# TAX EXECUTIVES INSTITUTE, INC.



Please respond to:
Ms. Lynn Moen
Senior Vice-President, Tax
Walton Global Investments, Ltd.
24th Floor, 605 – 5th Avenue SW
Calgary, AB T2P 3H5

August 28, 2015

Mr. Brian Ernewein
General Director
Tax Policy Branch
Department of Finance
90 Elgin Street
Ottawa, ON K1A 0G5

Re: *Synthetic Equity Arrangements, Draft Legislation*

Dear Director Ernewein:

The Government released draft legislation on July 31, 2015 to implement proposals announced in the April 21, 2015 Budget that would deny the inter-corporate dividend deduction on dividends received by a taxpayer on Canadian shares involving synthetic equity arrangements ("SEAs"). Tax Executives Institute, Inc. ("TEI") is writing to express our concerns with one aspect of this draft legislation, which could significantly affect the ability of Canadian public companies ("CPCs") to offer incentive-based compensation to their employees.

We understand the draft legislation is an anti-base erosion measure targeting SEAs issued primarily to achieve a tax-motivated purpose. The draft legislation attempts to curb base erosion by denying tax benefits otherwise inherent in SEAs. TEI takes no position with the Government's attempt to limit such tax benefits when SEAs are issued for primarily tax-motivated purposes. We are writing to illustrate how hedging agreements that appear to be covered by the draft SEA legislation can fulfill a legitimate commercial, non-tax business purpose, such as supporting a CPC incentive-based compensation plan, and to recommend that the Government revise the draft legislation to clearly exclude such agreements.

***About Tax Executives Institute***

TEI is the preeminent international association of business tax executives. The Institute's approximately 7,000 professionals manage the tax affairs of more than 2,800 of the leading companies in North and South America, Europe, and Asia. Canadians constitute nearly 15 percent of TEI's membership, with our Canadian members belonging to chapters in Calgary, Montreal, Toronto, and Vancouver. TEI members must contend daily with the planning and compliance aspects of Canada's business tax laws. Many of our non-Canadian members (including those in Europe and Asia) work for companies with substantial activities and investments in Canada. The comments set forth in this letter reflect the views of TEI as a whole, but more particularly those of our Canadian constituency.

TEI concerns itself with important issues of tax policy and administration, and is dedicated to working with government agencies to reduce the costs and burdens of tax compliance and administration to our common benefit. In furtherance of this goal, TEI supports efforts to improve Canadian tax laws and their administration at all levels of government. We believe that the diversity, professional training, and global viewpoint of our members enable us to bring a balanced and practical perspective to the issues raised by the draft legislation discussed herein.

***Incentive-Based Compensation Plans and Hedging Contracts***

CPCs commonly offer stock-based compensation plans to their employees. In some cases, a CPC will allocate a notional amount of its shares to its employees (referred to herein as, "Notional Share-Based Compensation"). Notional Share-Based Compensation plans are an alternative to directly issuing shares to employees and generally minimize administrative, funding, and incentivizing complexities. In such arrangements, the notional share amount paid to the employee typically increases as the CPC pays dividends on its shares. An employee's value in the Notional Share-Based Compensation can either vest over a period of time or sometimes all at once, and the CPC usually pays this value to the employee in cash. Prior to making the cash payment, the CPC must account for the notional share amounts as a compensation liability. Current accounting practice requires this liability to be marked to market, varying with the notional amounts of stock in the Notional Share-Based Compensation plans and, of course, with the CPC's public stock price.

Because of this accounting variance, CPCs that pay Notional Share-Based Compensation commonly enter into a hedging contract with a counterparty – in most cases a Canadian financial institution ("FI") – to offset potential losses and gains associated with the Notional Share-Based

Compensation liabilities. In these hedging arrangements, the CPC acquires an asset (*i.e.*, an equity derivative explained below) that increases or decreases in value in the opposite direction as the Notional Share-Based Compensation liability. Thus, from an accounting perspective, a rise in stock price – obviously an aspiration for any CPC and its employees – would be directly offset by the hedge and therefore would not have a negative impact on the CPC's financial position.

Under Canadian corporate law, a CPC cannot purchase its own shares that might otherwise have this stabilizing effect. Therefore, the CPC cannot directly hedge the costs of its Notional Share-Based Compensation plans with its own stock. Rather, the CPC must enter into an equity derivative contract, generally with an FI, requiring the FI to pay the CPC a total return on the CPC's notional shares in its Notional Share-Based Compensation plans. The total return is typically an amount equal to the stock-price increase plus the value of declared dividends. The economics of such a contract (mark-to-market plus dividend compensation receipt) move in the opposite direction of the economics of the CPC's Notional Share-Based Compensation liabilities (mark-to-market plus notional dividend reinvestment). Therefore, the CPC hedges any volatility in profit and loss otherwise arising from its Notional Share-Based Compensation plan. To hedge its own exposure under the equity derivative contract, the FI typically purchases CPC shares in the open market. The CPC typically pays the FI a notional funding cost that covers the FI's cost of borrowing money to purchase the CPC's shares in such a contract.

