The Joint Committee on Taxation of
The Canadian Bar Association
and
Chartered Professional Accountants of Canada

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May 26, 2015

Ms. Alexandra MacLean
Director, Tax Legislation Division, Tax Policy Branch
Department of Finance
L'Esplanade Laurier, East Tower
140 O'Connor Street, 17th Floor
Ottawa, ON K1A 0G5

Dear Ms. MacLean:

Re: 2015 Federal Budget – Synthetic Equity Arrangements

Further to our recent telephone conversation, we are enclosing a submission which considers the potential application of the proposed synthetic equity arrangement provisions to ordinary share purchase transactions. We also anticipate providing you with other submissions in respect of the 2015 Federal Budget in the near future.

We would like to thank you for your consideration of this matter. A number of members of the Joint Committee and others in the tax community have participated in the discussions concerning our submission and have contributed to its preparation, in particular:

Michael McLaren (Thorsteinssons LLP)
Matias Milet (Osler, Hoskin &Harcourt LLP)
Siobhan Monaghan (KPMG Law LLP)
Angelo Nikolakakis (Couzin Taylor LLP)
Janice Russell (Deloitte LLP)
Mitchell Sherman (Goodmans LLP)
Carrie Smit (Goodmans LLP)
Jeffrey Trossman (Blake, Cassels & Graydon LLP)
Craig Webster (Borden Ladner Gervais LLP)

We trust that you will find our comments helpful and would be pleased to discuss them further at your convenience.

Yours very truly,

Janice Russell
Chair, Taxation Committee
Chartered Professional Accountants of Canada

Mitchell Sherman
Chair, Taxation Section
Canadian Bar Association

Cc: Gabe Hayos, Vice President, Taxation, CPA Canada

Synthetic Equity Arrangements – Commercial Agreements of Purchase and Sale

Budget 2015 proposes to expand the definition of a "dividend rental arrangement" to include a "synthetic equity arrangement" ("**SEA**").[1] As a result, subsection 112(2.3) will deny a deduction under subsection 112(1) or (2) or 138(6) (a "**Dividend Deduction**") in respect of a dividend received on a share as part of a SEA (subject to proposed subsection 112(2.31)). According to the Budget Papers, these measures are generally a response to arrangements, typically undertaken by financial institutions, that involve the receipt of a deductible dividend on a Canadian share and the payment of tax deductible dividend-equivalent amount to a tax-indifferent investor which bears all or substantially all of the economic exposure in respect of the share.

We are concerned that, in the context of many typical commercial share purchase transactions, the breadth of the definitions of SEA and "tax-indifferent investor" may lead to inappropriate consequences where pre-sale dividends are paid. Furthermore, if the proposed consultation results in the removal of the requirement for a tax-indifferent investor, our concerns will only be magnified.

We do not comment below in any way on the impact of the proposals in the context of the financial services industry; instead, our comments will be limited to the potential application of the proposals to "ordinary" share purchase transactions.

The definition of SEA is very similar to the definition of a "synthetic disposition arrangement" ("**SDA**") which was recently enacted.[2] Each provision contemplates an arrangement that effectively transfers "all or substantially all" of the taxpayer's "risk of loss and opportunity for gain or profit" in respect of a share to a counterparty. Notably, notwithstanding the "synthetic" component of the SEA definition and the concerns expressed with regard to the payment of tax deductible dividend-equivalent amounts, the basic SEA rule does not appear to require either the use of a derivative or the payment of compensation in respect of a dividend received by the taxpayer. Rather, subject to certain exceptions (which appear to be inherently limited to derivatives), the proposal requires only the transfer of risk of loss and opportunity for gain or profit to the counterparty.

The October 2013 Technical Notes to the definition of a SDA clearly contemplate that an agreement to sell shares at a future date for a specified amount would have the effect of eliminating all or substantially all of the vendor's risk of loss and opportunity for gain or profit in respect of the shares.[3]

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[1] Proposed paragraph (*d*) of the definition of "dividend rental agreement" contains an anti-avoidance rule which applies in similar circumstances. It must be ensured that paragraph (d) will not apply to these types of excluded transactions as well.

[2] The SDA definition contemplates "eliminating" the risk/opportunity, whereas the SEA definition contemplates "providing" the risk/opportunity to the counterparty. In the context of a typical share purchase arrangement, our initial impression is that the difference in wording would not significantly affect the analysis.

