or harmonize the two tests in the jurisprudence with respect to de facto control and, if necessary, to distinguish that test from the test for de jure control. However, given Judge Bowman's findings of fact and his compelling analysis of the legal issue, the Federal Court of Appeal may simply dismiss the Crown's appeal without commenting upon the de facto control test at all. In the meantime, this case should provide franchisees with some degree of comfort that their franchise arrangements, which otherwise come within the letter and spirit of the franchise exception in subsection 256(5.1), will not lose the benefit of that exception simply because the arrangements include ancillary agreements relating to the operation of the business of the franchise.

L. Michele Anderson

HOW TO TAX INNOVATIVE FINANCIAL TRANSACTIONS: "IF THE PEG IS SQUARE, MAKE THE ROUND HOLE BIGGER" SAYS TAX COURT JUDGE

Hayes et al. v. The Queen
2003 DTC 1205

KEYWORDS: DERIVATIVES ■ HEDGING ■ PARTNERSHIPS

In 1995, the Federal Court of Appeal heard the *Schultz* case involving the taxation of a husband and wife who had entered into a series of convertible hedge transactions.[26] In that case, the court determined that the husband and wife were partners with the result that their attempt at income splitting failed. In 2003, another case involving pairs of taxpayers who had entered into convertible hedge transactions came before Judge Miller in the Tax Court of Canada. There were many similarities between the facts of the new case, *Hayes*, and the facts in the earlier *Schultz* decision. In fact, the convertible hedge transactions were structured by the same adviser, took place during the same period of time (the early 1980s to mid-1990), and generally involved husband and wife couples. Notwithstanding the substantial similarities in the two cases, Judge Miller does not follow the precedent established by *Schultz*. Instead, Judge Miller charts a course that involves a novel application of the concept of property to the components of the convertible hedge strategies.

An analysis of Judge Miller's decision must start with an understanding of the nature of the taxpayers' typical convertible hedge transactions. The transactions involve one taxpayer's selling short a particular corporate share. A short sale is a sale of stock that the seller does not own; for the sale to be completed, the stock must be borrowed. The result of a short sale is that the seller receives the cash price of the shorted stock and is liable to return the borrowed securities at a future

26 *Schultz et al. v. The Queen*, 95 DTC 5657; [1996] 2 CTC 127 (FCA).

date. Meanwhile, the second taxpayer purchases a security[27] that is convertible into the stock that has been sold short. The conversion feature means that taxpayer 2 has a source for the stock that taxpayer 1 must eventually return to the lender that supported the short sale. The economics of the transaction are optimized when the brokerage accounts of the two taxpayers are cross-guaranteed for margin requirements. This allows taxpayer 2 to use the credit position from taxpayer 1's short sale to acquire the long position in the convertible security.

Once the two taxpayers have established their long and short positions, they have, between them, hedged the exposure to the price of the shorted common stock. At the same time, the long holding of the convertible security produces an income stream of interest or dividends. In addition, the convertible security often has different price volatility than that of the underlying common stock. In a falling market, this generally means that the convertible security does not lose value as quickly as the common stock.

The central tax issue in the case is whether the taxpayers should be taxed on the basis of the income, loss, or gain of the separate identifiable stock transactions that comprised the "legs" of a set of convertible hedge transactions. The taxpayers argued for such separate treatment. Separate treatment would recognize a loss (on income account) when a short position was closed out even though the corresponding long position might not be sold. Separate treatment would also allow capital treatment for long positions where a subsection 39(4) election had been made. The minister argued for composite treatment of the legs of the convertible hedges. This treatment would preclude recognition of income, loss, or gain until the entire convertible hedge was wound up.

The *Hayes* case required Judge Miller to choose between the component parts and the composite approach to the taxation of the convertible hedge strategies. Judge Miller perceived this to be a challenging task because the convertible hedges represented modern financial innovations and the tax laws, by comparison, were blunt, stone-age tools. Judge Miller's solution to this unequal matchup was to inject a measure of innovation into the interpretation of the tax laws. At the beginning of the epic-length reasons for judgment, the judge states:

> At the outset, I should mention that the conundrum in applying tax principles to the financially innovative strategy of convertible hedging is that tax laws have not necessarily kept apace with the ingenuity of the financial community. It is therefore appropriate, when viewing the transactions through the tax looking glass, that the focus not be so finely adjusted as to preclude a broad, common sense, but equally innovative, approach to the application of our tax laws. A square peg does fit in a round hole if the round hole is big enough.[28]

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27 Convertible debt, convertible preferred shares, and warrants or rights for common stock were typically used to establish the long leg of a convertible hedge transaction.

28 *Hayes et al. v. The Queen*, 2003 DTC 1205, at paragraph 2 (TCC).

The square peg/round hole challenge is centred on Judge Miller's treatment of a convertible hedge as a property. That is, the combination of a long and a short position and the related cross-margining of brokerage accounts form a property within the broad definition of the Act.[29] Judge Miller, through his analysis of the components of the property definition, excavates a hole that is big enough to accommodate the square peg of a convertible hedge transaction.