The hedging transactions described above are in no way tax-motivated. To the contrary, they are a key aspect of the Notional Share-Based Compensation plans offered by many CPCs. Absent the hedging transactions, the accounting volatility associated with Notional Share-Based Compensation liabilities would preclude CPCs from offering Notional Share-Based Compensation plans to their employees.

***Synthetic Equity Arrangement Draft Legislation***

The draft SEA legislation in its current form would adversely impact an FI that has entered into an equity derivative contract with a CPC in connection with the CPC's Notional Share-Based Compensation plan. The cost of these adverse tax consequences would be passed through to the CPC and would ultimately be borne by employees receiving the Notional Share-Based Compensation.

Specifically, the draft legislation would deny a deduction under Subsection 112(1) of *the Income Tax Act (Canada)* (the "ITA")[1] for an inter-corporate dividend received by a taxpayer (in this case, the FI) on a Canadian share with respect to which the taxpayer has entered into an SEA. Broadly

[1] All "§" references are to the ITA.

speaking, an SEA is an arrangement in which an entity has legal ownership of a Canadian share but "all or substantially all" of the associated risks and rewards of that ownership have been effectively transferred by way of an equity derivative to a person who is not subject to tax in Canada (a "tax-indifferent investor"). The legislation excludes hedges with taxable Canadian residents and branches of non-residents that are subject to Canadian tax if certain affirmative representations are made, but, as discussed below, the required representations are impracticable in the case of Notional Share-Based Compensation plans.

In Notional Share-Based Compensation plans, the ultimate risk of the shares rests with the employees who are entitled to the Notional Share-Based Compensation. Therefore, the hedging of Notional Share-Based Compensation generally does not involve a transfer of risk on Canadian equities to a tax-indifferent investor, which is the target of the draft legislation. Nevertheless, under the draft SEA legislation, a person assuming the risk of loss or opportunity for gain on Canadian equities is required to make a representation to the counterparty that the person is a taxable Canadian resident. In a Notional Share-Based Compensation plan, the economic exposure to the shares does not ultimately rest with the CPC, but rather with its employees. Accordingly, the CPC would be required to obtain a representation from its "counterparty" – in this case, each of its participating employees – that they are not tax-indifferent investors and have not eliminated their economic exposure to the shares.

While, generally speaking, most CPC employees receiving Notional Share-Based Compensation are Canadian residents,[2] CPCs cannot practically require such representations from each employee participating in their Notional Share-Based Compensation plans. The draft legislation clearly contemplates singular, counterparty-to-counterparty transactions, such as the derivative with the FI, rather than compensation arrangements with thousands of employees. Because the draft SEA legislation would affect both existing and future Notional Share-Based Compensation plan arrangements,[3] the number of employees under affected plans would be enormous and obtaining and tracking such a representation from thousands of employees would be administratively onerous and impractical.

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[2] CPCs include multinational companies, but participating employees under Notional Share-Based Compensation plans are predominantly Canadian residents.

[3] The draft SEA legislation would apply to dividends received after April 30, 2017 on hedge contracts or arrangements that were in place on April 21, 2015 provided that the contract or arrangement is not altered after April 21, 2015. For hedge contracts or arrangements entered into or altered after April 21, 2015, the draft legislation would apply to dividends received after October 31, 2015.

If the draft SEA legislation were to become law in its current form, FIs would require their CPC counterparties to provide representations from each and every employee participating in the CPC's Notional Share-Based Compensation plan. Otherwise, the hedging contracts would not be tax-effective for the FI. If the CPC could not provide the representations, and TEI strongly believes it is impracticable to do so, the FI would increase the price of the hedging contract with the CPC to offset the non-deductibility of the dividend the FI counterparty receives on the shares it hedges. The ultimate effect of the draft legislation would be to increase the cost of Notional Share-Based Compensation plans and reduce incentive-based pay to CPC employees.

Such a result is a significant unintended consequence of the draft SEA legislation and cannot be reconciled with the Federal Budget's stated purpose of the SEA Proposals, which is:

> Certain taxpayers, typically financial institutions, enter into … [SEAs]…. The taxpayer realizes a tax loss on the arrangement by taking advantage of the inter-corporate dividend deduction, resulting in tax-free dividend income, while also deducting the amount of dividend compensation payments.
>
> Synthetic equity arrangements entered into with certain investors that do not pay any Canadian income tax on the dividend-equivalent payments received … have the potential to significantly erode the Canadian tax base.[4]

The CPC's hedge of its Notional Share-Based Compensation plan liability does not erode the Canadian tax base. Dividend compensation payments paid by the FI to the CPC, as described above, are included in the CPC's income and are subject to Canadian income tax. Ultimately, the benefit of the share appreciation, including notional reinvestment of dividends, as described above, will be taxed in the hands of predominantly Canadian-resident employees.

