Cassels

Supreme Court of Canada Decision in MacDonald Minimizes Role of Taxpayer Intent in Characterizing Derivative Contracts

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In a rare decision of the Supreme Court of Canada (SCC) in the derivatives law area, the Court characterized a derivative contract for tax treatment purposes by looking at the underlying economics of the contract rather than the intention of the parties and most notably the intention of the taxpayer.

Background

The Court's judgment in *MacDonald v Canada* [2020 SCC 6] (*MacDonald*) released on March 13, 2020, considered the extent to which a taxpayer's intent in entering into a derivative contract was determinative in characterizing such contract as a hedge or speculation for tax purposes.

The appellant taxpayer in *MacDonald*, a former banking executive with extensive experience in capital markets and corporate finance, held common shares in the Bank of Nova Scotia (collectively, the BNS Securities). The taxpayer entered into a lending transaction with Toronto-Dominion Bank (TD) and a cash-settled forward contract with TD Securities Inc. (TDSI) on the BNS Securities. Availability under the credit facility could not exceed 95% of the value of the BNS Securities on a mark-to-market basis and was secured by, among other things, a pledge of the BNS Securities and any cash settlement payment entitlements (namely, in-the-money settlement payments made by TDSI to the appellant) arising from the forward contract in the ordinary course.

In the tax years 2004, 2005 and 2006, the appellant made cash settlement payments to TDSI in satisfaction of his out-the-money position in respect to the forward contract. The appellant's corresponding tax filings characterized the forward contract as being speculative in nature, which would result in gains or losses being treated as basic income for tax purposes. By contrast, tax treatment for hedge transactions takes on the characteristic of the underlying asset being hedged.

The Ministry of National Revenue (the Ministry) disputed the taxpayer's characterization as being "speculative in nature" and reassessed the forward contract as a hedge of the BNS Securities which, being capital assets in nature, resulted in losses being treated as "capital losses." The Tax Court sided with the taxpayer and his characterization and held the forward contract was speculative in nature, finding the

appellant's sole intention was to speculate on the value of the BNS Securities, rather than to mitigate underlying risk. On appeal, the Federal Court of Appeal unanimously overturned the Tax Court decision and held that a taxpayer's intention at the outset of the formation of the derivative contract is not a relevant consideration to hedging, but that the court must look at the objective linkage between the underlying asset and derivate contract.

Writing for the majority at the SCC, Justice Abela affirmed the decision of the Federal Court of Appeal. The majority affirmed an analytic framework considering the taxpayer's risk created by the underlying asset, liability or transaction, and the extent to which the derivative contract mitigates or neutralizes such risk. The more effective such contract is at mitigating or neutralizing the underlying risk, regardless of how the contract is settled, the stronger the inference such contract is a hedge. Applying this framework, the majority found that the forward contract nearly perfectly neutralized price fluctuations on the BNS Securities as well as credit risk relating to the lending transaction. This supported the Ministry's position characterizing the forward contract as a hedge.

Justice Côté, in dissent, argued that both the majority and Federal Court of Appeal improperly interfered with the Tax Court's finding of fact. The dissent of Justice Côté relied on precedent supporting a taxpayer's intent as the principal factor to be considered in determining the character of a derivative contract for tax purposes, and that this is a finding of fact. The dissent held that placing too great a focus on the economic reality of a derivative contract creates a high degree of uncertainty in the tax treatment of any derivative product, and, further, expressly rejected the majority's consideration of the underlying lending transaction between MacDonald and TD, arguing it was and should be properly viewed as an unrelated transaction to the forward contract.

Market Impact

As a result of *MacDonald*, even if a taxpayer enters into a derivative contract for speculative purposes, where the underlying asset being hedged is held by the taxpayer, and the derivative contract materially mitigates or reduces risk associated with holding such asset, the Ministry may nevertheless characterize such contract as a hedge. Tax treatment of settlement payments relating to derivative contracts will vary depending on the character of such derivative; with gains and losses arising from speculative contracts being deemed ordinary income and arising from hedging contracts taking on the characteristic of the underlying asset, liability or transaction being hedged. *MacDonald* strengthens the Ministry's power to reassess a taxpayer's characterization of such payments based on how successful the operative derivative contract is at mitigating underlying risk, irrespective of a taxpayer's *bona fide* intention in entering into such contract.

Where a taxpayer intends to enter into a derivative contract relating to an asset, liability or transaction of such taxpayer, or where such derivative contract can directly mitigate risks relating to existing credit

facilities, such taxpayer should seek legal advice on the benefits of expressly tying in any underlying credit facilities in a more fulsome manner and understanding the tax consequences associated with any prospective view of the Ministry that such contract is and shall be treated as being a hedge.

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