synthetic dispositions

Budget 2013 proposes to introduce new anti-avoidance rules to deal with "synthetic dispositions" - "financial arrangements" that allow a taxpayer to "economically dispose of a property while continuing to own it for income tax purposes." The Budget Papers provide the following description of these kinds of transactions.

> A synthetic disposition transaction typically involves a taxpayer entering into an arrangement under which the taxpayer eliminates their future risk of loss and opportunity for gain or profit in respect of a property and acquires another property (or a right to acquire another property) the value of which approximates what the taxpayer would have received as proceeds from disposing of the property. A taxpayer may enter into a synthetic disposition transaction to defer the tax associated with a sale or to obtain tax benefits associated with the continued ownership of a property (e.g., to avoid the application of the stop-loss rules in section 112 of the *Income Tax Act*).

Apparently, the Government's view is that certain of these types of monetization transactions can be challenged based on existing rules in the *Income Tax Act* (Canada) (the "**Tax Act**") Specific anti-avoidance rules are being introduced, however, to ensure that the "appropriate tax consequences" apply to these transactions because "any such challenge could be both time-consuming and costly."

deemed disposition

Under the proposed rules, a taxpayer who enters into a "synthetic disposition arrangement" will be deemed to have disposed of the property in question immediately before the arrangement is entered into for proceeds equal to its then fair market value, and to have reacquired the property at the time the arrangement is entered into at a cost equal to the same amount. As a result, accrued gains or losses on the property will be realized at the time the arrangement is entered into. Although the Budget Papers do not address the interaction of the new anti-avoidance rules and certain existing loss denial rules, it would appear that, in many situations, the loss denial rules will apply to deny or suspend recognition of a capital loss realized on a deemed disposition under the proposed rules.

The Notice of Ways and Means Motion included in the Budget Papers defines a "synthetic disposition arrangement" as "one or more agreements or other arrangements" that:

- are entered into by a taxpayer or by a person or partnership that does not deal at arm's length with the taxpayer;
- have the effect, or would have the effect if entered into by the taxpayer instead of the non-arm's length person or partnership, of eliminating all or substantially all of the taxpayer's risk of loss and opportunity for gain or profit in respect of the property in question for a period of more than one year;
- where the arrangement or agreement is entered into by a non-arm's person or partnership, can reasonably be considered to have been entered into, in whole or in part, with the purpose of obtaining the effect described above (i.e., eliminating risk of loss and opportunity for gain or profit for a period of more than one year); and
- do not otherwise result in a disposition of the property within one year of the time that they are entered into.

The proposed rules do not apply to commercial leasing arrangements or to any transaction that otherwise results in a disposition (including a tax-deferred disposition). The Budget Papers further indicate that the proposed rules will not apply to "ordinary hedging transactions" because they "typically only involve managing the risk of loss" or generally affect the tax treatment of "ordinary-course securities lending arrangements."

In addition, the Budget Papers state that the proposed rules will not apply to an arrangement entered into by a non-arm's length person if it is "reasonable to conclude" that the non-arm's length person did so "without knowledge of the taxpayer's ownership of the property." Although the language in the Notice of Ways and Means Motion is quite different, the purpose test referred to in the third point above appears to be intended to provide the basis for this carve-out.

The proposed rules will apply regardless of the form of the transaction. The Budget Papers suggest that they may apply to forward sales of property (whether or not combined with a secured loan), "put-call collars" in respect of property, debt obligations that are exchangeable for property, total return swaps in respect of property, or a securities borrowing to facilitate a short sale of property that is identical or economically similar to a property of the taxpayer (or non-arm's length person).

The above definition is quite broad and does not incorporate the second component of the description of a "synthetic disposition" in the Budget Papers (i.e., the acquisition by a taxpayer of another property (or a right to acquire another property)). Accordingly, the new anti-avoidance rules may apply to a much broader range of arrangements than those that result in an "economic disposition".

stop-loss rules

The Tax Act includes stop-loss rules that, in general, reduce a loss realized by a taxpayer on the disposition of shares by the amount of certain dividends received by the taxpayer before the disposition. These rules do not apply where, among other things, the taxpayer has held the shares in question throughout the 365-day period before the disposition.

Budget 2013 proposes to amend these stop-loss rules so that a taxpayer who is deemed to have disposed of and reacquired a property under the synthetic disposition arrangement rules (or who would be deemed to have disposed of the property under these rules if the references to "one year" in the definition of a "synthetic disposition arrangement" were to "30 days") will be deemed not to own the property while the arrangements are in place. This rule will not apply where the taxpayer owned the property in question throughout the 365-day period before the arrangement is entered into.

The definition of a "synthetic disposition arrangement" that applies for the purposes of this rule is broader than the definition that applies for the purposes of the new deemed disposition rule because it includes fairly short-term arrangements (i.e., anything more than 30 days). Accordingly, a taxpayer's period of ownership of a share for the purposes of the stop-loss rules may be interrupted in circumstances where the new deemed disposition rule does not apply because the duration of the arrangement is less than a year. In these circumstances, it would appear that, if the arrangement terminates without an actual disposition of the share, the ownership period is effectively reset at the time of the termination.

foreign tax credits

The Tax Act limits the foreign tax credits to which a taxpayer is entitled in respect of the non-Canadian taxes paid on dividends or interest on shares or debt obligations held by the taxpayer for a period of one year or less to, in simplified terms, a portion of the taxpayer's economic profit on the shares or debt obligations determined in accordance with the rules in the Tax Act.

Budget 2013 proposes to modify this rule so that a taxpayer who is deemed to have disposed of a property under the synthetic disposition rules (or who would be deemed to have disposed of the property under these rules if the references to "one year" in the definition of a "synthetic disposition arrangement" were to "30 days") will be deemed, for the purpose of determining the ownership period for the purposes of this rule, to have acquired the property at the earlier of the time that is immediately before the deemed disposition and the time at which the arrangement is no longer in effect. This rule will not apply where the taxpayer owns the property for more than one year before the arrangement is entered into.

As is the case with the proposed changes to the stop-loss rules, this rule will apply more broadly than the deemed disposition rule and, specifically, will apply where the duration of the arrangement in question is for more than 30 days.

effective date

The synthetic disposition rules proposed in Budget 2013 apply to arrangements or agreements entered into on or after March 21, 2013, and to any agreement or arrangement entered into before March 21, 2013, the term of which is extended on or after that date. An arrangement that is extended will be deemed to have been entered into at the time of the extension.

The amendments to the stop-loss rules proposed in section 112 and to the foreign tax credit rules in section 126(4.2) of the Tax Act are deemed to have come into force on March 21, 2013.

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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.