The Income Tax Characterization of Derivatives: The Supreme Court of Canada Weighs In

April 06, 2020

Kate Amirault, Jonathan W. Willson

On March 13, 2020, the Supreme Court of Canada ("SCC") released its judgment in *James S.A. MacDonald v. Her Majesty The Queen*.[1] In an eight-to-one split decision, the majority of the SCC re-affirmed the existing test for determining whether a derivative contract entered into by a taxpayer constituted a hedging transaction for Canadian income tax purposes. While the decision does not break new ground, it remains useful as it consolidates several principles relating to the income tax characterization of derivatives that were previously found in a number of different cases, rendered by courts of different levels, into one judgment of the SCC.

Facts and Case History

In *MacDonald*, the taxpayer entered into what appears to have been a monetization transaction consisting of the following components: (i) a credit facility ("Loan") with a Canadian bank ("Lender") under which he was entitled to borrow up to $10.5 million; (ii) an agreement under which he pledged in favour of the Lender, 165,000 common shares of another Canadian bank ("Shares") of the 183,333 Shares that he owned, and (iii) a forward sale contract ("Forward") with an affiliate of the Lender ("Counterparty").

At the time the Loan was entered into, the Shares that were subject to the pledge agreement had a market value that was approximately equal to 90% (later increased to 95%) of the maximum amount that could be drawn under the Loan. Pursuant to the terms of the Forward, the taxpayer agreed to synthetically sell to the Counterparty, 165,000 Shares at a specific price per share ("Forward Price") at specific future date ("Settlement Date"). The Forward Price was, subject to certain adjustments, approximately equal to the trading price of the Shares at the time the Forward was entered into. Instead of having the taxpayer actually sell the Shares to the Counterparty at a price equal to the Forward Price on the Settlement Date (i.e. "physical settlement"), the parties chose "cash settlement" of the Forward such that, if the market price of the Shares on the Settlement Date was higher than the Forward Price, the taxpayer would be required to pay the Counterparty an amount equal to the difference. Conversely, if the market price of the Shares on the Settlement Date was lower than the Forward Price, the taxpayer would be entitled to receive an amount equal to that difference from the Counterparty. Among other things, the terms of the Forward provided for an extension to the Settlement Date and for pre-settlement (i.e., partial termination) prior to the Settlement Date.

During the term of the Forward, the trading price of the Shares increased, thereby requiring the taxpayer to make cash settlement payments to the Counterparty totaling approximately $10 million ("Settlement Payments"). Mr. MacDonald took the position that the Forward was entered into for the purpose of speculation and, on this basis, characterized Settlement Payments as being fully tax deductible, thereby creating significant business losses for the taxpayer for his 2004, 2005 and 2006 taxation years. The Canada Revenue Agency ("CRA") denied the taxpayer's deductions and re-assessed Mr. MacDonald on the basis that the Settlement Payments gave rise to losses that were on capital account. The taxpayer successfully appealed his re-assessment to the Tax Court of Canada ("TCC") but the decision was overturned by a unanimous decision of the Federal Court of Appeal ("FCA"). In their judgment, the majority of the SCC denied the taxpayer's appeal and restored the judgment of the FCA and, by extension, the CRA's re-assessment.

Analysis

It is a relatively well settled principle that for Canadian income tax purposes, a derivative contract will be treated as either a hedging transaction or a speculation. If found to be a hedging transaction, the income tax characterization of a derivative contract (i.e., whether it will be on income or capital account) will adopt that of the transaction, asset or liability that it hedges. Otherwise, the income tax characterization of the derivative contract will be determined in accordance with ordinary principles – which, as a practical matter, will usually result in the derivative contract being held by the taxpayer on income account. It is also reasonably well understood that, for Canadian income tax purposes, a derivative contract that is a hedging transaction is one that is entered into by the taxpayer for the purpose of reducing or eliminating risk. In contrast, a derivative contract that is a speculation is one through which the taxpayer assumes risk in expectation of realizing a gain or earning a profit.