The impact of the draft legislation is illustrated by the following example. Assume the fair-market value of a CPC's share is $9.[5] When the FI owns the share, the CPC makes profits, pays Canadian income tax, and declares and pays a $1 dividend out of after-tax income. As the legal holder of the share under current legislation, the FI is entitled to a §112 deduction with respect to the dividend received. The FI makes a dividend compensation payment to the CPC, which is included in the CPC's income and subject to Canadian income tax. Upon employee retirement, the employee receives a cash payment of $10 (*i.e.*, including the value of the notionally reinvested dividend) in incentive pay, which is deducted by the CPC and fully taxable to the employee. This dividend is subject to double-taxation – the CPC is taxed on the pre-tax profits from which this

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[4] Federal Budget, Supplementary Information, pg. 461.

[5] To simplify the example, we have ignored changes in stock price.

dividend is paid and is taxed upon the compensation payments received from the FI for the CPC's own dividend. Ultimately, the reinvested value of this dividend is taxed when paid to the employee as compensation (with an offsetting deduction to the CPC). Under current rules, the §112 deduction to the FI provides relief from this double taxation. If the SEA Proposals were enacted as proposed, this double taxation upon the CPC would be unrelieved, and the cost of the denial of the §112 deduction to the FI would pass to the CPC and ultimately its employees. Furthermore, CPCs pay dividends from profits already subject to Canadian tax in accordance with the ITA. The effect of the draft SEA legislation would be to deny the dividend deduction, imposing double taxation on these profits. Again, the FI would inevitably pass through the cost of this double taxation to the CPC and the CPC's employees.

Ultimately, the risk of loss or opportunity for gain on Canadian Notional Share-Based Compensation plans rests with employees who participate in the plans. Exempting hedges that facilitate such plans from the draft SEA legislation would be entirely appropriate for legislation intended to curb base erosion. However, the anticipated means to exclude such hedges from the draft SEA legislation (an FI receiving representations from the CPC sponsoring the plan and each of its employees) is impractical for Notional Share-Based Compensation plans covering thousands of employees. The net effect of the draft legislation would be an increase in the cost of Canadian Notional Share-Based Compensation plans, thus discouraging stock-based incentives to Canadian employees. As incentive-based compensation often represents a material component of retirement savings for Canadians, the unintended negative effect to Canadian workers, Canadian public-company employers, and the Canadian economy would be significant as incentive-based compensation often represents a material component of retirement savings for Canadians.

### *Draft SEA Legislation Should Not Be Further Expanded*

The SEA legislation as currently drafted would have the unintended consequence of adversely affecting Notional Share-Based Compensation plans. Thus, it is already overbroad as the intent was only to cover potentially base-eroding counterparty-to-counterparty transactions. The Government, however, invited comments by August 31, 2015 on a potential expansion of the SEA proposals regardless of the tax status of the counterparty to the SEA, noting:

> From a tax policy perspective, a case can be made that a shareholder should always be required to bear the risk of loss and enjoy the opportunity for gain or profit on a Canadian share in order to take advantage of the inter-corporate dividend deduction on dividends received on that share.[6]

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[6] Federal Budget, Supplementary Information, pg. 463.

The effect of the draft SEA legislation on the hedging of Notional Share-Based Compensation liabilities illustrates why the draft SEA legislation should not be so extended. To the contrary, the current draft legislation should be narrowed to exclude Notional Share-Based Compensation plans.

***Summary***

Stock-based compensation provides incentives to Canadian employees, which is broadly beneficial to the Canadian economy. CPCs develop Notional Share-Based Compensation plans, as described above, as an alternative to directly issuing shares to employees to minimize administrative, funding, and incentivizing complexities. The ITA endorses this type of deferred compensation by recognizing that the income received from such arrangements does not fall under the "salary deferral arrangement" rules.[7] The essence of such plans is that employees have economic exposure to shares they do not legally hold. Hedging these plans necessarily involves another Canadian taxpayer (the FI) to legally hold the shares, the economic exposure to which is transferred to the CPC and, ultimately, to the participating employees. It is entirely appropriate tax policy that the dividend deduction apply in these circumstances. To deny the deduction would, as described above, impose double taxation on profits of CPCs, the cost of which would ultimately be borne by Canadian employers, their workers, and the Canadian economy.

***Recommendation***

Canadian employers and workers should not suffer the impact of increased costs and reduced returns on Notional Share-Based Compensation plans, many of which are long-standing plans, simply because of the practical impossibility of obtaining residency and hedging representations from each participating employee, which the draft SEA legislation otherwise contemplates.

Accordingly, TEI recommends an express exception for agreements that hedge Notional Share-Based Compensation plans of CPCs.

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[7] Reg. 6801(d) under the ITA.

TEI's comments herein were prepared by its Canadian Income Tax Committee, whose chair is Grant Lee of HSBC Bank Canada. Should you have any questions about TEI's comments, please feel free to contact Mr. Lee at 604.641.2502 (or grant_lee@hsbc.ca) or Lynn Moen, TEI's Vice President for Canadian Affairs, at 403.750.2278 (or lmoen@walton.com).

Respectfully submitted,

**Tax Executives Institute, Inc.**

C.N. Macfarlane

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International President

cc: Grant Lee, 2015-2016 Chair, TEI's Canadian Income Tax Committee