Synthetic Dispositions: Get Cash Now, Pay Tax Later

The 2013 budget addresses concerns about transactions that use financial engineering to disentangle economic substance from legal form, effectively making the timing of a disposition of property for tax purposes an election. Normally, the purpose of such a transaction is to obtain the cash for property while deferring the tax on a gain—for example, in an equity monetization (EM). However, nothing in the proposals limits their application to equity holdings or even to capital property, and the budget notes that the transaction's purpose could be to more fully recognize a loss by avoiding stop-loss rules rather than to defer tax on a gain.

An EM in its plain vanilla form may be as simple as a loan secured by a pledge of shares, without further recourse against the borrower. The taxpayer retains the title to the shares, the voting rights, and the right to any dividends declared and paid. Upon maturity (typically, five years or longer), the taxpayer may forfeit the pledged shares (likely, if they are worth less than the outstanding loan balance) or settle the loan in cash and secure the return of the pledged shares (likely, if they are worth more than the outstanding loan balance). Further refinements of this simple arrangement using options and other financial derivatives can also eliminate the upside potential of holding the shares in return for increased cash.

The government's problem is that there are a wide variety of potential deal structures, some of which leave the equity owner with more risk or return than others. When the government legislated against a previous tax-avoidance strategy involving derivatives known as weak currency loans, it chose a specific quantitative threshold ("exceeds by more than two percentage points": subsection 20.3(1)). This time, the government has chosen a more conceptual approach: the budget proposes to create a deemed disposition at the time the taxpayer enters into a synthetic disposition arrangement, which is defined to be all types of transactions that "have the effect of . . . eliminating all or substantially all of the taxpayer's risk of loss and opportunity for gain or profit in respect of the property for a period of more than one year" (subject to certain exclusions). Thus, the loan-based EM discussed above would not be caught unless the refinement eliminating the upside potential was also added.

In the United States, similar issues have been addressed for many years in the interplay between EMs and both the "constructive sale" provisions and the meaning of the "sale or exchange" of property. Accordingly, the US market response may provide some guidance on how to structure transactions to stay outside the proposed Canadian legislation as well as the general legal definition of "disposition." The following amendments to EM deals may be instructive:

- the taxpayer retains the benefit of price appreciation of up to 10 percent, and accepts the risk of price decreases of up to 10 percent over the length of the contract (perhaps five years);
- the pledged shares are not to be lent to the party on the other side of the transaction (typically a bank) or, for 60 days, to any other party;
- the taxpayer retains voting and dividend rights; and
- at the maturity of the contract, the taxpayer has the option of making a cash settlement rather than delivering the shares, and of delivering other shares rather than the specific shares originally pledged.

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Unexpected Application of Part XII.2 Tax to a Canadian Personal Trust

An inter vivos trust resident in Canada may initially have only Canadian beneficiaries, but over time the beneficiaries' residences may change. For example, an individual designated as a beneficiary of a trust may study in the United States and then decide to remain there, severing his or her residential ties with Canada. In such a case, part XII.2 tax may apply to the trust, which is a resident of Canada, since one of its beneficiaries has become a non-resident of Canada under the Act.

Part XII.2 tax is imposed on a trust in order to ensure that certain types of trust income allocated to a non-resident beneficiary bear an appropriate level of tax—that is, tax at rates comparable to those applicable under part I to income that is received directly (without interposing a trust). In the absence of part XII.2, the rates applicable under part XIII would apply.

Where applicable, part XII.2 tax applies at the rate of 36 percent on the income from a business operated in Canada earned by a trust, on the income from real property located in Canada earned by the trust, and on the taxable capital gains from the disposition of taxable Canadian property owned by the trust. Interest and dividend income are not included in the definition of "designated income" in current subsection 210.2(2) or in proposed subsection 210(1) and thus are not subject to part XII.2. Part XII.2 tax must be paid by the trust within 90 days from the end of its fiscal year, and it applies to the three types of trust income mentioned above, not just to the amounts allocated to the non-resident beneficiaries. However, beneficiaries who reside in Canada are generally entitled to a refund of the part XII.2 tax paid by the trust on the portion of income attributed to them. Cash flow problems can arise because part XII.2 tax must be paid by the trust many months before the beneficiary's tax return is filed and the refund is received.

Planning opportunities to deal with the emigration of a beneficiary and the resulting application of part XII.2 tax to a trust appear to be quite limited. In some non-arm's-length situations, the non-resident might agree to be removed as a beneficiary. Alternatively, the non-resident could avoid receiving any income or capital from the trust for any given fiscal year in the hope that he or she would not be classed as a beneficiary and thus would not trigger the application of the tax to the trust for that year. The basis of this argument is that the Act does not define the term "beneficiary" for the purposes of part XII.2. Although the non-resident would be "beneficially interested" (as defined in subsection 248(25)) in the trust and thus would meet the definition of "beneficiary" in subsection 108(1), the preamble to that subsection limits the application of the definition to subdivision k (sections 104 to 108). However, in obiter dicta in *Propep Inc.* (2009 FCA 274), the FCA extended the application of the definition of "beneficially interested" beyond those specific sections (in that decision, to subparagraph 256(1.2)(f)(ii)). Thus, at present it is unclear whether avoiding distributions from the trust to non-residents of Canada during a taxation year will be sufficient to eliminate the application of part XII.2 tax to the trust.

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Are Payments to Research Assistants Tax-Free?

A common tax-planning strategy employed by universities in the last several years has been to treat payments to students holding research assistantships as tax-exempt scholarship income rather than as taxable research grants or employment income. However, this strategy has not been directly tested in court, and the CRA's opinion is ambiguous. The CRA's current views are described in a folio (the successor to interpretation bulletins, information circulars, and other documents) released for public consultation on March 28, 2013 (*Income Tax Folio* S1-F2-C3, "Scholarships, Research Grants and Other Education Assistance"). Consultations are to last for three months.

Unlike employment income and research grants, scholarship income may be fully exempt from personal income tax pursuant to subsection 56(3), provided that it is considered to be received in connection with the recipient's enrolment in an educational program in respect of which an education tax credit can be claimed under subsection 118.6(2). Generally, if the student is enrolled on a full-time basis at a university or college in a program that either leads to a diploma or degree or does not consist primarily of research, the exemption will be available.

The CRA's view is that an award involving a research component should be classified as follows:

1) if the primary purpose of the award is to further the education and training of the recipient, the award will be considered a fellowship (scholarship) (paragraph 3.31);
2) if the primary purpose of the award is to enable the recipient to carry out research for its own sake, the award will be considered a research grant (paragraph 3.32); and
3) if the research is conducted in the context of a traditional employment relationship as determined by the usual factors, the award will be employment income (paragraph 3.29).

This guidance seems to provide universities with some flexibility to classify research assistantships in programs with a thesis requirement (especially PhD programs, but also some master's programs) as scholarships, since the research can be viewed as integral to the completion of the educational program.

The CRA's statements seem relatively clear, if open to interpretation. However, paragraph 3.72 (restating *Interpretation Bulletin* IT-75R4, paragraph 30) suggests that when the funds for a research assistantship are paid out of a research grant—presumably received by the supervising faculty member from a source such as NSERC or SSHRC (as opposed to general university monies)—the payment should be classified as either a research grant or employment income to the student. This implies that such payments cannot be classified as scholarships, and hence should not be eligible for the corresponding exemption from tax. Finally, in commenting on the tax treatment of amounts paid to exceptional international students in their capacity