Despite the existence of these well settled principles, the TCC and the FCA interpreted certain aspects of these principles differently and reached opposite conclusions when applying them to the facts of this case. While supportive of the FCA's disposition of the matter, in its decision, the SCC fine-tuned some of the FCA's reasoning when setting out the key principles for determining the proper income tax characterization of a derivative contract.[2] Those key principles are as follows:

- The characterization of a derivative contract as a hedging transaction or a speculation turns on the contract's purpose, which should be ascertained primarily by determining the degree of linkage between the derivative contract and an underlying asset, liability or transaction of the taxpayer that exposes the taxpayer to a particular financial risk.
- Purpose is generally ascertained objectively, although subjective manifestations of purpose may sometimes be relevant, a taxpayer's stated intention is not determinative. In this regard, the SCC made it clear that factors "outside the four corners of the derivative contract" will very often be relevant when assessing whether the contract is a hedging transaction or a speculation. The majority decision also provides useful clarification on the relevance of a taxpayer's purpose for entering into a derivative contract. The TCC's decision in *MacDonald* suggested that the taxpayer's purpose for entering into a derivative contract was a prerequisite for establishing the existence of a hedging transaction and that evidence of the taxpayer's subjective intention was fundamental to this analysis. The FCA properly rejected this interpretation of existing principles but, in so doing, its own judgment suggested that a taxpayer's intention or purpose was not even relevant for undertaking the linkage analysis. While essentially adopting the FCA's reasoning, the majority decision of the SCC nevertheless made it clear that the taxpayer's purpose is relevant to the linkage analysis but is not determinative of the analysis. It will be left to future cases, having more ambiguous fact patterns, to provide more guidance on the relative importance of purpose to the linkage analysis.
- When evaluating the strength of the linkage between the derivative contract and the applicable asset, liability or transaction, it is necessary to determine how effective the derivative contract is at mitigating or neutralizing the identified risk – the more closely connected the derivative contract is to the item purportedly being hedged, the stronger the inference that the purpose of the derivative contract was to hedge the taxpayer's exposure to that risk.

The SCC also reaffirmed certain secondary principles from existing case law including the following:

- *The method by which a derivative contract is settled is not determinative of linkage (or, ultimately, purpose)*.[3] In fact, based on the reasoning in the majority judgment, it is clear that the decision by the parties to cash settle or physically settle should be accorded little weight when ascertaining the purpose of a derivative contact. As was reflected in the TCC's judgment, there has previously been some sentiment within the Canadian income tax community that the decision the cash settle a derivative contract was indicative of a speculative purpose.
- *A perfect linkage is not required*. Again, this principle has been understood for some time, but the question remains how much linkage is required to determine that a derivative contract was entered into as a hedging transaction? In *MacDonald*, the SCC (and the FCA) had no trouble concluding that there was a high degree of linkage between the Forward and the taxpayer's ownership of the Shares. As a result, the SCC did not need to explore the question of how much symmetry between a derivative contract and an underling item is necessary before the requisite degree of linkage is established.
- *The absence of a synchronous transaction used to offset gains or losses arising from a derivative contract is not equivalent to the absence of risk and is not, by itself, determinative of the characterization of a derivative contract*. Put another way, the SCC's decision makes it clear that derivative contracts used to mitigate exposure risk associated with the ownership of assets (i.e., "ownership risk") are capable of being characterized as hedging transactions for income tax purposes and the tests for establishing or refuting such characterization are the same as for derivative contracts that purport to hedge transactions.

Conclusion

Although the *MacDonald* decision does not change the existing law or introduce new legal concepts, it consolidates (and elevates) many of the existing principles and, in so doing, provides a helpful framework for the income tax characterization of derivative contracts. While some issues still remain, such as the degree of linkage required to establish the existence of a hedging transaction and the relevance of a taxpayer's intention for entering into a derivative contract, the SCC's decision is useful addition in the body of jurisprudence involving the Canadian income tax treatment of derivative contracts.
