BUDGET 2018: FEDERAL GOVERNMENT TARGETS TRANSACTIONS BY FINANCIAL INSTITUTIONS

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Budget 2018 continues the Government's ongoing legislative efforts to prevent corporate taxpayers (in particular, financial institutions) from engaging in transactions that entitle those taxpayers to the deduction generally available to corporations in respect of dividends received on the shares of Canadian corporations (the "**Dividend Deduction**"), in a manner perceived to be abusive.

The latest proposed amendments raised in Budget 2018 generally fall into one of two categories:

1. Proposed amendments to the *Income Tax Act* (Canada) (the "**Tax Act**") relating to "synthetic equity arrangements" and "securities lending arrangements" that would discourage certain transactions whereby a corporation receives a dividend on a Canadian corporation's shares and the risk of loss or opportunity for gain or profit in respect of such shares accrues to a different taxpayer;
2. Proposed amendments to the Tax Act that limit the circumstances under which Canadian financial institutions may realize a loss on the repurchase of shares of the capital stock of a Canadian-resident corporation.
   In setting the context for the proposed amendments, the Government repeated its now common refrain that: "Although these [arrangements/transactions] can be challenged by the Government based on existing rules in the [Tax Act], these challenges could be both time-consuming and costly." However, we note that the Government's success in challenging the targeted transactions under the existing provisions of the Tax Act was far from assured.

Artificial Losses Using Equity-Based Financial Arrangements

Synthetic Equity Arrangements

The Dividend Deduction generally permits corporations to deduct amounts under the Tax Act equal to the amount of the taxable dividends received in respect of shares of Canadian-resident corporations. 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 in the Tax Act governing so-called “dividend rental arrangements” (the “**DRA Rules**”). Under the DRA Rules, the Dividend Deduction is generally denied in respect of an arrangement the main reason for which is to enable the shareholder to receive a dividend on a share, where economic exposure to the share accrues to, or is borne by, someone else.

The Government announced its intention in Budget 2015 to amend the Tax Act (the “**2015 Amendments**”) to prevent the perceived circumvention of the DRA Rules by certain taxpayers through the use of “synthetic equity arrangements”, pursuant to which equity derivatives could facilitate the transfer by a taxpayer of all or substantially all of the risk of loss and opportunity for gain or profit in respect of a share to a counterparty (typically including the right to dividend compensation payments), while the taxpayer retained legal ownership of the underlying share and the dividends paid on the share.

The 2015 Amendments limited the scope of such planning by, among other things, denying the Dividend Deduction in connection with synthetic equity arrangements. Prior to the introduction of the 2015 Amendments, taxpayers could arguably have realized tax losses in respect of such arrangements by claiming, first, the Dividend Deduction in respect of the amount of the dividends they received in respect of the underlying shares that were 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 were “tax-indifferent” entities that did not pay Canadian tax (such as tax-exempt entities or non-residents) and were, therefore, indifferent between receiving a dividend equivalent payment and a dividend. McMillan’s bulletin on the Budget 2015 announcement regarding the 2015 Amendments is available here.

The existing synthetic equity rules provide an exception to the denial of the Dividend Deduction where it can be established that the counterparty to the synthetic equity arrangement (or another equity derivative that is entered into in connection with the synthetic equity arrangement (a “**specified synthetic equity arrangement**”)) is not a “tax-indifferent investor” or a group of tax indifferent investors (the “**Tax-Indifferent Investor Exception**”). In order to qualify for the Tax-Indifferent Investor Exception, a taxpayer must obtain representations in writing from the counterparty to the effect that it is not a tax-indifferent investor 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. A tax-indifferent investor includes, for example, a person exempt from tax under Part I of the Tax Act pursuant to section 149 of the Tax Act (such as a pension fund) or a non-resident person that does not carry on business in Canada.