[3] In this regard, we refer specifically to example 1 under "Put/Call Arrangements" and examples 1 and 2 under "Future Sale".

Having regard to the foregoing, it is possible that the definition of an SEA will capture many share purchase transactions and thus affect dividends paid to the vendor during the period between the date of the agreement and the date on which ownership of the shares is transferred ("**Pre-Closing Dividends**"). This is potentially relevant to a broad range of transactions, from the sale of shares of a small business corporation by a single owner-manager to the acquisition of a large public corporation (whether by takeover bid, plan of arrangement or otherwise). For example, safe-income dividend planning is a common and accepted feature of many transactions. In addition, Pre-Closing Dividends could include regularly scheduled dividends where the dividend payment date happens to fall between the signing date and the closing date.

Where the amount of the Pre-Closing Dividends is sizeable relative to the total opportunity for gain or profit in respect of the shares, it might be possible to argue that the share purchase agreement does not transfer all or substantially all of the opportunity for gain or profit in respect of the shares to the purchaser. However, even if this is correct it does not eliminate our concerns. First, in any particular case, the Pre-Closing Dividends may or may not be significant in relation to the purchase price.[4] It seems fundamentally inappropriate that the outcome should depend on the relative size of the dividends. Moreover, in many cases, safe income dividends take the form of deemed dividends rather than actual dividends (e.g., stock dividends or dividends deemed paid under subsection 84(1)), such that there may be no effect on the purchase price of the shares under the share purchase agreement. Second, in many cases, including those with a working capital adjustment or an earn-out, for example, the purchase price may not be so readily determined or determinable. Accordingly, we think a more holistic solution – one that applies irrespective of the size of the Pre-Closing Dividends – is appropriate.

In addition, if the vendor establishes that the purchaser is not a "tax-indifferent investor", the agreement may not be subject to the proposals. However, the rules are quite broad in this respect and include many trusts and partnerships, in addition to non-residents and tax-exempts. Even where the immediate purchaser is not tax-indifferent, it is possible that it may have agreed to on-sell the shares to a tax-indifferent investor in circumstances where that second sale is not being disclosed to the vendor. Again, because the planning which gives rise to Pre-Closing Dividends is wholly unrelated to the tax or legal status of the purchaser, we believe a more appropriate solution is one that applies whether or not the purchaser is (or has agreed to sell the shares to) a "tax-indifferent investor".

Finally, we have considered whether it might be argued that Pre-Closing Dividends are not received "as part" of the SEA. However, the various arrangements that give effect to the share transfer (whether private agreement, takeover bid or plan of arrangement) will specifically contemplate, and permit, the payment of the Pre-Closing Dividends. In this context, we have significant concern that such payment will be treated "as part" of the arrangement.

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[4] We would also note that there may be some uncertainty with the interpretation of this provision in such a situation (i.e. whether the purchaser's risk/opportunity should include the Pre-Closing Dividend); in addition, it is not clear that the "substantially all" threshold invites only a mechanical comparison of the quantum of the Pre-Closing Dividends to the purchase price. Further, the "substantially all" threshold itself is ambiguous in terms of the relevant percentage it contemplates, and has been the subject of litigation.

Recommendation

We believe that the definitions of an SEA and dividend rental arrangement should be amended to exclude *bona fide* transactions of purchase and sale of shares that are not part of any ongoing arrangement between the parties. We understand from our prior discussions with you respecting the SDA rules that it may not be a simple matter to form a bright-line rule which makes appropriate distinctions in all cases. We would, however, note that: (i) most of the transactions we are concerned with do not involve financial institutions (although financial institutions should themselves be protected in relation to the "ordinary" share purchase transactions we are contemplating); and (ii) these transactions do not contemplate dividend compensation payments being made (although the purchase price for the shares is typically negotiated with reference to the fixed dividend or is adjusted (through working capital provisions or otherwise) where the dividend payment is not known at the time the arrangement is agreed to).

In addition, we also believe that you should confirm that accepted transactions in the market place, for example exchangeable shares, are not intended to be subject to the proposals.[5]

We look forward to discussing these matters with you with a view to limiting the potential application of these proposals to the range of transactions that fall within Finance's policy concerns.

[5] See CRA document 2014—0546701C6 in relation to exchangeable shares and derivative forward agreements.