The key element of the property definition is the inclusion of a "right of any kind whatever." If a convertible hedge can be said to create or give rights to a taxpayer, it will be "property." Judge Miller stipulates that such rights must be native to the convertible hedge and not simply an aggregation of rights inherent in the component long and short positions. According to Judge Miller, the essential right in a convertible hedge is found in the cross-margin relationship. The taxpayers had the right to have their brokers provide margin on the basis that the long and short positions would support each other. Judge Miller summarizes this analysis as follows:

> The right or rights must derive from the convertible hedge itself and not just from the accumulation of independent rights of components of the convertible hedge. The right to convert for example is a right attached to the long side of a convertible hedge. It exists whether or not it is a component of a convertible hedge. Similarly, the right to cover a short position at a time which would yield a favourable result is not dependent on the short position being part of a convertible hedge. These are both rights imbedded in the convertible hedge and arguably can be viewed together to constitute property. But the right which only arises from the convertible hedge itself, and consequently satisfies me that the convertible hedge is property, is the right to rely on one component of the convertible hedge to satisfy the margin requirements of the other component, whether this be in a single account or through the auspices of a Guarantor's account. The experts' description of the convertible hedge, combined with the evidence of Mr. Sildva [a financial adviser] and Mr. McCrodon [a securities broker] confirmed that the brokerage houses' agreement with those engaged in convertible hedges included a provision to waive the usual strict requirements for margin, and accept that a convertible long position was in and of itself sufficient margin for the short position. This was critical to the operation of the convertible hedge, and it was something the investor was able to rely upon in the arrangement with the broker. It was, I would suggest, a legally enforceable claim that the broker would provide margin on this basis. In summary, the convertible hedge consists of components containing rights; it also, by its very essence, creates a right particular to the convertible hedge alone. The convertible hedge meets the broad *Income Tax Act* definition of property.[30]

29 "Property" is defined in subsection 248(1) of the Act to mean "property of any kind whatever whether real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing, includes (a) a right of any kind whatever."

30 *Hayes*, supra note 28, at paragraph 120.

There is a weakness in Judge Miller's conclusion that it is the margin arrangements that, being rights, imbue the convertible hedge strategy with the character of "property." The weakness is apparent when the concept is applied to single-account hedges, as Judge Miller asserts is appropriate. In a single-account convertible hedge, a single taxpayer will have a short position and a long convertible position in the same brokerage account. It is a standard feature of any broker margin agreement that all property in an account is collateral for any margin requirements of the account. There is no logical basis to treat the securities of the hedge legs any differently than any other assets in the account. On Judge Miller's theory, all of the assets in the single account should be treated as a single property. This is clearly not supportable.

The conclusion that the convertible hedges were properties was contrary to the conventional analysis argued for by the taxpayers. The taxpayers' position was that the tax rules should be applied to the actual securities trades, which, when combined, produced a convertible hedge. Cases such as *Shell*[31] and *Singleton*[32] were submitted as authority for the proposition that legal transactions were to be respected and not recharacterized on the basis of economic result or tax motivation.

The conclusion that the relevant property was the convertible hedge meant that the taxpayers could not realize a loss on the closing of only one leg of the transaction. Judge Miller's analysis dictates that the tax event occurs when the convertible hedge is fully disposed of. This result is contrary to the approach taken by higher courts in analogous situations. In *Friedberg*, the courts gave separate treatment to the legs of commodity spread transactions.[33] In *Schultz*, the Federal Court of Appeal addressed the timing of taxation and said:

> It seems to me that the losses, expenses and gains on the hedging transactions here in issue should be calculated when the leg of a particular hedge was finally closed out. The respondent concedes that if the appellants had truly closed out one leg of a hedge there would have been a disposition of securities even though the other leg was still held.[34]

Judge Miller does not directly address the contradiction between his conclusion and that of the Federal Court of Appeal. Rather, he focuses on the factual aspects of the case that prevented him from finding a partnership, the key element in the *Schultz* decision. In contrast to the *Schultz* case, the taxpayers in *Hayes* were not active traders entering into numerous transactions. The evidence did not support a finding of carrying on business, a critical element of the definition of partnership.

31 *Shell Canada Limited v. The Queen et al.*, 99 DTC 5669; [1999] 4 CTC 313 (SCC).

32 *The Queen v. Singleton*, 2001 DTC 5533; [2002] 1 CTC 121 (SCC).

33 The Supreme Court of Canada endorsed the lower court decisions on separate treatment for the long and short legs: "As to whether it is appropriate to consider the loss and gain legs of a spread transaction in isolation from one another . . . we substantially agree with the reasons of the learned trial judge as affirmed by . . . the Federal Court of Appeal." *The Queen v. Friedberg*, 93 DTC 5507, at 5508; [1993] 2 CTC 306, at 307.

