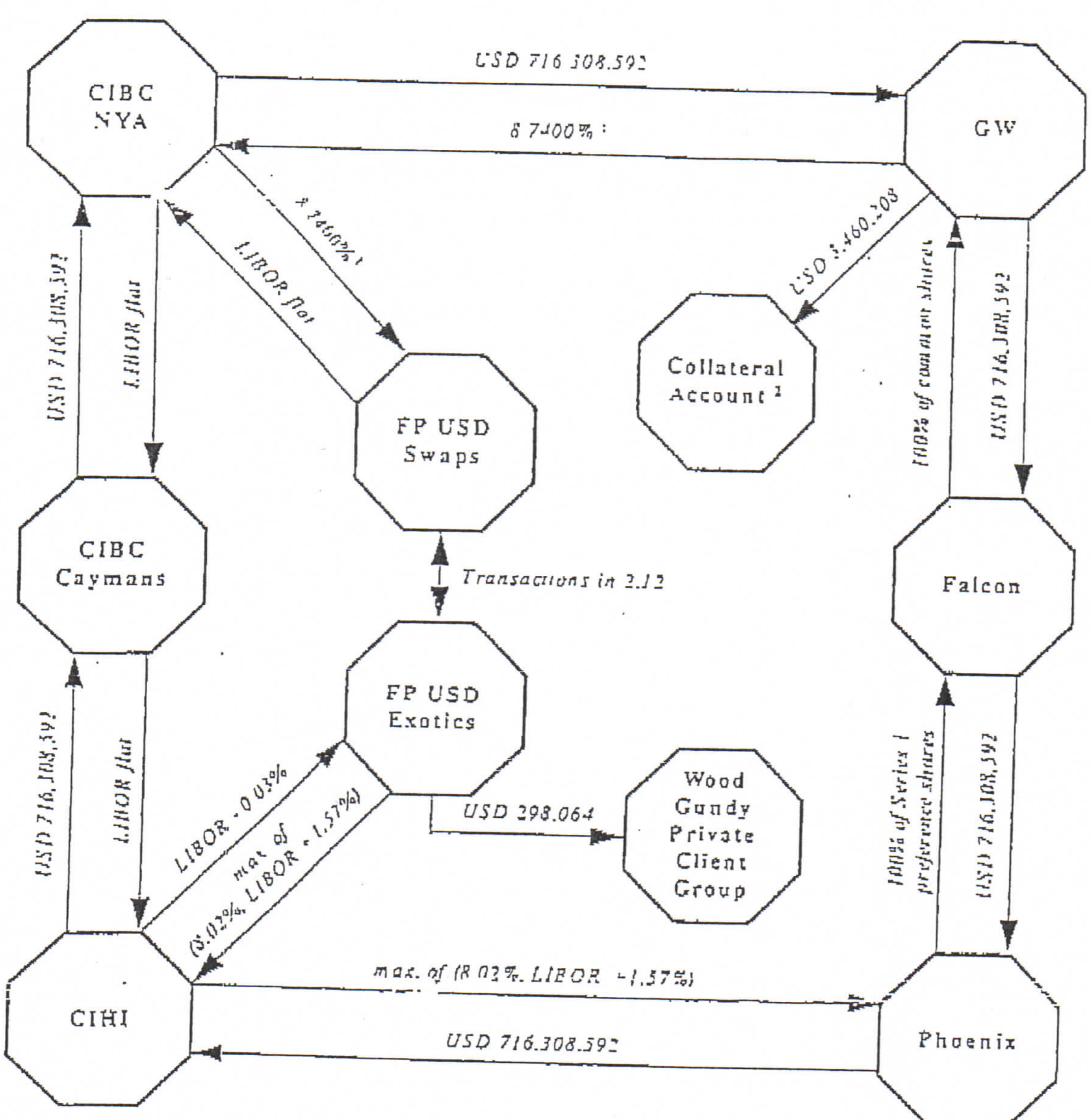
ADDENDUM - 2

APPENDIX E

SCHEMATIC OF COMPONENT TRANSACTIONS



1. Net USD interest amounts are modified by the bridge loan (see 2.2 and 2.10).
2. Collateral account balance earns interest (see 2.8) and is lent to FP-USD-Swaps (see 2.9).

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Extracted from Icarus Trade "G.W" Deal Bib