Regulatory Update –
New Budget Measures

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Synthetic Equity Arrangements
2015 Federal Budget

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Background

- A corporation that receives a dividend from a Canadian corporation will include the amount of the dividend in income and may, subject to certain restrictions, claim an equal deduction so that such income is effectively received tax-free
- Avoids multiple levels of corporate tax on the same income
- For many years, the *Income Tax Act* (Canada) has contained “dividend rental arrangement” rules intended to prevent a corporation from receiving inter-company dividends tax-free in circumstances where it did not have an economic interest in the shares
  - employs a “main reason” test

Targeted Arrangements

- According to the Department of Finance ("**Finance**"), certain corporations (typically financial institutions) enter into "synthetic equity arrangements" where the corporation acquires shares of a Canadian corporate issuer ahead of a dividend record date and enters into an equity derivative which provides substantially all of the risk of loss and the opportunity for gain or profit in respect of the share to the counterparty
- Corporation would include the amount of the dividend in computing its income and would claim an equal deduction in respect of the dividend compensation payment made to the counterparty
- Additional tax benefits would be realized by the corporation claiming the inter-company dividend deduction based on an argument that the dividend rental arrangement rules did not apply (receiving the dividend was not the main reason for entering the arrangement)

Targeted Arrangements (continued)

- Finance considered this tax result to be inappropriate as the "extra" deduction on the arrangement results in a tax loss that could be applied to reduce other taxable income of the corporation
- Where the counterparty is not subject to Canadian tax on the dividend compensation payment (for example, a non-resident of Canada or a tax-exempt entity) there is said to be potential for the significant erosion of Canada's tax base
- While Finance indicated that synthetic equity arrangements can be challenged by the Canada Revenue Agency under existing anti-avoidance rules, these challenges were time-consuming and costly
- New measures introduced to prevent these tax benefits

Proposed 2015 Federal Budget Changes

- Proposals amend existing dividend rental arrangement definition so as to deny the inter-company dividend deduction in respect of dividends received by a taxpayer on a Canadian share in respect of which there is a “synthetic equity arrangement”
- Certain exceptions may apply
- Also creates an anti-avoidance provision that will apply to a synthetic equity arrangement if:
  - (i) the agreements or arrangements have the effect of eliminating substantially all of the taxpayer’s risk of loss and opportunity for gain or profit in respect of the share owned by the taxpayer,
  - (ii) as part of a series of transactions, a “tax-indifferent investor” (or an affiliated group of tax-indifferent investors) obtains all or substantially all of the risk of loss and opportunity for gain or profit in respect of the share, and
  - (iii) it is reasonable to conclude that **one of the purposes** of the series of transactions is to obtain the result described above in (ii)

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What is a Synthetic Equity Arrangement?

- Synthetic equity arrangement ("**SEA**") in respect of a share owned by a taxpayer will be a new defined term in the *Income Tax Act* (Canada) that expands on the dividend rental arrangement rules (very generally):
  - one or more agreements or arrangements that
    - are entered into with a counterparty
    - have the effect of providing substantially all of the risk of loss and opportunity for gain or profit in respect of the share to a counterparty including the benefits from a distribution on the share
  - includes agreements or arrangements with a counterparty entered into by a person or partnership that does not deal at arm's length with the taxpayer if it can reasonably be considered to have entered into with the knowledge, or where there ought to have been knowledge, that the effect described above would result

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SEA Exceptions – Trading Derivatives

- Proposed definition of an SEA excludes:
  - agreements that are traded on a recognized derivatives exchange unless it can reasonably be considered that, at the time the agreement is executed, the taxpayer knows, or ought to know, the identity of the counterparty

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SEA Exceptions – Synthetic Short Position

- Proposed definition of an SEA also excludes:
  - one or more agreements or arrangements that would otherwise be an SEA in respect of a share owned by the taxpayer ("synthetic short position") if
    - (A) taxpayer entered into one or more <u>other</u> agreements (other than an agreement under which the share is acquired or a *securities lending arrangement*) that have the effect of providing substantially all of the risk of loss and opportunity for gain or profit in respect of the share to taxpayer ("synthetic long position"),
    - (B) synthetic short position has the effect of offsetting <u>all amounts</u> included or deducted in computing the income of the taxpayer with respect to the synthetic long position, and
    - (C) synthetic short position was entered into for the purpose of obtaining the effect referred to in (B)

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SEA Exceptions – Index Derivatives

- Proposed definition of an SEA also excludes:
  - agreement under which the payment or settlement obligations are derived from, or referenced to an index
    - (A) that reflects the value of 75 or more types of identical shares,
    - (B) that references only long positions with respect to its underlying components,
    - (C) that is created and maintained by persons or partnerships that deal at arm's length with the taxpayer and the value of which is published and publicly available, and
    - (D) where the total fair market value of the shares of the capital stock of Canadian corporations reflected in the index is not, at any time during the term of the agreement, greater than 5% of the total fair market value of all shares reflected in the index

Exceptions

- SEA will not result in the loss of the inter-company dividend deduction where the taxpayer establishes that, throughout the term of the SEA, no tax-indifferent investor (or group of affiliated tax-indifferent investors) has substantially all of the risk of loss and opportunity for gain or profit in respect of the share because of the SEA
- Taxpayer is considered to have satisfied this condition if it obtains accurate representations in writing from its counterparty that it is not a tax-indifferent investor and it does not reasonably expect to become a tax-indifferent investor during the term of the SEA
- Lengthy provision also detail the need for representations for counterparties regarding the transfer or reasonable expectation of transfer of the risk of loss and opportunity for gain or profit
- If these representations prove to be false, the dividend rental rules will apply and the taxpayer will be denied the inter-company dividend deduction

What is a Tax-Indifferent Investor?

- Tax-indifferent investor means
  - (a) person exempt from tax,
  - (b) non-resident person (unless the amounts paid under an SEA may reasonably be attributed to the business carried on by the person through permanent establishment in Canada),
  - (c) trust resident in Canada (other than a "specified mutual fund trust") if any of the interests as a beneficiary is not a fixed interest as defined in subsection 251.2(1),
  - (d) partnership if more than 10% of the fair market value of all interests in the partnership can reasonably be considered to be held by person in (a), (b) or (c), and
  - (e) trust resident in Canada (other than a specified mutual fund trust or trust in (c)) if more than 10% of the fair market value of all interests as beneficiaries under the trust can reasonably be considered to be held, directly or indirectly through one or more trusts or partnerships , by any combination of persons described in (a), (b) or (c)

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Alternative and Application

- Finance has requested feedback from stakeholders regarding the possibility of eliminating the exception for circumstances where no tax-indifferent investor has the risk of loss and opportunity for gain or profit in respect of a share
- Therefore, to claim the inter-company dividend deduction, the recipient of the dividend would have to have the risk of loss and opportunity for gain or profit in respect of the share
- The deadline for comments is August 31, 2015

- The proposed changes related to SEAs will apply to dividends that are paid or become payable after October 2015

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