34 *Schultz*, supra note 26, at 5666; 143.

If Judge Miller's inquiry had stopped here, at the end of the road map provided by the *Schultz* decision, the square peg would not have fit into the round hole of the transaction. If there was no partnership and the taxable events were individual securities trades, the result would favour the taxpayers and not the minister.

If a convertible hedge is properly viewed as property, how is the investor to be taxed? Judge Miller acknowledges that a convertible hedge cannot be a property that is a source of income. However, it is the type of property that represents an adventure in the nature of trade for the investor. Thus, the investor's source of income is the business of transacting in convertible hedges. This analysis uncovers another link to the partnership problem. Partners "carry on" a business. Adventurers do not "carry on" a business. They have discrete adventures or instances of trade, but their activity lacks the continuity of a pure business. Judge Miller acknowledges that, on his analysis, even the most active participant in convertible hedges will always remain an adventurer:

> I wish to briefly tie in this finding of a convertible hedge as property with my finding of an adventurer rather than a trader. For how does one trade in convertible hedges? How transferable is this property? There is no exchange for convertible hedges. They are disposed of by being unwound. Nothing in the definition of property requires transferability as a requisite ingredient. It is difficult to conceptualize carrying on a business of trading in convertible hedges. Yet, there is no such difficulty in viewing transactions involving the convertible hedge as an adventure in the nature of trade. They exist in a commercial trading environment; indeed, they are a financial product of that very environment, though they cannot be traded as such. By their very nature, they are destined to remain as adventures in the nature of trade. This expression seems aptly suited to this particular application.[35]

Judge Miller determines that where a convertible hedge involves the accounts of two taxpayers, they are to be treated as co-adventurers, not as partners. The co-adventurer characterization is essential because the property (the convertible hedge) is partly in the hands of each of the two taxpayers. The unique nature of the property in question joins the two individuals in a joint adventure. The result is that any income from the adventure is shared equally between the adventurers for tax purposes. While there is technically no partnership involved, the tax result for the co-adventurers is virtually the same.

As noted above, the income is not derived from a disposition of a single leg during the existence of the convertible hedge. Rather, it is determined by computing the increase or decrease in the spread during the life of the convertible hedge. This is done by determining the difference between all income on short sales and all outlays on long purchases from the time the transaction starts to the time the two accounts first have offsetting long and short positions in the same security.

35 *Hayes*, supra note 28, at paragraph 128.

A secondary result of Judge Miller's property analysis is that any subsection 39(4) elections are ineffective with respect to long positions in a convertible hedge. If the property is the convertible hedge itself, it is outside the definition of "Canadian security" in subsection 39(6). This result was adverse to the positions of two of the *Hayes* taxpayers who had made subsection 39(4) elections and sought capital gains treatment for their long positions in convertible securities.

Looking beyond the specifics of the facts in the *Hayes* case, Judge Miller's adoption of a flexible notion of taxation principles[36] introduces the seeds of uncertainty into the interpretation and administration of tax law. Courts have consistently recognized the need for certainty in tax law.[37] In fact, Judge Miller himself identifies this requirement:

> The difficulty with these cases is the shortcoming of personal property and commercial laws defining late twentieth-century financial arrangements, compounded by tax principles that require clarity and certainty for their proper application.[38]

If the courts are able to stretch definitions and elasticize concepts to adjust the size of the round holes of tax rules to accommodate the square pegs of structured transactions, certainty and precision will be sacrificed. The taxpayers have appealed the Tax Court decision in this case. The Federal Court of Appeal will have the opportunity to restore certainty to this corner of the Act.

David Wentzell

CAPITAL GAINS STRIPS AND NORMAL COURSE DIVIDENDS

Canutilities Holdings Ltd. et al. v. The Queen
2003 DTC 1029

KEYWORDS: TRANSACTIONS ■ DIVIDENDS ■ TAX AVOIDANCE

Subsection 55(2) of the Act is a capital gains stripping anti-avoidance rule. Under the rule, an otherwise tax-free intercorporate dividend that is deemed to arise on a redemption of shares is deemed to be proceeds of disposition of the shares where the deemed dividend is part of a "series of transactions or events" that results in a reduction in capital gains realized on the disposition of the shares. Under an

36 "This is where the round hole of taxation principles must expand to accommodate the square peg of financial innovation: where what is real in law is not so restrictively interpreted as to deny a result that meshes economic and legal reality." *Hayes*, ibid., at paragraph 118.

37 "[C]ertainty is to be preferred in the area of tax law": *Ludco Enterprises Ltd. et al. v. The Queen*, 2001 DTC 5505; [2002] 1 CTC 95, at paragraph 59 (SCC); "vagueness and uncertainty . . . results in unfair and arbitrary treatment of taxpayers": *Stewart v. The Queen*, 2002 DTC 6969; [2002] 3 CTC 439, at paragraph 47 (SCC).

38 *Hayes*, supra note 28, at paragraph 215.