BUDGET 2017: TIMING OF RECOGNITION OF GAINS AND LOSSES ON DERIVATIVES

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In Budget 2017, the federal Government proposed both new rules to introduce an elective regime to respond to recent jurisprudence relating to the recognition of certain gains and losses on derivative transactions, as well as anti-avoidance measures designed to discourage taxpayers from entering into "straddle transactions". While the former elective provisions could promote flexibility and reduce uncertainty to taxpayers, the breadth of application of the straddle transaction provisions could give rise to unexpected tax consequences.

Elective Mark-to-Market Methodology

The Government introduced an elective regime in Budget 2017 that would generally permit taxpayers to elect (the "**Election**") to recognize gains and losses attributable to certain derivative agreements that were held on income account on a "mark-to-market" basis. Taxpayers that choose not to make the Election would generally be liable to tax in connection with any such derivatives when the derivative agreement was disposed of (e.g., settled, extinguished, assigned or transferred) on a realization basis, subject to certain restraints identified below.

The draft legislation released with the Budget documentation states that an "eligible derivative" for purposes of making the Election generally means a swap agreement, a forward purchase or sale agreement, a forward rate agreement, a futures agreement, an option agreement or a similar agreement if:

1. the agreement is not a capital property, a Canadian resource property, a foreign resource property or an obligation on account of capital of the taxpayer,
2. either
    a. the taxpayer has produced audited financial statements prepared in accordance with generally accepted accounting principles in respect of the taxation year, or
    b. the agreement has a readily ascertainable fair market value; and

3. in the case of property held by a "financial institution"
(a "**Financial Institution**"), the agreement is not a "tracking property", other than an "excluded

property", of the Financial Institution, each as defined in subsection 142.2(1) of the *Income Tax Act* (Canada) (the "**Tax Act**").

A taxpayer that has made the Election, is not a Financial Institution, and holds eligible derivatives (i.e., is a party to an agreement that is an eligible derivative) at the end of a taxation year is deemed to dispose of, and immediately reacquire, reissue or renew, as applicable, such eligible derivatives, at their fair market value, immediately before the end of the taxation year. Accordingly, increases or decreases in the value of an eligible security would be deemed to be taxable in the year as a gain or loss, respectively. Analogously, eligible derivatives held by a taxpayer that has made the Election and is a Financial Institution in a year are deemed to be "mark-to-market property", as defined in subsection 142.2(1) of the Tax Act, of the taxpayer for the taxation year.

As a transitional measure in respect of a taxation year in which an Election is filed, any gain or loss that has already accrued prior to the start of such taxation year shall be suspended until such time as the eligible derivative is disposed of.

It is understood that the Government introduced the elective mark-to-market regime in response to the recent Federal Court of Appeal decision in Kruger v. R.[1] in which a taxpayer was permitted to realize gains and losses in respect of certain derivative contracts held on income account on a mark-to-market basis in accordance with generally accepted accounting principles, rather than on a realization basis (as was assessed by the Government). The Court found "that the realization principle can give way to other methods of computing income pursuant to section 9 of the [Tax] Act where these [other methods] can be shown to provide a more accurate picture of the taxpayer's income for the year."[2]

Taxpayers that make the Election will generally not be eligible to revoke the Election in a subsequent taxation year without the concurrence of the Canada Revenue Agency (the "**CRA**"). Presumably, the Government introduced this restriction to avoid taxpayers entering and exiting the elective mark-to-market regime in a manner that would permit taxpayers to selectively reduce or differ income recognition (or increase/accelerate loss recognition). Accordingly, taxpayers will need to carefully consider the appropriateness of filing the Election before reporting taxable income for a year using the elective mark-to-market regime.

Taxpayers electing to have eligible derivatives taxed on a mark-to-market basis could derive some incremental benefit and administrative convenience from having their taxable income more closely correspond to accounting income. However, it is anticipated that the elimination of the ability of taxpayers to selectively realize gains and losses on such derivatives will, on aggregate, accelerate the timing of when taxes might otherwise be payable and could also increase the aggregate amount of tax payable to the Receiver General.[3]

The draft legislation included in the Budget documentation also includes various supplementary provisions to generally ensure that eligible derivatives held by a taxpayer that has made a valid Election may not be transferred by the taxpayer on a tax-deferred basis. Accordingly, eligible derivatives will generally be deemed not to be "eligible property" of a person or partnership for purposes of subsection 85(1), and will not be eligible for tax-deferred treatment under subsections 85(2) and 97(2), of the Tax Act. Similarly, the draft measures generally provide that any gain or loss of a taxpayer in respect of an eligible derivative will be realized immediately before a qualifying amalgamation or wind-up pursuant to subsections 87(2) and 88(1) of the Tax Act, respectively.

An Election in respect of a taxation year is generally required to be filed on or before the due date of the taxpayer's annual income tax return for the year. The Budget documentation and draft legislation did not address whether late-filed Elections would be administratively permitted. The failure to permit the filing of such late elections could give rise to severe adverse tax consequences to taxpayers that had planned to make the Election but inadvertently failed to do so before the deadline.