The Government expressed concern in Budget 2018 that certain taxpayers have taken the position that the

Tax-Indifferent Investor Exception is available in circumstances where a tax-indifferent investor ultimately obtains all or substantially all of the risk of loss and opportunity for gain or profit of a Canadian share from a counterparty to the taxpayer otherwise than through a synthetic equity arrangement or a specified synthetic equity arrangement.

Budget 2018 proposes to amend the Tax-Indifferent Investor Exception by specifying that that the exception cannot be satisfied when a tax-indifferent investor obtains all or substantially all of the risk of loss and opportunity for gain or profit in respect of a Canadian share, in any way, including where the tax-indifferent investor has not entered into a synthetic equity arrangement or a specified synthetic equity arrangement in respect of the share.

Unfortunately, the breadth of transactions that would fail to qualify under the revised Tax-Indifferent Investor Exception could create uncertainty in ordinary arm's length commercial transactions as it may be difficult to determine the economic exposure of a tax-indifferent investor to particular subject shares.

The Government has indicated that the foregoing proposed amendments will apply to dividends that are paid, or become payable, on or after February 27, 2018.

Securities Lending Arrangements

The Government also proposed in Budget 2018 to expand the scope of the "securities lending arrangement" rules in the Tax Act to provide that certain securities lending and repurchase arrangements that are functionally and economically similar to the synthetic equity arrangements described above should be included within the scope of the securities lending arrangement provisions of the Tax Act.

Certain taxpayers have traditionally loaned securities to other market participants to facilitate, among other things, the borrower's short selling of shares. Alternatively, such lending arrangements have been structured as sales of the underlying securities to the "borrower", with the vendor having a repurchase obligation at some later date. Typically, the borrower of such securities (or the purchaser of the securities in the case of a repurchase arrangement) would compensate the lender or vendor of such securities, as the case may be, for any dividends that the borrower/purchaser received. To reflect the fact that the lender in such arrangements has generally retained its economic interest in the shares throughout the arrangement, the Tax Act currently includes a number of deeming provisions, in particular section 260 of the Tax Act, that deem the loaned securities to be owned by the vendor for several purposes under the Tax Act and to generally deny borrowers a deduction on such dividend compensation payments.

The Government has expressed concern that certain taxpayers are entering into arrangements that do not currently fall within the scope of the securities lending arrangement provisions but are economically and functionally similar to a synthetic lending arrangement. Since the securities lending arrangement provisions do not apply, the borrower could arguably claim a deduction for the dividend compensation payments while also claiming a Dividend Deduction in respect of any dividends received. The Government has indicated that it views the deduction of such dividend compensation payments as potentially generating an inappropriate loss, allowing a taxpayer effectively to deduct an amount in respect of the dividend twice.

To address this concern, the Government has proposed to add a new defined term – "specified securities lending arrangement" – to the Tax Act. A specified securities lending arrangement will generally be an arrangement (excluding a securities lending arrangement) pursuant to which:

1. a person transfers or lends at any particular time a particular share described in paragraph (a) of the definition of a "qualified security" in section 260 of the Tax Act to another person,
2. it may reasonably be expected, at the particular time, that the other person will transfer or return to the person, after the particular time, a share that is identical to the particular share so transferred or lent, and
3. the person's risk of loss or opportunity for gain or profit with respect to the particular share is not changed in any material respect.

The Government has also proposed to amend the definition of an "SLA compensation payment" to include compensation paid pursuant to a specified securities lending arrangement. As a consequence of these changes, a specified securities lending arrangement will be deemed to be a dividend rental arrangement, such that the borrower of securities will not be entitled to the Dividend Deduction.

Although the borrower under such circumstances will be ineligible for the Dividend Deduction, the borrower will generally be expected to be able to deduct dividend compensation payments to the lender to offset the dividend inclusion.

