April 2015

mcmillan Budget 2015 Bulletin

New Rules Target "Synthetic Equity Arrangements"

Budget 2015 contains specific proposals targeted to counteract what the Government characterizes as the inappropriate use of so-called "synthetic equity arrangements" to generate tax losses.

Background

Under the *Income Tax Act* (Canada) (the "**Tax Act**"), a corporation can, subject to certain exceptions, generally deduct an amount equal to the amount of a taxable dividend it receives in respect of a share of a Canadian corporation (the "**Dividend Deduction**"). The Dividend Deduction is intended to prevent the imposition of multiple levels of Canadian corporate tax on earnings distributed from one corporation to another.

An important exception to the availability of the Dividend Deduction is contained in special rules contained in the Tax Act governing so-called "dividend rental arrangements" (the "**DRA Rules**"). Under the DRA Rules, the Dividend Deduction is denied in respect of arrangements where the main reason for such an arrangement is to enable the shareholder to receive a dividend on a share, while economic exposure to the share accrues to, or is borne by, someone else.

In Budget 2015, the Government expressed the concern that certain taxpayers have entered into certain arrangements ("**synthetic equity arrangements**") with counterparties, which have the effect

of transferring all or substantially all of the economic exposure in respect of a particular share to the counterparties (often by, at least in part, a dividend equivalent payment equal to the amount of any dividends received in respect of such shares) in a manner that potentially avoids the application of the DRA Rules in their current form. As a result of such synthetic equity arrangements, notwithstanding that such taxpayers have not realized any real economic loss, the taxpayers could potentially realize tax losses in respect of such arrangements by claiming, first, the Dividend Deduction in respect of the amount of the dividends they receive in respect of the underlying shares that are the subject of the arrangement and, second, deductions in respect of any dividend equivalent payments made to the relevant counterparties. In many instances, such counterparties are "tax-indifferent" entities that do not pay Canadian tax (such a tax-exempt entities or non-residents) and are, therefore, indifferent between receiving a dividend equivalent payment and a dividend.

While the Department of Finance disputes the contention that such arrangements are not caught by the existing DRA Rules, Budget 2015 proposed new rules governing synthetic equity arrangements to eliminate this perceived loophole in the DRA Rules.

New Synthetic Equity Rules

Budget 2015 proposes to amend the DRA Rules to deny the Dividend Deduction for dividends received by a taxpayer as part of a "synthetic equity arrangement" as defined in the new rules. Excluded from the scope of this new statutory definition are (i) agreements that are traded on a "recognized derivatives exchange" (unless the taxpayer knows, or ought to know, the identity of the counterparty to the arrangement), (ii) agreements or arrangements giving rise to a "synthetic short position", and (iii) agreements whose

payments or settlement obligations are linked to certain types of indices.

Initially, the proposed new rules will provide an exemption to the denial of the Dividend Deduction where it can be established that the counterparty to the synthetic equity arrangement is not a "tax-indifferent" entity. In order to qualify for this exemption, a taxpayer must obtain "**accurate** representations" in writing from the counterparty to the effect that it is not a tax-indifferent entity and either (i) does not reasonably expect to eliminate all or substantially all of the risk of loss and opportunity for gain or profit associated with the share, or (ii) has transferred all or substantially all of the risk of loss and opportunity for gain or profit to another counterparty and has also obtained similar representations from that counterparty. Because this exemption is only available where a taxpayer obtains accurate representations, the taxpayer will be denied the Dividend Deduction if such representations are subsequently determined to be inaccurate.

In addition, Budget 2015 also contains a proposed anti-avoidance rule that would extend the DRA Rules to certain agreements and other arrangements that are not otherwise synthetic equity arrangements, where such agreements have the effect of eliminating all or substantially all of the taxpayer's risk of loss and opportunity for gain or profit in respect of a share if the effect of, and one of the purposes of, the series of transactions that includes such agreements or arrangements is to transfer all or substantially all of the risk of loss or opportunity for gain or profit to tax-indifferent investors.

The proposed amendments to the DRA Rules, if enacted, will apply to dividends that are paid or become payable after October 2015.

Finally, while the current proposal will only capture synthetic equity arrangements involving counterparties that are "tax-indifferent"

persons, Budget 2015 states that the Government is considering extending the proposed rules to all synthetic equity arrangements, regardless of the tax-status of the counterparty. To that end, the Government has invited stakeholders to submit comments on this alternative proposal by August 31, 2015.

Commentary

From a policy perspective, the Government's desire to prevent taxpayers from avoiding the application of the DRA Rules is understandable. Nevertheless, the proposed synthetic equity arrangement rules raise a number of practical concerns.

First, the obligation to obtain "accurate" representations as to the tax status of a counterparty in order to avoid the application of the new rules will require parties to derivative transactions that potentially fall within the ambit of a synthetic equity arrangement to ensure that their documentation is amended to contain the required representations to avoid the application of these new rules. More problematic, however, is the requirement that such representations be accurate. Taxpayers who enter into transactions seemingly covered by the exemption to these rules on the basis of the representations of the counterparty cannot rely on those representations to avoid the application the DRA Rules if the representations turn out to be inaccurate, potentially giving rise to considerable uncertainty as to the tax treatment of such arrangements.

Second, while the proposed rules are targeted at a narrow set of transactions, the proposed rules may have broader application than foreseen or intended by the Department of Finance. In recent years, anti-avoidance rules targeted at specific types of transactions have been proposed by the Government, which, by virtue of their initially broad scope, often are found to apply in manners seemingly unintended by the Government. Given the breadth of the definition

of a synthetic equity arrangement, it is possible that the application of the proposed new rules may have similar unintended consequences.

Finally, while the proposed amendments appear to be intended to be relatively narrow in scope (in that they are intended to only apply to synthetic equity arrangements with tax-indifferent investors), they would have much broader application if the Government goes forward with the proposal to extent these changes to all synthetic equity arrangements. Therefore, taxpayers potentially affected by these changes should consider making submission to the Department of Finance ahead of the August 31, 2015 deadline for comments.

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a cautionary note

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