BUDGET 2016: SIGNIFICANT CHANGES TO THE TAXATION OF LINKED NOTES ANNOUNCED

Posted on March 31, 2016

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In Budget 2016, the new Government announced a significant change to the taxation of index and equity linked notes ("**Linked Notes**") described in paragraph 7000(1)(d) of the *Income Tax Regulations* (the "**Regulations**").

Background

Linked Notes are debt obligations, the return on which is "linked" in some manner to the performance of one or more reference assets or indexes. The appeal of Linked Notes for many investors is that they provide access to sophisticated investment strategies in a single, simple, cost-effective product. In recent years, demand for Linked Notes has grown rapidly and issuers have developed ever more specialized products to satisfy heightened demand, including foreign currency denominated notes.

Under existing tax rules, an investor who holds a Linked Note until maturity is generally required to fully include any gain on the note in his/her taxable income for the taxation year in which the return on the note becomes determinable (typically at or shortly prior to maturity). However, investors who hold Linked Notes on capital account, and who dispose of their Linked Notes at a time when the final return on the notes is not determinable (often by selling in a secondary market supported by the issuer), generally take the position, based on past Canada Revenue Agency ("**CRA**") administrative statements, that any gains realized on the disposition of the notes are capital gains, only 50% of which are required to be included in computing their income.

Although the *Income Tax Act* (the "**Tax Act**") contains specific rules that require investors who dispose of debt obligations (including Linked Notes) to include in their income any interest that accrued on the obligations to their date of disposition, in the case of Linked Notes, investors have long taken the position, again based on past CRA administrative statements, that so long as the ultimate return on the Linked Notes was not determinable at the time of their disposition, no amount in respect of the return on the Linked Notes would be considered to have accrued on the date of their disposition (in part, on the basis that the investors had no certainty that they might actually receive a return if the notes were held to maturity).

New Rules Governing Linked Notes

Budget 2016 proposes to change the taxation of debt obligations described in paragraph 7000(1)(d) of the Regulations to eliminate the difference in the tax treatment of the return on Linked Notes held to maturity and Linked Notes disposed of prior to maturity at a time when their return is uncertain.

The proposals contained in Budget 2016 introduce a new rule that will deem any gain realized on the sale of a Linked Note to be interest that accrued on the note for the period ending on the date of disposition of the note, such that the gain will be required to be included in computing the investor's income as fully taxable interest. In effect, subject to new special rules that will apply to foreign currency denominated Linked Notes (discussed below), any gain realized on the disposition of a Linked Note prior to maturity will be deemed to be interest and must be included in the income of the investor in the year in which the disposition occurs. These new rules will be effective in respect of dispositions of Linked Notes after September 2016.

For Linked Notes denominated in foreign currencies, the Budget proposals contain a potential relieving provision with a hidden dark side. In calculating the deemed interest inclusion on the disposition of a Linked Note, the new rules will exclude any gain realized by investors to the extent that it is attributable to fluctuations in the value of the foreign currency in which the note is denominated relative to the Canadian dollar. For investors who hold their Linked Notes on capital account, that foreign currency gain would generally give rise to a capital gain, of which only 50% would be included in their income and subject to tax. While this provision seems favourable to investors, it can be disadvantageous to an investor that realizes a foreign currency loss.

Consider the following scenario. Investor A subscribes for a US dollar denominated Linked Note having a principal amount equal to US$100 at a time when the US/Canada exchange rate is 0.75. A year later, the investor sells the note for US$105, at a time when the US/Canada exchange rate is 0.85 (i.e., the value of the Canadian dollar has appreciated relative to the US dollar). In this example, in Canadian dollar terms, Investor A would have lost C$9.80 as a result of the decline in value of the US dollar relative to the Canadian dollar. However, for tax purposes, under the new rules, Investor A would have a deemed income inclusion of C$5.88 (representing the US$5 increase in the value of the Linked Note in US dollar terms, converted to Canadian dollars at the exchange rate in effect at the time of the sale), but would realize a capital loss equal to C$15.68 (since the proceeds of disposition of the note would reflect the decline in value of the US dollar relative to the Canadian dollar and would exclude the deemed interest inclusion, based on past CRA administrative statements). Because Investor A's capital losses cannot be applied to reduce Investor's A taxable income, in this scenario, Investor A would be subject to tax on the deemed income inclusion, notwithstanding that, in economic terms, he lost money.

Finally, Budget 2016 proposes to add, effective October 1, 2016, Linked Notes described in paragraph 7000(1)(d) of the Regulations to the list of securities for which traders or dealers in securities who buy securities for their own account or sell securities as an agent or nominee for any vendor, are required to issue T5008 forms. As a result of this change in reporting requirements, traders and dealers in securities will need to ensure, by October 2016, that their tax reporting systems can accommodate the proposed increased reporting obligations associated with trades in Linked Notes.

Commentary

The policy rationale for the proposed changes relating to the taxation of Linked Notes is unclear. On the one hand, it is true that the different taxation of the return on Linked Notes held to maturity and those sold prior to maturity is hard to justify on tax policy grounds. On the other hand, in many instances, if investors instead held the underlying securities directly, much (though, admittedly, not all) of the return realized on the underlying securities (or the components of the underlying indexes) would be treated as capital gains.

The revenue projections from the proposed changes set out in the Budget documents do not suggest that the contemplated legislative amendments will generate material tax revenue.

The real possibility of a mismatch between income inclusions and capital losses for Linked Notes denominated in foreign currencies, resulting in investors paying net tax on investments on which, in Canadian dollar terms, they lost money is troubling. Since the 2016 Budget documents focus solely on the impact of the special rule for foreign currency denominated notes in the situation where there was a foreign currency gain, it is possible that this adverse result was not intended.

Investors (particularly investors whose Linked Notes will mature in late 2016 or in 2017) will want to consider whether they should realize gains on Linked Notes prior to the effective date of the new rules (i.e., prior to October 2016) in order to take advantage of the historical capital gains treatment of such notes. On the other hand, investors holdings notes with longer terms should weigh the potential tax savings from such a sale against the potential advantages of deferring the taxation of gains until the maturity of their notes (which, in many instances, may be almost 10 years in the future).

Similarly, issuers of Linked Notes will need to review their disclosure of the tax treatment of Linked Notes in their offering documents and other investor disclosure and consider what revisions and updates are necessary. Traders and dealers in securities will also need to ensure that their tax reporting systems can accommodate the new T5008 reporting obligations arising in respect of the sale of Linked Notes.

by Carl Irvine

A Cautionary Note