In addition, the Government has also proposed to clarify the interaction between two provisions of the Tax Act that address the deductibility of dividend compensation payments under a securities lending arrangement. Under paragraph 260(6)(a) of the Tax Act, a registered securities dealer is generally permitted to deduct up to two-thirds of a dividend compensation payment to a counterparty. In addition, subsection 260(6.1) of the Tax Act generally allows all taxpayers to deduct dividend compensation payments if the securities lending arrangement is a dividend rental arrangement under paragraph (b) of the definition of a dividend rental arrangement. The proposed amendments will clarify that the former rule does not apply when the latter rule applies.

The Government has indicated that the amendments to the securities lending arrangement provisions will apply to dividend compensation payments that are paid on or after February 27, 2018, unless the securities lending or repurchase arrangement was in place before February 27, 2018, in which case the amendment will apply to dividend compensation payments that are made after September 2018.

Stop-Loss Rules on Share Repurchase Transactions

The dividend stop-loss rules in the Tax Act are designed to limit the scope and application of the Dividend Deduction in circumstances where its application would otherwise result in a perceived abuse of the Dividend Deduction. In particular, there are various provisions of the Tax Act that limit the ability of a taxpayer to use the Dividend Deduction to create a loss on the redemption or purchase for cancellation of shares.

An announcement in Budget 2011 gave rise to amendments to subsection 112(5) of the Tax Act that resulted in the dividend stop-loss rule in subsection 112(5.2) applying where a Canadian financial institution received a deemed dividend under subsection 84(3) of the Tax Act to the extent the shareholder received consideration in exchange for its shares that exceeded the paid-up capital attributable to such shares.

The 2011 proposals were said to be in response to transactions by Canadian financial institutions with Canadian public companies that were looking to repurchase shares from their public shareholders. Such public corporations would enter into an agreement with a Canadian financial institution that provided for the repurchase of shares of the Canadian public company pursuant to a private agreement. Since the shares in such circumstances were not being purchased in the open market, the Canadian financial institution was deemed to have received a dividend to the extent that the amount the public company paid to the financial institution on the repurchase of the shares exceeded the paid-up capital attributable to the shares. Such an arrangement was described by the Government as permitting the financial institution to claim a double deduction: (a) once for the Dividend Deduction, and (b) once because the deemed dividend was excluded from proceeds of disposition for the purposes of calculating profit or loss on the share repurchase.

In reaction to these transactions, Budget 2011 introduced proposals that would make the dividend stop-loss rule pertaining to shares held as mark-to-market property apply in all situations where a taxpayer received a deemed dividend on a share repurchase. However, Budget 2011 did not propose to make a corresponding adjustment to the formula for computing allowable losses in subsection 112(5.2) of the Tax Act. Accordingly, the application of the dividend stop-loss rules in such circumstances would generally result in only a partial denial of any loss realized on the transaction. Under the formula, the portion of the tax loss equal to the mark-to-market income previously realized on the shares would generally be allowed, purportedly on the theory that the financial institution would have already paid tax on that income.

In Budget 2018, the Government noted that it is frequently not the case that a financial institution has borne the economic cost of a tax on the portion of such tax loss that is equal to the mark-to-market income previously realized on the shares, since, in many cases, the financial institution would have hedged its exposure to the underlying shares, such that any mark-to-market income realized on the shares would be fully offset under the hedge. Consequently, the Government asserts that Canadian financial institutions are able to realize an artificial tax loss on such share repurchases.

To address this perceived deficiency, the Government proposes to amend subsection 112(5.2) of the Tax Act to reduce the available tax loss realized on the share repurchases described above by the dividend deemed to be received on the repurchase when that dividend is eligible for the inter-corporate dividend deduction and is in respect of mark-to-market property.

The Government has indicated that the foregoing amendment will apply in respect of share purchases that occur on or after February 27, 2018. The Budget 2018 materials forecast that the Government believes such amendments will generate approximately $1.35 billion of additional tax revenue over five years.

by Andrew Stirling

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.