Notwithstanding the *Kruger* decision, the draft provisions included in the Budget documents provide that a taxpayer that has not made an Election and is not a Financial Institution is generally prohibited from filing its returns using a method of profit computation that produces a substantially similar effect to the mark-to-market treatment described above in respect of swap agreements, forward purchase or sale agreements, forward rate agreements, futures agreements, option agreements or similar agreements.

The proposed market-to-market regime would apply to taxation years beginning on or after March 22, 2017.

Straddle Transactions

The Government announced its intention in Budget 2017 to eliminate tax deferral and potential avoidance opportunities associated with "straddle transactions".

A straddle transaction generally refers to an arrangement where a taxpayer enters into two or more positions, frequently derivative positions, that are expected to generate equal and offsetting gains and losses. Shortly before a taxation year-end, the taxpayer typically disposes of or otherwise realizes the losses associated with the position or positions that have accrued losses (the "losing leg"). The taxpayer then typically disposes of or otherwise realizes the gain on the position or positions that have accrued gains (the "winning leg") shortly after the taxation year-end. In such circumstances, the taxpayer might claim a deduction in respect of the losses realized in the first taxation year against income from other activities, while correspondingly including the income realized on the winning leg in the subsequent taxation year.

The net effect of the offsetting positions is that the taxpayer could effectively defer income otherwise taxable in one year to a subsequent year. The Government identified a concern in the Budget documentation that taxpayers could indefinitely defer the recognition of gains by entering into successive straddle transactions. The Government also identified a concern that that the straddle transaction framework could be combined with a transfer to a tax-indifferent investor, effectively eliminating tax otherwise payable.

The Budget documentation noted that the Government has challenged certain of these straddle transactions using existing provisions of the Tax Act, including the general anti-avoidance rule (GAAR), and judicial principles. However, in an effort to streamline the Government's efforts to discourage and challenge straddle transaction strategies, and presumably as a hedge in the event the courts uphold the straddle transactions currently being challenged, the Government announced its intention in Budget 2017 to introduce a specific anti-avoidance regime to address such transactions.

The proposed measures would introduce a stop-loss rule that defers the realization of any loss on the disposition of a loss position generally to the extent of any net unrealized gains on offsetting positions.

The draft legislation included in the Budget documentation indicates that a "position" of a person or partnership will mean one or more specified properties, obligations or liabilities of the person or partnership, provided that, if it is reasonable to conclude that there is more than one property obligation or liability, each is held in connection with each other. The specified types of properties identified in the proposed legislation include (i) a broad range of actively traded personal property, such as a share in the capital stock of a corporation, an interest in a partnership, an interest in a trust, a commodity, a foreign currency, certain derivative agreements, certain debts, and (ii) an obligation to transfer or return such property to a prior owner or lender, and an interest, or for civil law a right, in such property.

An "offsetting position" under the draft legislation has been defined to include positions held by the holder or persons not dealing at arm's length with, or affiliated with, the holder (referred to in the draft legislation as a "connected person") that have the effect of eliminating all or substantially all of the risk of loss and opportunity for gain or profit in respect of the position. The legislation contemplates that an offsetting position held by a connected person will only be an "offsetting position" if it can reasonably be considered to have been held with the purpose of eliminating all or substantially all of the risk or opportunity for gain described above.

The above stop-lose rules would generally not apply in respect of:

- certain deemed dispositions under the Tax Act;
- any position that was a capital property or an obligation or liability on account of capital of the transferor;
- a position held by Financial Institutions, mutual fund corporations or mutual fund trusts;
- certain types of hedging transactions entered into in the ordinary course of a taxpayer's business;
- a position with respect to which a taxpayer continues to hold the offsetting position throughout a 30-day period that begins on the date of a disposition of the position, provided that the taxpayer and its

connected persons do not otherwise engage in a transaction or arrangement that would limit risk of loss or opportunity for gain in connection with the outstanding position; and
- a transaction or a series of transactions none of the main purposes of which is to avoid, reduce or defer tax that would otherwise be payable under the Tax Act.

Given the breadth of the above anti-avoidance regime, there is risk that a taxpayer and its connected persons could inadvertently be subject to such stop-loss provisions. In corporate groups where management and decision making is disbursed, it is possible that an entity within the group could enter into a position without realizing that another member of the group entered into an offsetting position. The draft legislation contains certain measures that might limit this risk, including specific carve-outs from the stop-loss rules for certain activities carried out with a business purpose, or if none of the main purposes of a transaction or series of transactions was a deferral or avoidance of tax. In addition, the proposed definition of offsetting position specifically requires that a connected person can reasonably be considered to have held a position with the purpose of eliminating all or substantially all of a taxpayer's risk of loss and opportunity for gain or profit. It is nonetheless unclear how broadly the provisions will be applied and how comfortable taxpayers will be relying on such exemptions.

The straddle transaction regime will apply in respect of a position, or an offsetting position in respect of the position, that is acquired, entered into, renewed or extended, or becomes owing, by a person or partnership on or after March 22, 2017.

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[1] 2016 FCA 186 [Kruger].[ps2id id='1' target=''/]

[2] Ibid. at para 59.[ps2id id='2' target=''/]
[3] The Government has estimated that an additional $304 million of federal tax will be payable over the next five fiscal years as a consequence of the measures implementing the Election and the straddle period provisions (see below). The Government did not identify what portion of such tax was attributable to each measure.[ps2id id='3' target=''/]

A Cautionary Note